# ECO EMERGING

1st quarter 2021

## EDITORIAL

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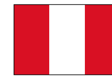
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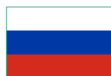
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ECONOMIC RESEARCH

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## CAUTIOUSLY OPTIMISTIC

**As the new year gets underway, emerging countries are benefiting from a combination of favourable factors for a recovery (catching-up movements in foreign trade, a weak dollar, rising commodity prices, and domestic financing costs that are lower than pre-crisis levels). Yet lots of uncertainty and threats remain: the rollout of vaccination campaigns, the risk of a surge in insolvency cases among the poorest countries, despite financial support from international institutions and official creditors, and a rise in non-performing loans in banking systems as of 2021. The main risk in the medium term is the combination of a probable loss of growth potential due to the pandemic and the private sector's record-high debt burden.**

After a Q3 rebound, emerging countries seem to have avoided another downturn in economic growth. A widespread improvement in economic and financial indicators can be seen in Q4 2020.

### THE SKY HAS BECOME CLEARER…

Purchasing manager indexes (PMIs) for the manufacturing sector have continued to improve. In a few countries (China, Brazil and Hungary), manufacturing PMIs deteriorated in December albeit from high levels (above the 50 threshold). Mexico is the only country whose PMI suggests an ongoing industrial recession. For the majority of countries, year-on-year export trends swung into positive territory again over the summer or early fall. In Asia, where foreign trade has been more robust thanks to China's contribution, the export catching-up movement has already run its course. This movement is intensifying in central Europe. In contrast, the recovery in exports still seems to be very fragile in Latin America (including for manufactured goods) and in Africa and the Middle East. Yet the later regions should benefit from the ongoing rebound in commodity prices, which is resulting from both the consolidation of metal prices and a more clear-cut upturn in oil prices, which should consolidate with Saudi Arabia's recent cutback in oil production.

The improvement in financial indicators is more spectacular, notably portfolio investment flows, exchange rates and risk premiums. According to the IIF, portfolio investment was still hesitant over the summer months, but soared in the fourth quarter to a record high of nearly USD 60 bn a month on average (USD 42 bn excluding China), easily erasing the outflows reported earlier in the year. Since the shock last spring, net investment flows have reached a cumulative total of USD 250 bn. In comparison, for the same interval following the shocks of the 2008-2009 financial shock and the mini-crash of the Chinese stock market in 2015, net investment flows simply returned to their point of departure. Bond issues hit an air pocket only once, in March, and by the second half, the pace of issues had surpassed the 2019 level.

With a few rare exceptions, exchange rates appreciated against the US dollar between end-September and end-December (with a median of 4%, vs 2% in Q3). At a time when external accounts were improving, emerging currencies also benefited from the weak US dollar. With few exceptions, sovereign bond yields in the local currency and risk premiums (CDS spreads) have fallen, even though there were fewer key rate cuts than in Q3. Pressures have eased, even in the countries that have proven to be the most vulnerable to the shock (South Africa, Brazil and Turkey, although for the later, at the expense of a reversal and tightening of monetary policy).

### … BUT THERE ARE STILL CLOUDS ON THE HORIZON

On the whole, emerging countries are benefiting from a combination of factors that should support their recovery in the short term (weak US dollar, rising commodity prices, lower financing costs than pre-crisis levels). But a lot of uncertainty and pitfalls remain.

In the short term, logistical constraints and population size raise fears of an unequal race against time between the rollout of vaccination campaigns and the spread of the virus (notably in Brazil and Russia), even though its propagation does not necessarily result in higher mortality rates. The second threat, potentially only in the very short term, is the surge in the number of insolvency cases among the poorest countries despite support from the international financial institutions (IFI) and official creditors, via emergency funds and the debt servicing suspension initiative (DSSI). Even after DSSI was extended into 2021, the initiative provides relief for only 20% of the financing needs of eligible countries. Lastly, the banks will have to absorb the rise in non-performing loans. In all three cases, let's hope the key players (governments, IFIs, bilateral official creditors and private creditors and banks) have the capacity to mobilise and/or show proof of resilience to manage these risks.

Looking beyond 2021, one of the big uncertainties is the erosion of growth potential due to the pandemic. The health crisis could be seen as a transitory shock, unlike shocks generated by a structural decline in the terms of trade (for commodity producing countries) or by a financial and/or banking crisis. Yet the pandemic was global, and not just regional as in previous cases. Even under a scenario in which vaccination campaigns bring the pandemic under control, the World Bank evaluates the loss of growth potential at 0.6 points of GDP a year for all of the emerging and developing countries (including China) in the period 2020-2029. Let's keep in mind that growth potential has already contracted by 1 point over the past decade. The extra loss of growth potential is mainly due to the smaller contribution of investment. According to the World Bank, the main reasons are uncertainty, risk aversion and the decline in corporate earnings. We would like to add the record-high level of private sector debt (even excluding China), knowing that the causal relation between growth potential and debt is a two-way street.

*Completed on 11 January 2021*

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## FIRST SIGNS OF CREDIT POLICY TIGHTENING

**Economic growth reached 2.3% in 2020. Activity has rebounded rapidly since March and the recovery has gradually spread from industry to services. Infrastructure and real estate projects continue to drive investment, but it is also beginning to strengthen in the manufacturing sector, encouraged by solid export performance. Private consumption is still lagging, but yet has picked up vigorously since the summer. Whereas fiscal policy should continue to be growth-supportive in the short term, the monetary authorities are expected to adjust their priorities. Credit conditions should be tightened slowly, especially via the introduction of new prudential rules. Corporate defaults are likely to increase alongside efforts to clean up the financial sector.**

China has experienced a V-shaped economic recovery since lockdown restrictions were lifted last March. After contracting 10% between Q4 2019 and Q1 2020, real GDP regained all of the lost ground in just a quarter (+11.6% q/q in Q2). Real GDP then rose by 3% q/q in Q3 and by another 2.6% in Q4. Moreover, the recovery has gradually spread. The rebound was initially driven by industrial production and by investment in public infrastructure and real estate, which were buoyed by policy stimulus measures. Then the rebound in global demand has boosted the export sector. Lastly, the services sector and private consumption have regained strength since the summer. In full-year 2020, real GDP growth reached 2.3%.

However, the crisis triggered by the Covid-19 pandemic has left scars. Private consumption in particular is still far from returning to normal, since households have been hard hit by the downturn in the labour market and in disposable income. Moreover, enterprises have faced increasing financial difficulties while their debt ratios are excessively high. Credit risks are on the rise and we are bound to see an increase in corporate defaults both on bank loans and in the bond market. The authorities have begun to adjust their credit policy to give priority to controlling the risks of instability in the financial sector, albeit without thwarting the turnaround in the economy.

## V-SHAPED RECOVERY IN ECONOMIC ACTIVITY

The economic recovery has been solid over the last months of 2020 (chart 1). On the supply side, industrial production has accelerated continuously since lockdown restrictions were first lifted in March, and reached 7.3% year-on-year (y/y) in December. In 2020, industrial production was 2.8% higher in volume than in 2019 (and about +1%in value terms given the 1.8% decline in producer prices in 2020).

In the services sector, the rebound started much later, but activity has accelerated strongly since September. After plummeting in Q1, growth in the services sector swung from -0.4% y/y in Q2 to +4.3% in Q3. In Q4, it finally caught up with and surpassed the growth of industrial production (+7.7% y/y). although activity in the services sector slightly declined in December, it is expected to resume its role as the main growth engine in 2021.

The acceleration in services has kept pace with the renewed vigour of private consumption. Although online commerce picked up rapidly in Q2, the rebound in retail sales was very hesitant at first and did not strengthen until the end of the summer (it reached +5% y/y in Q4). In 2020, retail sales volumes were still nearly 5% below the 2019 level.

Households are regaining confidence, bolstered by the recent improvement in the labour market and by declining inflation. The urban unemployment rate has fallen since March, and hit 5.2% in November and December, the same level as in December 2019. Consumer price inflation has fallen sharply in 2020, dropping from 5% y/y in Q1 to 0.1% in Q4. This is mainly due to the major slowdown in food prices, which had soared in the last months of 2019 and the first months of 2020. Core inflation is also low, but stable (+0.5% since July, down from an average of 1.6% in 2019).

Household demand should continue to recover, although it is likely to idle somewhat longer given the increase in the number of precarious jobs that accompanied the improvement in the labour market and the mild increase in disposable income in 2020 (+2.1% in real terms, vs. 5.8% in 2019) and persisting uncertainties over the epidemic situation.

**FORECASTS**

| | 2019 | 2020e | 2021e | 2022e |
|---|---|---|---|---|
| Real GDP growth (%) | 6.1 | 2.3 | 9.5 | 5.3 |
| Inflation (CPI, year average, %) | 2.9 | 2.5 | 2.3 | 2.8 |
| Official budget balance / GDP (%) | -2.8 | -3.6 | -3.0 | -3.0 |
| Central government debt / GDP (%) | 17.0 | 19.5 | 20.6 | 22.0 |
| Current account balance / GDP (%) | 1.0 | 2.0 | 1.7 | 1.4 |
| Total external debt / GDP (%) | 14.4 | 16.1 | 16.0 | 15.6 |
| Forex reserves (USD bn) | 3 108 | 3 217 | 3 260 | 3 300 |
| Forex reserves, in months of imports | 15.0 | 16.5 | 15.5 | 15.0 |
| Exchange rate USDCNY (year end) | 7.0 | 6.5 | 6.4 | 6.5 |

TABLE 1 e: ESTIMATE & FORECASTS SOURCE: BNP PARIBAS ECONOMIC RESEARCH

**V-SHAPED REBOUND, RETAIL SALES STILL LAGGING**

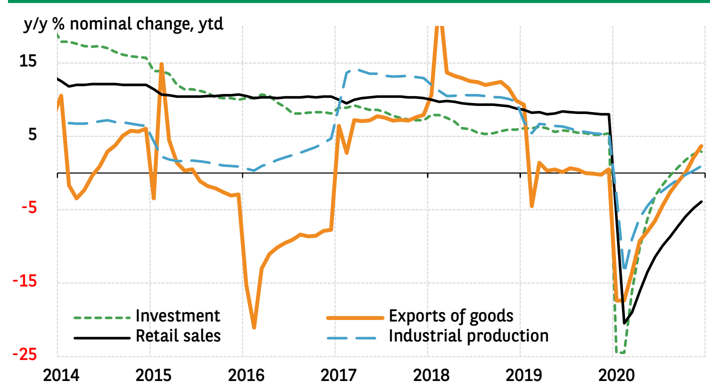
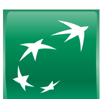



CHART 1 SOURCE: NBS, CEIC



At the same time, new measures to stimulate private consumption will probably be adopted next year, since expanding consumption remains a top priority for China's economic strategy. In the new five-year plan presented last fall, the domestic market is clearly specified as one of the pillars of economic growth. The details of the 2021-2025 five-year plan will be released in March.

Domestic investment has strengthened gradually since Q2, growing by 2.9% in full-year 2020. It has been largely fuelled by Infrastructure and real estate projects, even though these have recently started to slow slightly. Investment in the manufacturing sector has shown signs of picking up, bolstered notably by the solid performance of exports.

These exports have rebounded since June and rapidly gained strength, rising from an average of +10% y/y (in current USD) for the period July-October to an average of 20% y/y in the last two months of the year. China has successfully responded to the strong increase in global demand for medical supplies and equipment, technological goods, and more recently, for other consumer goods such as toys. Export prospects are still uncertain, however, since they are dependent on the ongoing turnaround in global demand, which hinges on the spread of the pandemic, and on future trade talks between Washington and Beijing.

## PRUDENT CHANGE IN MONETARY AND CREDIT POLICY

Fiscal policy and public investment are expected to continue to support economic activity. Meanwhile, the authorities have begun to selectively tighten their credit policy. Given the solidity of the economic rebound, the monetary authorities have now some leeway to adjust their goals and give priority to controlling risks in the financial sector. Yet tightening the screws on lending will be no easy task. On the one hand, it must not hamper the ongoing economic turnaround, nor add to deflationary pressures. Beijing probably also wants to avoid accentuating the yuan's appreciation, which has already gained 9% against the USD since the end of May 2020. On the other hand, while encouraging healthy loan practices, the authorities must continue to support otherwise healthy enterprises that are encountering financial difficulties due to the Covid-19 crisis, while limiting the risks of instability and bouts of stress in the financial sector.

The central bank, PBOC (People's Bank of China), should therefore remain prudent. Since April, it has maintained its key policy rate at 2.95% (after a 30 basis point cut earlier in the year) and gradually tightened money market rates until November (the 7-day repo rate rose from an average of 1.5% in April to 2.3% in November). Yet, PBOC has reversed the trend since December (the 7-day repo rate averaged 1.9% in the first two weeks of January 2021). In the very short term, the central bank will probably act to ease any excessive tension in the local monetary and bond markets and maintain liquidity at comfortable levels in the financial sector.

In contrast, the authorities are likely to slowly tighten credit conditions by acting primarily on the prudential framework and by demanding greater discipline from financial players. They have recently introduced rules to put debt limits on real estate developers, and also clearly signalled their determination to supervise internet finance more closely. In early December, they announced tighter prudential standards applicable to banks considered to be too big to fail, and the list of these institutions is expected to get longer, notably to increase supervision of regional banks. Growth in the social financing stock (total domestic credit), which accelerated from 10.7% y/y at year-end 2019 to 13.7% in October, already levelled off during the last two months of 2020.

NEW RISE IN DEBT LEVELS

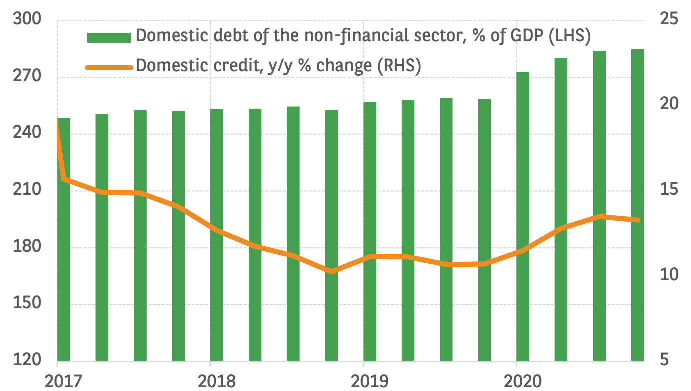



CHART 2 SOURCE: PBOC, BNP PARIBAS

## CORPORATE DEFAULTS ARE EXPECTED TO INCREASE

Corporate defaults are expected to increase in 2021 due to the effects of the Covid-19 crisis and the corollary impact of efforts to clean up the financial sector. The Chinese economy entered the Covid-19 crisis with excessively high levels of debt, estimated at 258% of GDP at the end of 2019 (domestic debt of the non-financial sector). In 2017-2019, measures were implemented to reduce financial risks (including tighter regulations, a decline in shadow banking activities, and the start of corporate debt reduction), but this movement was cut short by the Q1 2020 crisis and the ensuing easing of the monetary and regulatory environment. The debt excess of the economy has only worsened: the debt-to-GDP ratio is estimated to have increased by about 25 percentage points in 2020, after a ten-point increase in the previous three years (chart 2).

Although economic activity has returned to normal in most sectors, many corporates and households are still in fragile positions after the financial losses of the beginning of the year. Domestic credit conditions are starting to be tightened and the weight of debt servicing charges will increase considerably in the months ahead as post-Covid support measures (credit lines, refinancing, rescheduling of debt repayments) wind down. In the banking sector, the official non-performing loan ratio increased slightly to 1.96% in Q3 2020, which is still low but trending slightly upwards. Recent corporate defaults in the local bond market also foreshadow more to come. The number of corporate defaults is expected to rise rapidly in the coming months. More importantly, the share of state-owned enterprises in default is starting to increase, showing proof of a slow decline in implicit state support.

*Completed on 18 January 2021*

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# INDIA



## STRUCTURAL REFORMS INSTEAD OF FISCAL SUPPORT

**The economy has rebounded strongly since July, driven by the recovery in industry, which then spread to the services sector starting in October. Although the recovery still seems to be fragile, the central bank has raised its growth forecast for fiscal year 2020/2021 to -7.5%. Fiscal year 2021/2022 is expected to see a major automatic rebound in growth. Lacking the means to support growth through a fiscal stimulus package, the government has set out to create a more propitious environment for investment that would enable medium-term growth to return to a pace of about 7%. The latest reforms are working in this direction. Yet passing reform measures does not guarantee that they will be implemented, much less that they will be successful.**

### A FRAGILE REBOUND

In the second quarter (July-September 2020) of the fiscal year that will end on 31 March 2021 (FY2020/2021), India's GDP growth contracted "only" 7.5% year-on-year (y/y), after contracting 23.9% y/y in the previous quarter. Business accelerated in agriculture (+1.4% y/y) and to a lesser extent in industry (+0.6% y/y), but continued to contract in services (-11.4% y/y). At the end of September 2020, economic activity was still 9% short of the figure reported for full-year 2019/2020.

At the beginning of fiscal Q3, the recovery began to expand into the services sector. Activity accelerated rapidly in industry in October 2020, even though November's industrial production was still 6% below the year-end 2019 level. Demand for electrical power rose above the 2019 level. The unemployment rate continued to decline to 6.5%, after peaking at 23.5% last April. Lastly, VAT revenues increased by nearly 15% compared to the same period last year, after several months of decline.

November indicators suggest, however, that the recovery is still fragile, for both households and corporates, even though India has not yet been hit by a second wave of Covid-19. Although business confidence indexes in both industry and the services sector have held above the 50 threshold (which indicates economic expansion), they declined slightly in services. Bank credit to industry also contracted for the second consecutive month (-0.7% y/y).

The household confidence index rebounded slightly in November 2020 but remains far below pre-crisis levels. The unemployment rate is now close to the level that prevailed in late 2019, but the labour market participation rate is still 2 points below pre-crisis levels. Employment is still sluggish in the construction, hotel & restaurant, tourism and textile sectors. Lastly, there seems to be a dichotomy between urban and rural household consumption. Motor vehicle sales (cars and two wheelers) declined in November after rising for two months. In rural areas, in contrast, household consumption seems to be robust, as illustrated by the sharp increase in tractor sales, buoyed by a bumper harvest and an increase in rural wages (between 8% and 10%) as part of the Mahatma Gandhi National Rural Employment Generation Act.

In full-year 2020/2021, the IMF and the World Bank are forecasting a contraction of about 10% of GDP. The World Bank fears a sharp increase in the poverty rate because 90% of workers do not benefit from sufficient social protections.

Fiscal year 2021/22 should see a major, automatic rebound in growth. Household consumption is expected to accelerate, bolstered by the winding down of the pandemic and efforts to vaccinate the population, which should begin in mid-January. Business is also expected to rebound progressively among small and mid-sized enterprises. Although we cannot exclude the risk of a new wave of the virus, it does not seem likely that the government would impose a lockdown as strict as the one in March-April 2020.

**FORECASTS**

| | 2019 | 2020e | 2021e | 2022e |
|---|---|---|---|---|
| Real GDP growth(1) (%) | 4.2 | -11.4 | 11.6 | 5.0 |
| Inflation (1) (CPI, year average, %) | 4.8 | 5.8 | 4.3 | 3.8 |
| General Gov. Balance(1) / GDP (%) | -7.3 | -13.2 | -11.0 | -9.0 |
| General Gov. Debt(1)/ GDP (%) | 72.2 | 89.8 | 90.1 | 90.3 |
| Current account balance(1) / GDP (%) | -0.9 | 0.3 | -0.9 | -2.0 |
| External debt(1)/ GDP (%) | 19.9 | 21.5 | 21.0 | 20.5 |
| Forex reserves (USD bn) | 457 | 541 | 590 | 620 |
| Forex reserves, in months of imports | 7.7 | 11.0 | 9.1 | 9.2 |
| Exchange rate USDINR (year end) | 71.3 | 73.1 | 73.4 | 73.9 |

TABLE 1

(1) Fiscal year from April 1st of year n to March 31st of year n+1
e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

**INDUSTRIAL OUTPUT**

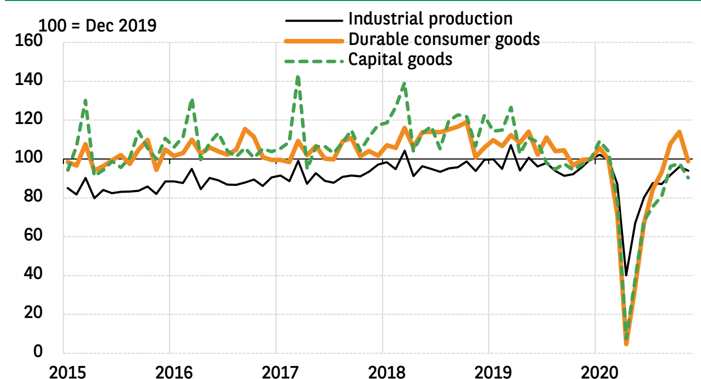


CHART 1

SOURCE: CEIC

### MEASURES TO STIMULATE MEDIUM-TERM GROWTH

India's economy should be in a position to absorb the shock of 2020/2021. Though fragile, the banking and financial sector should be able to support the expected increase in non-performing loans, even though the government may have to make more capital injections. Although the fiscal deficit is rising, refinancing risks are still mild.

Looking beyond 2021, in contrast, the situation could deteriorate if GDP growth fails to exceed 5%, at a time when fiscal leeway will still be tight.

This is why the N. Modi government has been striving to correct the slowdown in growth since 2019. It is still working towards its goal of becoming an industrial power. Consequently, although it cannot set up a fiscal programme to stimulate growth in the short term, the government has adopted new reforms to stimulate medium-term growth.

The reforms adopted in 2019 and pursued through fall 2020 aim to create a more favourable environment for private investment (both domestic and non-resident) and employment, especially jobs in the formal sector. Declining investment was one of the factors behind the slowdown in growth reported in recent years. The investment ratio had dropped to only 26.9% before the Covid-19 crisis, compared to 35.8% in 2008.

To stimulate domestic and foreign investment, the government lowered the corporate tax rate in late 2019 from 30% to 22% (and from 25% to 15% for newly created manufacturing companies). Aligning its corporate tax rates with those practised in the other Asian countries was a positive move.

The government also adopted major legislation to ease the restrictions hampering the labour market and to encourage the creation of jobs in the formal sector. This allows companies to develop more labour-intensive activities, much like the model that China followed in the 1980s and 90s, and to increase their participation in global trade through labour-intensive assembly work using low-skilled workers.

To increase productivity in the agricultural sector, the Modi government passed three bills in September 2020. The government would allow farmers to sell their crops at prices they set with their buyers, without using the government as an intermediary (this is now the case for the majority of farmers). This reform aims to increase investment and productivity in the agricultural sector. Yet it was very poorly received by the agricultural world, which feared the elimination of minimum sales prices (which are nonetheless guaranteed by the government). After several months of protests, the Supreme Court announced on January 12 the suspension of these three bills in order to find a compromise between the government and the farmers.

Lastly, the government announced that it intends to privatise all state-owned companies in so-called non-strategic sectors, which includes rail transport and electrical power companies.

If all of these reforms were implemented successfully, they could have a positive impact on medium-term growth. Yet adopting reforms has always been problematic in India, as illustrated by the mixed results of the introduction of the Goods and Services Tax (GST) in 2017.

## BANKING SECTOR: SUPPORTING THE RECOVERY WILL NOT BE EASY

After several years of consolidation, India's banking sector now seems to be better positioned to handle a crisis than it was three years ago. On the other hand, it might not be solid enough to stimulate the recovery.

Between March and the end of August 2020, the banks granted a 6-month moratorium on debt payments. No loans were recorded as non-performing loans. In Q3-2020, despite the contraction in economic activity, the non-performing loan ratio continued to decline to 7.5%, from a high of 11.5% in Q1 2018. The banking sector did not begin to feel the impact of the Covid-19 crisis until Q4 2020. In November,

NON-PERFORMING LOANS ARE STILL LIMITED

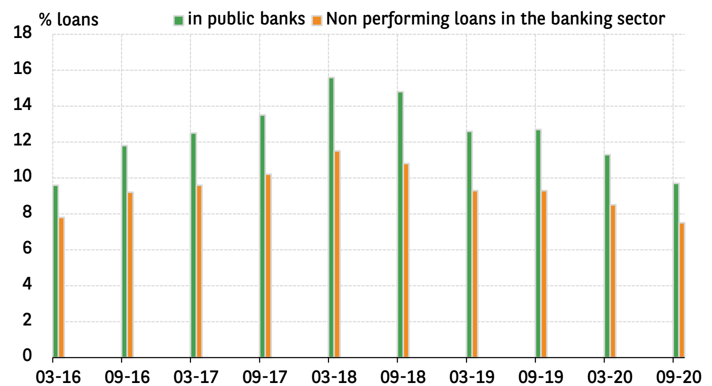


CHART 2 SOURCE: RBI

the rating agency S&P estimated that the doubtful loan ratio could increase by 2 to 3 percentage points to 10-11% by the end of fiscal year 2020/2021. In its most recent report on financial stability, the central bank estimated that the NPL ratio could reach 13.5% by September 2021 (16.2% among state-owned banks), even under a scenario based on a strong rebound in growth (from 0% y/y in H2 2020/2021 to 14.2% y/y in H1 2021/2022).

Indian banks are better capitalised than they were three years ago. In Q3 2020, provisions covered 72.4% of doubtful loans, and the solvency ratio for the banking sector as a whole was 15.8%. Yet the state-owned banks are still much more fragile than the private banks (their ratio was 13.5%). According to the central bank, without capital injections, four banks will not be able to meet their equity capital requirements by September 2021.

The central bank considers that the overall solvency ratio could decline by 1.6 percentage points to 14% by September 2021. At the end of August 2020, Moody's estimated that the state-owned banks would need new capital injections of between INR 1.9 trillion and INR 2.2 trillion (1% of FY2020 GDP) over the next two years to maintain a provisioning coverage ratio of 70% and to meet their equity capital requirements. The state-owned banks are in a more comfortable financial situation than they were a few years ago, and the big state-owned banks have already launched moves to raise capital. They could still benefit from government support, which already injected INR 2.8 trillion between 2016/2017 and 2019/2020. Yet certain banks might be much less inclined to increase their credit offer as long as their financial position has not been consolidated, as was the case in 2017-2018.

*Completed on 11 January 2021*

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# MALAYSIA



## PRIORITY ON FISCAL SUPPORT

**Malaysia is one of the emerging Asian countries hit hardest by the Covid-19 crisis. Although a recovery is underway, it is bound to be hampered by new lockdowns in Q4 2020 and January 2021. Public finances have deteriorated sharply, but the government does not seem inclined to pursue fiscal consolidation. It is giving priority to the economic recovery and support for the most fragile households. The public debt ratio will continue to deteriorate, and in December, the rating agency Fitch downgraded Malaysia's sovereign rating. Yet refinancing risks are moderate: the debt structure is not very risky and the country has a large domestic bond market. Malaysia will continue to report a current account surplus and has a solid banking sector.**

### DEEP ECONOMIC CONTRACTION IN 2020

Malaysia's economy was hard hit by the coronavirus pandemic. From a health perspective, although Covid-19 did not hit the country nearly as hard as Indonesia and the Philippines, the situation is much worse than in Thailand, South Korea or Vietnam. In March 2020, the government imposed severe shelter-in-place restrictions throughout the country. These restrictions were partially lifted in mid-May, but were tightened again in Q4 2020 and in January 2021 after a surge in the number of new cases. Looking beyond the decline in domestic demand due to the general lockdown of the population, the Malaysian economy – which is highly integrated in world trade – was hard hit by the disruption in global supply chains, the collapse of tourism revenues and the decline in commodity prices. Nonetheless, its external accounts are still solid: at year-end 2020, foreign exchange reserves and the ringgit (MYR) were close to year-end 2019 levels, and the country is expected to report a current account surplus.

In the first three quarters of 2020, real GDP contracted by 6.4% compared to the same period in 2019. Economic activity rebounded strongly between June and September, especially thanks to an upturn in exports, before slowing again in October and November, under the impact of tighter lockdown restrictions. In November, industrial output was 2% below the year-end 2019 level. In full-year 2020, real GDP is expected to decline by 5% compared to 2019.

In 2021, economic growth prospects are looking strong, even though the new lockdown is bound to slow the recovery and the vaccination campaign will not begin before February 2021. Looking beyond a favourable base effect, domestic activity will get a boost from an expansionist fiscal policy that is geared towards helping the most fragile households and increasing public investment. Export activity should remain buoyant as well, bolstered by the rebound in global trade and the electronics market.

To reach its medium-term objective of becoming a high-revenue country by 2023, the government will have to pursue structural reforms to raise productivity growth, which has declined over the past several years. To achieve this, it must increase the level of training and education of workers and improve the business environment to make the economy more propitious for domestic and non-resident private investment, which has been declining since 2018. Yet the government has only a slim majority in parliament, which is not good news for reforms. New elections will also have to be held, as soon as the health situation improves enough for them to be safe.

**FORECASTS**

| | 2019 | 2020e | 2021e | 2022e |
|---|---|---|---|---|
| Real GDP growth (%) | 4.3 | -5.0 | 7.5 | 3.9 |
| Inflation (CPI, year average, %) | 0.9 | -1.2 | -0.3 | 1.0 |
| General Gov. balance / GDP (%) | -3.4 | -6.9 | -5.6 | -4.5 |
| General Gov. debt / GDP (%) | 52.5 | 61.3 | 63.0 | 64.7 |
| Current account balance / GDP (%) | 3.4 | 4.0 | 2.0 | 2.1 |
| External debt / GDP (%) | 62.6 | 66.5 | 66.0 | 65.5 |
| Forex reserves (USD bn) | 97 | 98 | 98 | 98 |
| Forex reserves, in months of imports | 5.7 | 6.2 | 5.7 | 5.6 |
| Exchange rate USDMYR (year end) | 4.1 | 4.1 | 4.1 | 4.1 |

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

**INDUSTRIAL OUTPUT**

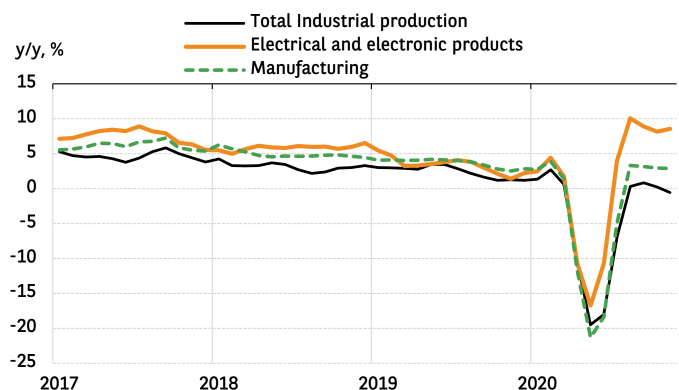


CHART 1

SOURCE: CEIC

### EROSION OF PUBLIC FINANCES: WHAT ARE THE RISKS?

Public finances began to deteriorate well before the Covid-19 crisis. In 2018, government revenues (excluding exceptional dividends) began to decline after the newly elected government eliminated the tax on goods and services.

Meanwhile, its dependence on oil revenues increased considerably, and oil revenues accounted for 39% of total revenues in 2019. The new government also followed a much more expansionist fiscal policy. Whereas government expenditures had declined by 5.3 points of GDP in the period 2013-17, they rose by 1.6 points of GDP over the next 2 years to 20.9% of GDP. The increase is mainly due to higher social welfare spending.

In the first 11 months of 2020, government revenues contracted 21.6% in keeping with the downturn in economic activity and the contraction in oil revenues. Spending was reduced by 10.1% thanks to cutbacks in investment spending while sparing social welfare spending. The central bank bore most of the brunt of the support package for households and small businesses. At the end of November 2020, the fiscal deficit had risen by more than 65.6% compared to the same period in 2019. The full-year deficit is expected to swell to nearly 7% of GDP (up from 3.4% of GDP in 2019).

At the same time, the federal government's debt-to-GDP ratio is expected to rise by nearly 9 points to more than 61%. After integrating all of the government-backed guarantees as well as the debt pertaining to 1MDB, total public debt could rise to nearly 88% of GDP at year-end 2020 (up from 77.4% of GDP in 2019).

The government does not seem to be inclined to consolidate the fiscal situation significantly in 2021. It continues to give priority to the economic recovery and to the support oflow-income households. In the 2021 budget that parliament approved in December, the government plans to reduce the fiscal deficit by only 0.6 points to 5.4% of GDP (vs 6% of GDP in the revised 2020 budget). Government spending should remain high (20.5% of GDP) while fiscal revenues, which are still highly dependent on oil, are unlikely to exceed 15.1% of GDP, even though growth is forecast at between 6.5% and 7.5%. The government does not plan to reduce the fiscal deficit to pre-Covid levels even by a horizon of 2022-2023, when it will still amount to about 4.5% of GDP.

These projections do not seem to be very compatible with the target of reducing the federal deficit below the threshold of 55% of GDP by 2023. By then, the federal debt-to-GDP ratio could exceed 65%. Yet refinancing risks are moderate, even though they have been on the rise, as illustrated by Fitch's downgrade of Malaysia's sovereign rating to BBB-.

The interest charge on government debt accounted for only 12.5% of government revenues in 2019, and according to the government, they should rise to only 15.1% in 2021. The cost of financing is still low. In December 2020, 10-year government bond yields were only 2.7% (down from 3.3% in the year-earlier period). Moreover, nearly 97% of government debt is denominated in the domestic currency and is still held primarily by residents (non-residents held 21.8% of debt in Q3 2020). Malaysia has a key advantage over countries like Indonesia: with its highly developed financial markets, the government is able to issue domestic debt easily.

## A SUFFICIENTLY SOLID BANKING AND FINANCIAL SECTOR

Malaysia has a solid banking and financial sector. It is in a position to face up to the deterioration in the financial situation of economic agents, the downturn in the real estate market and the increase in credit risk triggered by the Covid-19 crisis.

ECONOMIC RECOVERY DRIVEN BY EXPORTS

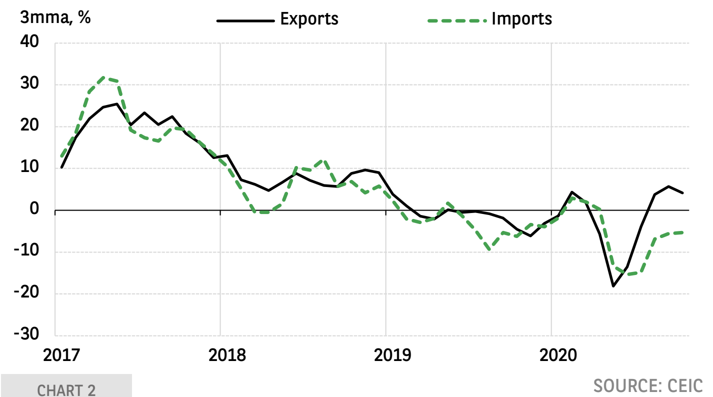


CHART 2 SOURCE: CEIC

Yet companies, already heavily in debt, were hard hit by the Covid-19 crisis after being weakened by the 2019 economic slowdown. In Q2 2020, corporate debt swelled to 108.1% of GDP. Although corporate profits declined, they still covered interest charges by 3.7 times in mid-2020 (down from 4.8 times at year-end 2019).

The household situation has also deteriorated. Household debt rose to 87.5% of GDP in Q2 2020, although it was largely offset by financial assets, the value of which still amounted to 190% of GDP in Q2 2020. Liquid assets still covered household debt by 1.4 times in mid-2020.

As in many other emerging countries, households and corporates benefited from a 6-month moratorium on loan payments between April and September 2020. Moreover, at the end of September, the most fragile households and small businesses could request debt restructuring for a period of 6 months. To prepare for the expected increase in credit risks, banks sharply increased their provisions, which strained profitability. Although ROA and ROE both declined, they still held at 1.2% and 10.1%, respectively, in Q3 2020. According to the central bank, 60% of household loan defaults will occur in H2 2021, and the doubtful loan ratio could rise to 4.1% at year-end 2021, up from 1.4% in Q3 2020. At the end of October, banks had sufficient capital to face up to this situation, with a capital adequacy ratio of 18.4%. Liquidity is also abundant, with a liquidity coverage ratio of 153% at the end of October.

*Completed on 11 January 2021*

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# VIETNAM



## STRONG PERFORMANCES

**The Covid-19 epidemic was well controlled last year and lockdown was swiftly eased. Productive activity has rebounded vigorously since May, notably driven by a solid recovery in exports. Fiscal support measures have been moderate, primarily based on the accelerated implementation of already-planned investment projects. In the end, economic growth and macroeconomic balances were only moderately and temporarily affected in 2020. However, there remains a weak link in the economy: banks are insufficiently capitalised while corporates, especially state-owned enterprises, are excessively indebted. Some of these institutions could be severely weakened when monetary support measures come to an end in 2021.**

### HEALTH CRISIS CONTAINED

Vietnam posted economic growth of 2.9% in 2020, making it one of the strongest performers in the world. The Covid-19 epidemic was particularly well-managed, thanks to strict case-tracking. Lockdown measures were introduced gradually from the end of January, building up to a strict lockdown, that lasted just three weeks, in April. These restrictions were gradually phased out from the end of April, with adjustments then made in certain provinces, depending on the health situation. As a result, after it slowed to 0.4% year-on-year (y/y) in Q2 2020, real GDP growth bounced back to 2.7% in Q3 and 4.5% in Q4. Mobility indicators have now returned to close to normal levels. Yet international tourism continues to be banned.

By mid-January, Vietnam had had only 1,515 Covid-19 cases and 35 deaths for a population of 98 million. A clinical trial of a locally produced vaccine began last month, and the first delivery of European vaccines has just been announced.

**FORECASTS**

| | 2019 | 2020e | 2021e | 2022e |
|---|---|---|---|---|
| Real GDP growth (%) | 7.0 | 2.9 | 7.0 | 6.9 |
| Inflation (CPI, year average, %) | 2.8 | 3.2 | 3.5 | 3.9 |
| Budget balance / GDP (%) | -3.3 | -6.0 | -4.5 | -4.0 |
| General government debt / GDP (%) | 43.4 | 46.9 | 46.9 | 46.4 |
| Current account balance / GDP (%) | 3.8 | 3.2 | 3.5 | 3.8 |
| External debt / GDP (%) | 35.6 | 36.3 | 34.4 | 32.0 |
| Forex reserves (USD bn) | 78.3 | 90.0 | 103.0 | 115.0 |
| Forex reserves, in months of imports | 3.6 | 4.0 | 4.1 | 4.1 |
| Exchange rate VND/USD (year end) | 23 170 | 23 150 | 23 070 | 23 000 |

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

### EXPORTS: A SOLID DRIVER OF ECONOMIC GROWTH

The Covid-19 shock hit a very buoyant economy, which had grown by an average of 7% per year between 2015 and 2019, and still enjoyed growth of 7% y/y in Q4 2019. This momentum was fuelled in particular by the export-oriented manufacturing sector, which has attracted substantial Foreign Direct Investment (FDI) and gradually moved up the value chain. Exports of goods accounted for 80% of nominal GDP in 2019, from 64% in 2014. They now consist primarily of phones, computers and other electronic goods[1], for which global demand has surged since the beginning of the health crisis. As a result, exports have been a solid driver of the economic growth rebound after the shock in S1 2020 (chart 1). After a 7% y/y contraction in Q2, exports have bounced back rapidly, posting growth of 6.5% over the full year (vs. 8.4% in 2019). Vietnam further strengthened its world market share, accounting for 1.6% of global exports in the first nine months of 2020 (from 1.4% in 2019 and 0.8% in 2014).

The export sector has proved able to adapt to changes in global demand in 2020. Moreover, it has also taken advantage of Sino-American tensions over the past three years, via the substitution of certain Chinese products by Vietnamese products and the relocation of factories to Vietnam[2]. These trends are likely to persist in 2021 and 2022, with the country well-placed to attract investors and continue to expand its export base. One dark cloud on the horizon, however, emerged in December, when the US officially designated Vietnam as a 'currency manipulator'[3]. This decision could result in a degree of tension with the US, which is the destination for around a quarter of Vietnamese exports.

**STRONG PERFORMANCE OF VIETNAMESE EXPORTS**

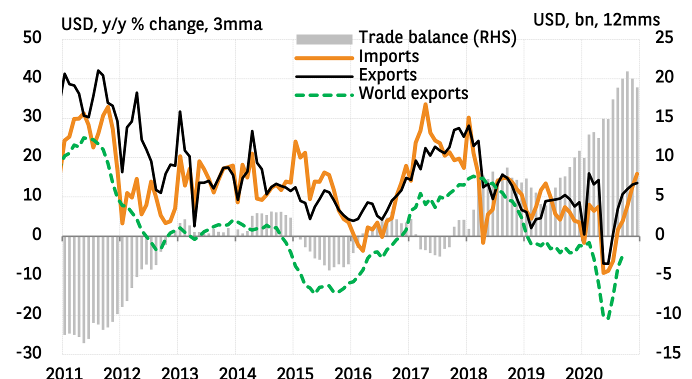
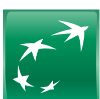



CHART 1

SOURCE: GENERAL STATISTICS OFFICE

1 In 2019, phones and components accounted for one-fifth of Vietnam's exports (vs. 16% in 2014), and other electronic and IT goods for 14% (vs. 8% in 2014). Textile and shoes remained at 19% of the total, whilst oil, agricultural and fisheries products declined to less than 8% from 20% in 2014. Foreign groups produced two-thirds of the goods exported, a share that has fallen slightly over the past three years.
2 One recent example is Apple, which began to assemble some of its products in Vietnam in May 2020.
3 This decision is the consequence of a bilateral trade surplus of more than USD 20 bn, Vietnam's current account surplus of more than 2% of GDP and forex market interventions of more than 2% of GDP.



We estimate that Vietnam's current account surplus was 3.2% of GDP in 2020, from 3.8% in 2019. The increase in the trade surplus was partly offset by the deterioration of the balance in services (collapse in tourism) and a drop in workers' remittances. Despite the reduction in foreign capital inflows, Vietnam continued to accumulate foreign exchange reserves, which reached USD 89 billion in September, meaning that they cover more than four months of imports of goods and services. The dong has appreciated slightly against the dollar since mid-2020.

## A MODEST SLOWDOWN IN DOMESTIC DEMAND

In 2020, the manufacturing sector grew by 5.8%, down from 11.3% in 2019, and the service sector grew by 2.3% vs. 7.3% in 2019. Although sectors linked to tourism (6% of GDP) continued to struggle, services activities that depend on domestic demand have either held steady during the lockdown (IT & communications, healthcare) or recovered well since May (most notably in the retail sector). In fact, after a contraction during the lockdown period (-27% y/y in April), retail sales volumes have rebounded once lockdown was loosened, and posted a small decline of less than 1% in 2020.

Vietnam's labour market and households have been hit less hard than those of other countries in the region by the Covid-19 shock, given the rapid recovery in productive activity from Q2 2020. According to the World Bank, only 3% of workers lost their jobs last year because of the pandemic. Nevertheless, 33% of households suffered a reduction in income (compared to 79% in Indonesia for example), inequality increased, and the financial support provided by government proved to be weaker than expected. Meanwhile, households have benefited from slower inflation in consumer prices (1.4% y/y in Q4 2020 vs. 3.7% y/y in Q4 2019).

Private consumption growth stood at 0.6% in 2020, down from 7.4% in 2019. It is likely to rebound vigorously over the coming months, but not to return to pre-crisis levels in 2021. The slowdown in investment was much more modest (4.1% in 2020 vs. 7.9% in 2019). On the one hand, the loss of vigour in private investment was contained, notably thanks to the still strong prospects for exports. In particular, FDI has proved more resilient in Vietnam than in the rest of the region. According to balance of payments data, FDI inflows dropped by only 4% y/y over the first nine months of 2020 and had already regained their Q3 2019 levels in Q3 2020. On the other hand, public investment was stepped up last year. The accelerated implementation of investment projects (most of which were already under way or in the planning stage) represented the biggest share of the fiscal support package. Whilst total government spending increased by 8% y/y in the first nine months of 2020, investment spending (a quarter of the total) rose by 40%.

## A TEMPORARY SHOCK TO PUBLIC FINANCES

Public finances had been consolidated over the five years prior to the Covid-19 crisis, leaving the government a small degree of latitude to absorb the shock and support activity. Thanks to greater discipline in managing expenditure, the partial privatisation of some state-owned enterprises and strong economic growth, the government registered a steady reduction in its deficit from 2014 to 2019 (from 5% of GDP to 3.3%) and a reduction in its debt between 2016 to 2019 (from 47.6% of GDP to 43.4% according to IMF data). This positive trend was interrupted last year, but this interruption is expected to prove only temporary.

MONETARY SUPPORT

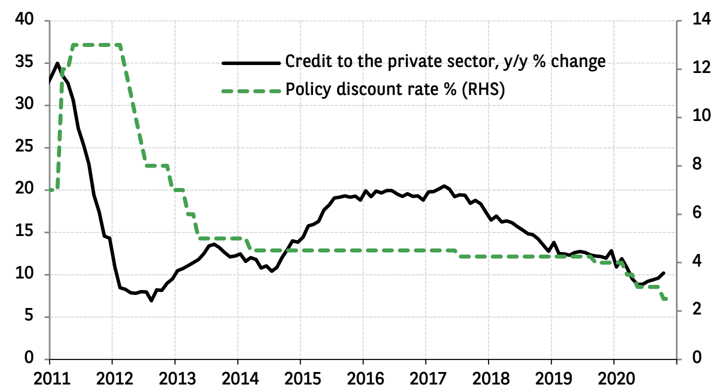



CHART 2 SOURCE: STATE BANK OF VIETNAM, IMF

The fiscal support package was modest – estimated at around 3% of GDP – and the fiscal deficit is unlikely to have exceeded 6% of GDP in 2020. It is projected to decline from 2021.

The government has been able to cover its financing requirements without difficulty, both on the local bond market and by using its fiscal reserves. Government debt remains moderately high, estimated at nearly 47% of GDP at end-2020 (from 43% in 2019, according to IMF data). It is projected to stabilise in 2021.

## A MAJOR TEST FOR THE BANKING SECTOR

There is a major weak link in the Vietnamese economy: banks are undercapitalised and lack a buffer to protect them from shocks, while corporates, particularly in the public sector, are excessively indebted (credit to the economy represented 145% of GDP in 2020).

Some of these institutions could therefore find themselves severely weakened, in turn creating a threat to public finances. Granted, the performance of the banking sector improved in 2018-2019, notably thanks to a strengthening of the regulatory framework, a more solid funding base and an improved quality of new loans. In addition, since the beginning of the health crisis, the easing of monetary conditions (through interest rate cuts, liquidity injections and a loosening of macro-prudential rules) and the support provided to banks and their customers (rescheduling of loans) have helped reduce the pressure (chart 2). However, some corporates have been weakened and are experiencing cash-flow constraints, particularly those in the tourism and transport sectors. Non-performing loans on bank loan books have started to increase. This trend is likely to accelerate when support measures are phased out over the course of 2021. Against this background, certain small private banks, lacking capital and stable sources of funding, could face significant difficulties.

*Completed on 11 January 2021*

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# BRAZIL



## A FRAGILE OUTLOOK DOMINATED BY CONCERNS OVER THE EPIDEMIC AND FISCAL WOES

**An active economic policy has helped attenuate the magnitude of the recessionary shock in 2020. The recovery in Q3 was vigorous and was prolonged into Q4. However, the economy showed signs of slowing down towards year-end. Brazil's external vulnerability did not deteriorate despite high volatility of both portfolio and direct investments as well as a sharp depreciation of the real in 2020. In 2021, the economy will benefit from the recovery in commodity prices and the maintenance of accommodative measures on the monetary side. However, the resurgence of the Covid-19 epidemic coupled with delays in rolling out vaccinations as well as uncertainty regarding the fiscal consolidation process and the lack of progress on reforms are likely to be sources of stress in financial markets and potential destabilising forces for the recovery.**

### RE-ACCELERATION OF THE EPIDEMIC, DELAYED VACCINATIONS

The Covid-19 epidemic – after slowing down between late July and early November – accelerated again over the past two months or so. The number of daily confirmed cases reached a peak in mid-December at more than 70,000 cases and averaged over 49,000 cases before year-end festivities (from around 14,000 cases on average at the beginning of November)[1]. Meanwhile, the average number of daily deaths more than doubled over the same period (to over 700 deaths). At the beginning of January, Brazil accounted for around 10% of confirmed cases and deaths worldwide (at around 8 million and more than 200,000 respectively) and remains the second most death-stricken country after the United States.

This second wave was however not accompanied by new restrictive measures[2]. There has also been no evidence of increased social distancing. In fact, prior to the holidays, Google Mobility data showed a tendency for Brazilians' movements to normalize rather than to adjust to the renewed acceleration of the epidemic. Data from Datafolha surveys corroborated this trend showing that social isolation had reached new lows since the beginning of the pandemic.

Constrained by logistical and regulatory obstacles, Brazil's vaccination plan has so far lagged behind that of other countries in the region (e.g. Argentina, Chile, Costa Rica and Mexico.) The start of the vaccination campaign has been constrained by delays in approving the 4 vaccines currently under consideration by the regulator (Sinovac, AstraZeneca, Pfizer and Janssen). The authorities are planning to immunize just under a quarter of the population by June 2021 (i.e. 51 million people). But the issue of vaccination has become highly politicized with the President himself indicating that he will not get vaccinated. This decision could fuel a reluctance to receive the vaccine (which could affect as much as 25% of the population according to some surveys).

The spread of the epidemic, the greater transmissibility of certain variants of the virus, the lack of new measures to contain the mobility of people and delays in rolling out the national vaccination campaign are all factors which risk holding back the recovery.

FORECASTS

| | 2019 | 2020e | 2021e | 2022e |
|---|---|---|---|---|
| Real GDP growth (%) | 1.4 | -4.3 | 3.0 | 3.0 |
| Inflation (CPI, year average, %) | 3.7 | 3.2 | 5.1 | 3.1 |
| Fiscal balance / GDP (%) | -5.9 | -15.0 | -7.3 | -7.1 |
| Gross public debt / GDP (%) | 76 | 91 | 91 | 92 |
| Current account balance / GDP (%) | -2.8 | -0.3 | -1.0 | -1.6 |
| 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 |
| Exchange rate USDBRL (year end) | 4.0 | 5.2 | 4.3 | 4.2 |

TABLE 1 e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

REBOUND IN THE EPIDEMIC (7-DAY MOVING AVERAGE)

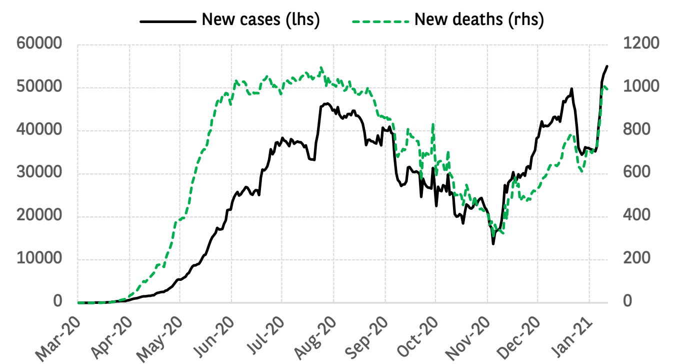


CHART 1 SOURCE : JOHN HOPKINS CSSE COVID-19 DATA

### 2020: THE ECONOMY REBOUNDS DURING THE SECOND SEMESTER...

The recovery in economic activity in Q3 was vigorous but not sufficient to offset the losses registered in Q2. The easing of containment measures, income-compensation policies, and the restart of production in many sectors allowed real GDP to rebound by 7.7% in Q3 (following a 9.6% contraction in Q2). Production volumes remained nonetheless 3.9% below their Q3 2019 levels.

Through November, monthly indicators continued to improve in industry and retail - two sectors which by August had already returned to their pre-pandemic (February) level of activity. In November, industrial production posted its seventh consecutive month of increase, helped by improved activity in real estate (in Sao Paulo in particular) and the good performance of retail sales (supported by the government's emergency aid programme). The reais' depreciation (-23% in 2020) also allowed for a greater share of domestic demand for industrial goods to

1 The big drop in cases registered over the holidays was solely due to a statistical artifact caused by a reduction in the number of tests carried out during this period.
2 With a few exceptions (e.g. the States of Sao Paulo and Amazonas). However, restrictions were limited and had only marginal effects on mobility.

be satisfied by internal production. Activity in services has also continued to improve in October but was still 6% lower than in February.

The balance of payments faced drastic adjustments – however, without leading to a weakening of the country's external vulnerability. The trade surplus strengthened in 2020 (+7% y/y), helped by (i) a nearly 10% slowdown in imports and (ii) the strength of Asian demand, which – by absorbing half of sales – helped to contain the decline of exports (-6% y/y). On the financial account, portfolio investment flows by non-residents resumed along with the economic recovery but were insufficient to compensate for the losses incurred over the first half of the year (USD 12 bn in net outflows from January to November). Foreign direct investment (FDI) also slowed down sharply (-49.6% y/y over period from January to November). However, net FDI flows have continued to comfortably cover the current account deficit, which – over the year – narrowed by around 2 percentage points of GDP. In addition, the country still has a very satisfactory external liquidity position relative to its imports and external liabilities.

## … BUT SHOWS SOME WEAKENING SIGNS TOWARDS YEAR-END

The economy has nevertheless shown some signs of slowing down that have been concomitant with the resurgence of the epidemic and the acceleration of inflation (+4.3% y/y in November, the largest increase in 18 months.) The loss of momentum is most visible in PMI data, which showed either slower (manufacturing) or almost stable (services) rates of expansion towards year-end. There has also been a drop in vehicles sales in December (a first since April). Meanwhile some confidence indicators (households, construction and services) have yet to rebound since declining in October.

Despite year-end dynamics on both the economic and epidemic fronts, the equity market rebounded quite strongly in 2020. After hitting record highs in January, the equity market then lost 50% of its value in March before ending the year on a 3% gain. The year also ended with a record number of initial public offerings (26 IPOs and nearly USD 8 bn in funds raised – the highest level since 2007). Cyclical and structural factors help explain this bounce-back: liquidity injections at the global level, the development of vaccines, the increase in the number of local retail investors (which has more than quadrupled since December 2018, facilitated by the development of online brokers), and the large drop in the SELIC policy rate, which has encouraged the reallocation of portfolio investments into equities. A rather moderate economic growth outlook could spur some corrective adjustments in 2021.

## 2021: AN OUTLOOK CONTINGENT ON FISCAL DEVELOPMENTS

Economic growth in 2021 will benefit from a large carry-over effect (at least 2.5 percentage points). Production levels last seen towards the end of 2019 are not expected to materialize until mid-2022. Growth, but also inequality and poverty, are likely to be affected by the end of emergency aid payments, high unemployment (14.3% in October) and the absence of a fiscal stimulus plan. Growth will also suffer from the end of tax breaks and could be further penalized by a slower-than-expected execution of the immunization program. On the other hand, the economy should benefit from the recovery of commodity prices and the maintenance of monetary measures (key rate at an all-time low, reduction in liquidity and capital requirements for banks, etc.). Meanwhile, the renewal of the government's public guarantee program, intended to support small and micro-enterprises, should help support firms' cash flow. These measures have already fuelled the strong rebound in corporate credit (+18.2% y/y in real terms).

STRONG REBOUND IN CORPORATE CREDIT (NOMINAL GROWTH %, Y/Y)

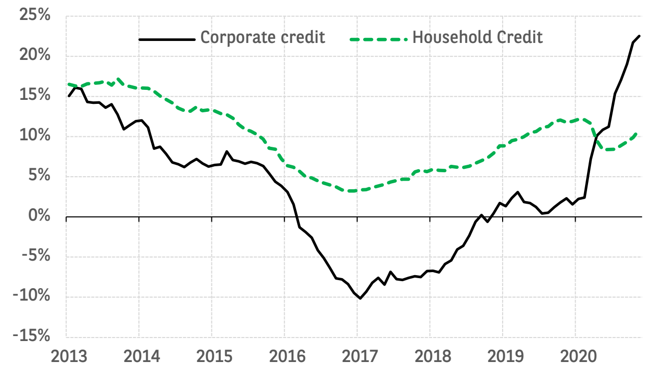


CHART 2 SOURCE: BCB

Finally, the new privatization and concession program, unveiled by the government (115 state assets targeted in 2021, including 22 airports and the 5G network), could support capital expenditure – provided of course that investors' appetite resumes rapidly.

Discussions over the design of the country's fiscal rules and whether or not they will be upheld are likely to dominate headlines in 2021. Despite a better than expected central government result in the last few months of the year (emergency aid payments being cut by half, reduction in the number of beneficiaries from 68 to 56 million, improvement in tax collection, resumption of activity, retention of certain discretionary expenditures) the budget deficit has soared to unprecedented levels and so has the level of debt. Further, the debt's average maturity has shortened and concerns over its sustainability have increased.

In 2021, maintaining fiscal policy credibility will be a key determinant for the performance of the reais, the evolution of capital flows and the yield curve. This may have important implications for the Treasury who will have substantial debt payments to rollover (around 25% of the debt stock falls due over the next 12 months). For the time being, the budget (presented at the end of the summer) has still not been approved and is unlikely to be so until February, after the end of the parliamentary recess[3]. Some governors in the country's northern states have called for an extension to the state of emergency (which suspends fiscal control mechanisms) for at least the first half of 2021. The local press reports that some members of the government would be favourable to such a development, particularly if the second wave of the epidemic does not abate.

In 2021, the Bolsonaro presidency will lose an ideological ally in the White House. The Biden administration – in its effort to strengthen the US' involvement in international fora especially on the environment – could challenge the Brazilian government over issues related to deforestation in the Amazon. In February, the elections to pick new Presidents for the Senate and the Chamber of Deputies will also have a key impact on reform progress (at this stage, no significant reform bills are close to being approved). On a positive note, the municipal elections in November showed stronger voter support for parties at the centre to the detriment of the extremes.

*Completed on 11 January 2021*

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3 Congress nevertheless passed a Budget Orientation Act, which allows public spending to continue in the early months of 2021, pending final approval of the budget.

# PERU



## NO EXCEPTION

**Peru is one of the Latin American countries to have suffered most from the Covid-19 crisis. After a sharp contraction in Q2 2020, the recovery that began in Q3 has continued. This said, economic activity is unlikely to regain its pre-crisis level before the end of 2022. The economic contraction and the massive stimulus programme introduced by the government have hit public finances, but the deterioration is likely to remain manageable, for the short term at least. However, the deterioration of the political climate seen over the past few years is affecting the medium-term outlook.**

### A VERY SEVERE RECESSION

Peru is one of the countries that has suffered most from the Covid-19 crisis. The very strict lockdown measures introduced in mid-March proved unable to limit transmission or protect the restricted capacity of the healthcare system. In all, the country has seen more than a million cases since the beginning of 2020 (for a population of 32 million), and its mortality rate is amongst the highest (ranking sixth according to World Bank figures). Having peaked in August (at nearly 8,000 new cases per day on average), the number of new daily cases has fallen since early September, stabilising at around 1,600 in December. However, it has been climbing again since early January, averaging 2,300 per day over the first ten days of the month.

On the economic front, the recession in 2020 was severe. Real GDP is estimated to have fallen by 12%, having risen by 2.2% in 2019 and by 3.2% over the previous five years. By way of comparison, the IMF estimates that the region as a whole saw an average recession of 8% in 2020.

Real GDP plummeted in the second quarter, dropping 30% year-on-year, following lockdown measures that ran from mid-March to end-June. In April alone, monthly GDP and the industrial production index collapsed by 40% and 53% y/y respectively. All sectors, including mining, saw only a very gradual recovery from the end of May.

Good macroeconomic fundamentals allowed a massive intervention by the authorities, in order to prevent an even more spectacular collapse in GDP and support the growth recovery that began in Q3. At the beginning of 2020, external debt and government debt were modest (at 35% and 27% of GDP respectively), the current account deficit was largely covered by inflows of foreign direct investment and reserves were at a comfortable level (more than 15 months of imports in December 2019).

The central bank cut its policy rate by 200 basis points to 0.25% and promised to provide substantial liquidity. At the same time, the government has put in place a vast stimulus package, comprising both short-term measures (worth some 8% of GDP), aimed mainly at supporting the most vulnerable households and companies as well as increasing healthcare spending, and longer-term measures (worth around 4% of GDP) to help support growth. The government also introduced a programme of lending to business, 'Reactiva Peru', financed by the central bank and equivalent to 8% of GDP.

Lastly, in order to support the recovery in household consumption, in May Congress approved a law to enable beneficiaries to withdraw up to 25% of their assets from private pension funds. After acrimonious debate in parliament, further withdrawals were authorised at the end of November, covering beneficiaries affected by certain illnesses or those who have not contributed over the preceding 12 months. Meanwhile, at the end of June, the IMF approved a Flexible Credit Line, a financing facility (for USD11 billion with a two-year term) designed to help deal with crises (Peru can trigger this credit line if its economic and financial situation worsens significantly) and reserved for countries with particularly solid macroeconomic fundamentals[1].

The monthly indicator of economic activity has recovered continuously since July, but in October was still 11% below its end-2019 level (chart 1). Driven by rising metals prices (mainly for gold and copper,

**FORECASTS**

| | 2019 | 2020e | 2021e | 2022e |
|---|---|---|---|---|
| Real GDP growth (%) | 2.2 | -12.0 | 8.0 | 3.5 |
| Inflation (CPI, year average, %) | 2.1 | 1.8 | 2.1 | 1.9 |
| Central Gov. balance / GDP (%) | -3.0 | -7.5 | -7.5 | -3.5 |
| Public debt / GDP (%) | 26.8 | 35.4 | 37.1 | 36.8 |
| Current account balance / GDP (%) | -1.5 | 0.7 | 1.7 | 1.5 |
| External debt / GDP (%) | 34.7 | 44.7 | 42.2 | 41.7 |
| Forex reserves (USD bn) | 68.4 | 71.5 | 70.0 | 72.0 |
| Forex reserves, in months of imports | 19.4 | 25.1 | 18.5 | 18.0 |
| Exchange rate USDPEN (year end) | 3.3 | 3.6 | 3.7 | 3.6 |

TABLE 1 e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

**REAL GDP**

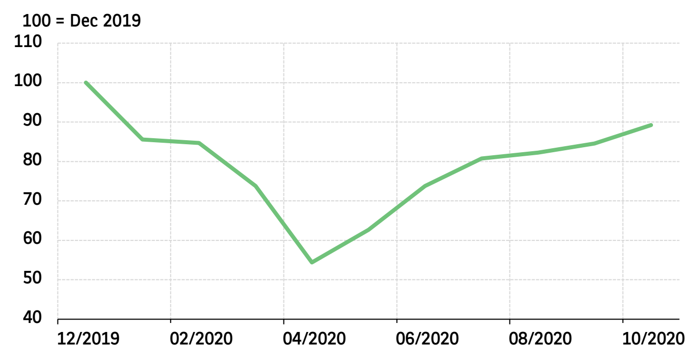


CHART 1 SOURCE: NATIONAL ACCOUNTS

1 To date, only five countries have been offered this facility: Chile, Colombia, Mexico, Peru and Poland.

the latter still accounting for nearly one-third of exports), favourable growth prospects in China (the main destination for exports since 2014) and the government's stimulus plan, the economic recovery should continue throughout 2021 and 2022. Real GDP growth is projected at 8% and 3.5% respectively. At this pace, the economy is unlikely to regain its pre-crisis level before the end of 2022.

## DETERIORATION OF THE POLITICAL CLIMATE

The risks are on the downside. In particular, the worsening of the political climate seen over a number of years gathered pace at the end of 2020 and will weigh on short-term growth prospects, and probably on economic fundamentals over the medium term.

On the one hand, a lack of clarity on the supply of vaccines and the effective commencement of the vaccination campaign limits growth prospects for 2021. The Health Minister initially announced that the campaign would begin in the first quarter of 2021. According to the local press, it seems, however, that the political crisis in October and November not only delayed the rollout, but also prevented the finalisation of orders for vaccines. The start of the vaccination programme might end up being pushed back to the beginning of the second half.

On the other hand, structural weaknesses in governance worsened over the course of the latest mandate (since 2016), concerning mainly parliament's defiance of the government and numerous corruption scandals. The mandate has thus seen a succession of four presidents (three in November 2020) who were removed from office or forced to resign following their implication in corruption scandals, two parliaments and a high rate of turnover in ministerial offices. However, under the Peruvian constitution, the duration of presidential and parliamentary mandates remains fixed. The next general elections (presidential and legislative) will therefore take place as planned at the end of the current mandate.

In mid-November, parliament elected Francisco Sagasti, a deputy and founder of the centrist Morado party, as interim President. He will remain as interim President until elections are held. He has committed to respecting the electoral calendar, thus to hold the first round of elections on 11 April of this year, and to leave power on 28 July, when the next presidential mandate begins. However, this has not calmed the political climate. Relations between parliament and the interim government will remain extremely tense, particularly if the country faces a further wave of infections.

At present, given the large number of candidates, it is difficult to predict the likely winner of these elections and any majority in the next parliament. However, all candidates seem to agree on a degree of continuity in economic policy, concerning for example the respect of fiscal discipline that has been seen for a number of mandates now. Between 2015 and 2019, the government deficit remained limited to 2.2% of GDP on average, despite the collapse in copper prices and several natural disasters.

It is likely, however, that relations between government and parliament will remain strained during the next mandate. The budget targets for the short term (stimulus measures in 2021, consolidation from 2022) and the medium term (increase in receipts through a reform of the collection system), and reforms designed to boost Peru's potential growth (labour market reform, tackling the informal economy), could

BUDGET DEFICIT AND PUBLIC DEBT

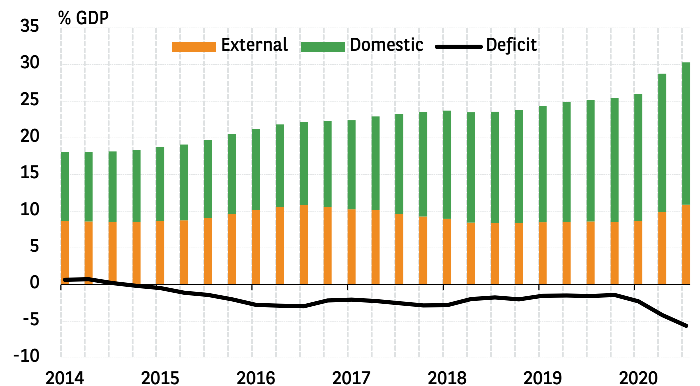


CHART 2

SOURCE: MINISTRY OF FINANCE

be delayed still further. In the longer run, political instability and the lack of reforms could hit potential growth and the attractiveness of the country to foreign investors.

## THE SHORT-TERM INCREASE IN GOVERNMENT DEBT IS NOT WORRYING

The government estimates that after increasing to 8.5% of GDP in 2020 (from 1.6% in 2019), the government deficit will fall to 6.5% in 2021. We think that the figure is likely to be closer to 7.5% in both years. Tensions between parliament and government prevented the implementation of a number of measures in the stimulus package – including several public investment projects – which will therefore be delayed until 2021. The deficit is then likely to shrink, given the temporary nature of the increase in public spending. Government debt is estimated to have risen from 27% of GDP in 2019 to 35% in 2020 and then should rise further to 37% in 2021. It will therefore remain moderate

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*Completed on 11 January 2021*

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# ISRAEL



## FAVOURABLE PROSPECTS DESPITE FISCAL UNCERTAINTY

**Fiscal support and the resilience of exports helped limit the economic recession in 2020. A strong recovery is likely in 2021, thanks primarily to a rapid vaccination campaign. The shekel has strengthened on the back of a growing current account surplus and massive capital inflows. The situation for public finances is more uncertain. In addition to the structural deterioration of recent years, the lack of a budget law against a background of repeated government instability is not helpful for budget consolidation. Although solid solvency indicators eliminate any short-term risk, a lack of reforms could weigh on potential growth over the medium to long term.**

### RECOVERY EXPECTED ON THE BACK OF THE VACCINATION CAMPAIGN

Economic activity held up pretty well in 2020, with a likely fall in real GDP of just 3.7% according to the latest Bank of Israel (BoI) estimates. After a drop in GDP of 1.1% year-on-year (y/y) in Q3, a second lockdown dented the country's economic performance in the final quarter. Over the full year, and given the fall in household consumption and investment, the scale of the recession was limited by public spending and the positive contribution from foreign trade. With imports shrinking by 15% y/y in the third quarter, exports grew by 6%. The strong export performance in 2020 was due in particular to the competitiveness of high-tech services exports and the start of gas exports to Egypt and Jordan.

The labour market deteriorated over the course of 2020, particularly during lockdowns. The Israeli statistical service has introduced a broad unemployment rate to better reflect the unusual economic circumstances. This definition adds to the standard definition of unemployment those people temporarily out of work due to coronavirus-related reasons and those who have withdrawn from the labour market because of the pandemic. From a level of less than 4% before the pandemic began, the broad unemployment rate hit a peak of 37% during the first lockdown in April. According to the BoI, it probably averaged 16% in the final quarter of 2020.

The economic recovery expected for 2021 is highly dependent on the speed and effectiveness of the vaccination campaign. Since the beginning of the year, the country has the OECD's highest rate of vaccination of its population. Some 20% of Israelis have now received the first dose of the vaccine, and the government aims to vaccinate everyone over 16 by the end of January. This said, it would be wise to remain cautious about the timing of economic recovery. The acceleration of the second wave of infections in December forced the government to introduce new lockdown measures, from 6 January for at least two weeks. Under the BoI's optimistic scenario, with a vaccination campaign that is completed in the second quarter, thus allowing the gradual removal of all restrictive measures, real GDP could grow by 6.3% in 2021. This scenario takes account of the uncertainties surrounding the recovery at a global level. Israeli exports account for around one-third of GDP and depend largely on the US and European markets. The BoI's growth forecast for advanced economies (3.4%) remains cautious. All in all, provided that the vaccination campaign is effective, it is this favourable scenario that currently looks the most likely.

Against a background of a sharp fall in household consumption, lower oil prices and a stronger shekel, consumer price inflation was negative in 2020 (estimated at -0.6%).

FORECASTS

| | 2019 | 2020e | 2021e | 2022e |
|---|---|---|---|---|
| Real GDP growth (%) | 3.4 | -3.7 | 6.3 | 5.0 |
| Inflation (CPI, year average, %) | 0.8 | -0.6 | 0.5 | 1.0 |
| Cent. Gov. balance / GDP (%) | -3.9 | -11.5 | -7.5 | -4.5 |
| Cent. Gov. debt / GDP (%) | 60 | 75 | 79 | 79 |
| Current account balance / GDP (%) | 3.5 | 4.2 | 3.9 | 3.5 |
| External debt / GDP (%) | 27 | 30 | 30 | 31 |
| Forex reserves (USD bn) | 126 | 168 | 200 | 210 |
| Forex reserves, in months of imports | 14 | 20 | 22 | 21 |
| Exchange rate USDILS (year end) | 3.5 | 3.2 | 3.2 | 3.3 |

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

ECONOMIC ACTIVITY (%, Y/Y)

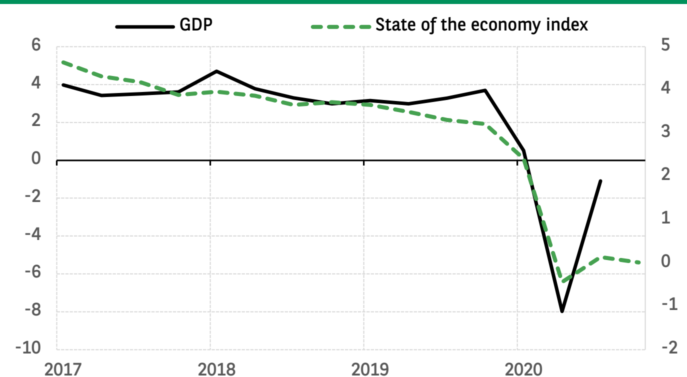


CHART 1 — SOURCE: BANK OF ISRAEL, BNP PARIBAS

### RECORD EXTERNAL SURPLUSES SUPPORT THE SHEKEL

The current account surplus could hit a record level in 2020 (at 4.2% of GDP, from 3.5% in 2019). On the one hand, imports collapsed. On the other, the growing share of high-tech services exports in total exports of goods and services makes the total figure less sensitive to international conditions. Over the first three quarters of the year, the volume of exports of goods and services grew by 0.3% on average, whilst that of imports fell by 10.5%. At the same time, capital inflows

were very substantial in 2020. Foreign direct investment reached USD 19.4 billion (up 56% on 3Q 2019), and portfolio investment was USD 17 billion (from USD -1.1 billion in 3Q 2019) thanks to the government's Eurobond issue.

All of these elements contributed to an increase in the balance of payments surplus and the strengthening of the shekel against the US dollar. This trend was further strengthened by the weakness of the US dollar on international markets and by the rise of international asset markets, both of which are traditionally associated with a stronger shekel. The BoI continued to buy foreign currency in 2020 (USD 21 billion) to help limit the currency's appreciation. It has announced its willingness to increase market interventions in 2021 (USD 30 billion scheduled). This should limit shekel appreciation in a context of narrowing current account surpluses as the economy recovers.

## THE FISCAL OUTLOOK IN AN UNCERTAIN POLITICAL CLIMATE

Unsurprisingly, the budget deficit is expected to be significant in 2020, due to a fall in tax receipts (-9.6% in the first 11 months) and more importantly the increase in spending (20% over the same period). Exceptional fiscal measures to support the economy were worth some 7% of GDP, according to the IMF. The total deficit for 2020 is thus likely to have been around 12% of GDP. In 2021 the reduction in the deficit will probably be modest, despite the return to growth. At least some of the economic support measures should be maintained. On the receipts side, continuing restrictions will reduce income from VAT (21% of total government receipts). All in all, we expect a budget deficit of 7.5% of GDP in 2021.

The lack of a budget law since 2019, due to political volatility, is a source of uncertainty over the future path of public finances. The government operates on the basis of a budget passed two years ago that is rolled over from month to month. However, this baseline budget was increased in 2020 in order to adapt to the economic context in 2021.

In the short term, we believe that the consequences of the absence of an approved budget can be managed and that the deterioration of deficit and debt ratios will not result in any increase in sovereign risk. The political trend remains favourable to the control of budget deficits, notably through the introduction of a mechanism for the control of spending that ties any new commitment to an identified source of revenue. However, the structural budget deficit, as calculated by the IMF, has been rising steadily since 2015. It reached 4.1% of GDP in 2019, from 0.7% of GDP in 2015, mainly due to higher social spending and investment. It is currently difficult to predict the trajectory of public spending over the coming years. Even if the government succeeds in controlling the spread of the virus in the short term, its economic consequences will be long-lasting and will require some form of fiscal support to be maintained.

The fiscal position benefits from significant sources of support, which should allow any increase in the cost of financing to be contained. In the short term, the BoI looks set to continue its policy of purchasing government papers and private-sector securities. In November 2020, the BoI held 7% of the tradable Treasury bonds issued by the government (from 0.4% at the end of 2019). The impact on money supply is negligible (money supply increased by 0.7%). This is likely to help limit possible upward pressure on the rates at issuance. In

GOVERNMENT BUDGET BALANCE (ILS BN)

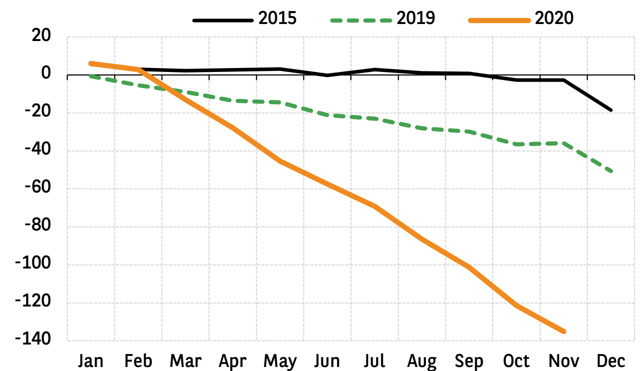


CHART 2 SOURCE: MINISTRY OF FINANCE, BNP PARIBAS

addition, although the trend in government debt was not favourable in 2020 (from 60% of GDP in 2019 to 75% in 2020), its structure remains an element of strength of public finances. The average maturity of the stock of debt was 8.2 years in 2019 (6.8 in 2008). Debt service costs have fallen from 10.7% of total government receipts in 2010 to 5.6% in 2019. The majority of the budget's financing comes from the local market. At the end of 2019, around 85% of government debt was in local hands, with 31% off the market. Israeli mutual and pension funds are significant holders of the tradable part of the debt (43% of the total).

The effect of political volatility on public finances could be more significant over the medium to long term. In order to boost potential growth, a number of structural reforms are needed, to improve productivity across the economy and reduce inequalities. These reforms will be costly and will require some difficult decisions to be made, particularly in terms of tax policy. For the time being, the lack of political stability limits the chances of putting such reforms in place.

*Completed on 14 January 2021*

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# RUSSIA



## A FRAGILE RECOVERY BUT RESILIENT FUNDAMENTALS

**The scenario of a partial and still fragile economic recovery is confirmed against a backdrop of a spreading pandemic at end-2020. Household consumption is the only component that managed to contribute to growth, but it could run out of steam with the upsurge in inflation. The recovery is expected to broaden in 2021, thanks to the expected resumption of production in the extractive industries, higher oil prices and the improvement in business confidence in the manufacturing sector. Yet monetary and fiscal supports will be relatively small. Public finances have been fairly resilient, and foreign reserves have consolidated despite capital outflows, since the rouble served as the adjustment variable. According to the Central Bank of Russia (CBR), the banks have sufficient reserves to cover the entire amount of restructured loans.**

### AS THE PANDEMIC SURGES IN LATE 2019, A VACCINATION CAMPAIGN IS ROLLED OUT

Russia has had to cope with a surge in the Covid-19 epidemic since Q4 2020. The number of new cases has increased 4-fold between late September and early January. So far, the official figure is 60,000 deaths, or a fairly low mortality rate of 408 deaths per million inhabitants. But the official figures probably underestimate the scope of the pandemic. A vaccination campaign was launched in early December using the Sputnik V, a locally developed vaccine, even though clinical trials have yet to be completed. The first phase of the vaccination campaign targets medical professionals and teachers (after military personnel) as well as individuals over age 60. In early January, 800,000 individuals had been vaccinated. Deployment of the vaccination will necessarily take a long time, both in terms of vaccine production and covering of the population (140 million inhabitants), especially since, according to various polls, close to 60% of Russians were reticent about being vaccinated.

### A PARTIAL, FRAGILE RECOVERY

The Russian economy was hit by a smaller recessionary shock than in most of the other emerging countries. Since Q2 2020, however, activity has barely levelled off. On a year-on-year basis (y/y), GDP was still contracting 4% on average in October-November, vs -3.4% in Q3 2020. Based on these preliminary estimates, GDP will still fall 3.5% short of the Q1 level. In November, oil production amounted to 9.3 m barrels/day (mb/d), a 12% decline from the Q1 figure, mainly due to OPEC+ oil production quotas. Natural gas production was also down 6% compared to Q1. Excluding the extractive industries, activity plummeted in the hotel & restaurant, leisure and transport sectors, down between 10% and 25% in volume between January and September 2020, compared to the same period in 2019. In contrast, manufacturing and construction were both more resilient. In November, manufacturing activity even grew 1% y/y.

An analysis of the components of demand, however, underscores the fragility of the recovery. In Q3, private consumption was the sole growth engine (3.7% q/q seasonally adjusted). In contrast, public expenditure and investment failed to pick up. Net foreign trade even made a negative contribution to growth due to the ongoing decline in exports.

Worse, the rebound in consumption seems to be winding down. On average in October-November, retail sales were still declining 2.2% y/y. Two powerful tailwinds are 1) rising unemployment (6.1% in November vs. 4.6% in Q1), and 2) accelerating inflation (4.9% y/y in December, vs 2% in Q1). With the surge in food prices (+6.7% y/y in December), the government opted to introduce targeted price controls. Monetary policy easing through the summer combined with measures to subsidize mortgage rates for households mainly helped stimulate mortgage loans.

Despite incentives to encourage investment in housing, total investment remained sluggish until Q3, due to the climate of uncertainty and declining exports. Gazprom scaled back its investments by 18% in 2020.

**FORECASTS**

| | 2019 | 2020e | 2021e | 2022e |
|---|---|---|---|---|
| Real GDP growth (%) | 1.3 | -4.5 | 3.8 | 3.0 |
| Inflation (CPI, year average, %) | 4.5 | 3.4 | 3.5 | 3.5 |
| Central Gov. balance / GDP (%) | 1.9 | -4.0 | -1.5 | 1.1 |
| Public debt / GDP (%) | 14.1 | 18.6 | 18.8 | 16.5 |
| Current account balance / GDP (%) | 3.8 | 1.9 | 2.5 | 2.0 |
| External debt / GDP (%) | 28.5 | 31.0 | 29.0 | 27.0 |
| Forex reserves (USD bn) | 444 | 450 | 453 | 455 |
| Forex reserves, in months of imports | 15.1 | 16.9 | 16.0 | 15.5 |
| Exchange rate USDRUB (year end) | 62.1 | 74.0 | 72.0 | 70.0 |

TABLE 1 e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

**A STILL PARTIAL RECOVERY OF ACTIVITY**

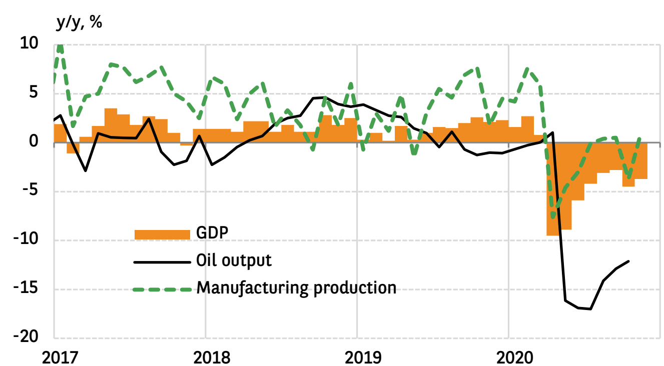


CHART 1 SOURCE: ROSSTAT, MINISTRY OF ECONOMIC DEVELOPMENT, JODI

Yet PMI indicators point to renewed confidence in the manufacturing sector. Moreover, non-hydrocarbon exports, which account for a little more than half of total exports, began accelerating again in September-October. If household consumption resists, investment could begin to contribute to growth again, providing a broader base for the recovery. We expect to see an improvement in the extractive industries, with a planned but moderate increase in oil production starting in February-March (+0.13 mb/d or an increase of 1.4% from current levels).

The recovery will still be restrained by the monetary authorities' lack of manoeuvring room due to inflationary pressures (the central bank's key policy rate has been held at 4.25% since July) and a cautious fiscal policy.

## MILD IMPACT ON PUBLIC AND EXTERNAL ACCOUNTS

Apparently, the deterioration in public finances was relatively mild in 2020. After reporting fiscal surpluses in 2018 and 2019, the central government deficit should rise to 4% of GDP this year (the 12-month cumulative total was only 3.6% in November) reflecting the need for fiscal support. The budget also benefited from a BCR transfer of 1.1% of GDP. Even so, fiscal revenues have held up well. Consequently, the public debt ratio will hold at 15-20% of GDP at year-end 2020 (it was only 16% of GDP in September), despite the rouble's sharp depreciation (sovereign debt in foreign currencies still accounts for 17% of the total). In 2021, the government expects to have a little more manoeuvring room in terms of spending to avoid hampering the recovery, but regulated withdrawals from the National Wealth Fund (NWF) will be limited to 1% of GDP, even if oil prices were to plunge again. At the end of October, NWF assets were valued at USD 177 bn (11.5% of GDP) compared to USD 125 bn at year-end 2019.

On the external side, the current and financial accounts all carry traces of the decline in oil prices and the outflow of non-resident portfolio investments. According to BCR estimates, the current account surplus was reduced by more than half in January-November, compared to the same period in 2019, while the deficit of financial transactions of the private sector widened by nearly 80%. Even so, Russia managed to consolidate its foreign reserves. Another positive point is that part of the capital outflows were due to the external deleveraging of non-financial private sector companies and banks (by USD 12.8 bn and USD 4 bn, respectively, between year-end 2019 and September 2020).

The main adjustment variable was actually the rouble, which depreciated by 17% between the end of December 2019 and April 2020, before stabilising with some difficulty thereafter. Once again, the Russian currency is highly correlated with oil prices, despite BCR interventions to sell dollars up to mid-January. The rouble should get some support from oil prices, assuming they continue to rise. However, the BCR has resumed buying USD on the fx market since January 15. Yet the rouble's potential appreciation is likely to be hampered by other more structural factors, such as the revision of tax agreements with offshore centres (notably Cyprus) and the diversification of investment savings by wealthy households into instruments denominated in foreign currencies.

## CREDIT RISK IS MANAGEABLE FOR THE BANKING SYSTEM

According to BCR, corporate debt has increased by 9.3 points of GDP since the beginning of the crisis due to the recession and the automatic impact of the rouble's depreciation. At 62.6% of GDP, corporate debt is still lower than its peak at year-end 2015 (70.8% of GDP). Service sector companies and SME have obviously been hit hardest (notably air transport, although it benefits from government support). However, the tourism, hotel and catering sectors account for a small share of all bank lending (1.1%). Production quotas and the decline in oil prices have weakened the hydrocarbon sector, but its debt burden is still moderate and the financial situation is stable. Higher oil prices and, to a lesser extent, increased production should help consolidate the sector.

Despite the recession, the ratio of loss loans and problem loans has remained practically unchanged at 10.7% between March and October. At the same time, however, the banks have restructured RUB 6.6 trillion in loans (about 9% of all loans), including RUB 5 trillion for major corporations, RUB 0.8 trillion for SME and RUB 0.8 trillion for households. Restructured loans are concentrated in the oil and natural gas sector (14%), the metal industry (13%), commercial real estate (12%) and the SME segment, all sectors combined (13%).

The need for additional provisions depends on the classification of restructured loans prior to restructuring. For now, the BCR allowed banks to postpone their provisioning needs for all loans (including restructured loans) through 1 April for major corporate loans and through 1 July for loans to households and SME.

Using the average provision coverage ratio observed for problem loans (52%) and assuming that these loans and those in the category just above them were restructured, the need for provisions would be RUB 1.6 trillion (i.e. 2.2% of all loans)[1]. Although provisioning charges will probably continue to rise, the increase in restructured loans slowed sharply in H2, for both companies and households alike.

Lastly, according to BCR, the banks' macro-prudential reserves account for 9% of all loans, which is largely sufficient to absorb any losses.

*Completed on 11 January 2021*

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1 The maximum is estimated at EUR 3.3 trillion if no provisions had been made for any of the restructured loans.

# POLAND



## A RESILIENT ECONOMY

**The second wave of Covid-19 that swept Poland in Q4 2020 was more severe than the first wave in Q2 2020. In contrast, economic growth was not hit nearly as hard thanks to the resilience of industrial output and demand (exports and household consumption). The authorities' stimulus measures combined with industry's competitiveness – which was not undermined much by the pandemic – bolstered growth, and the trade surplus increased. Against the background, a somewhat weak zloty is more a choice than a by-product of deteriorated fundamentals. The European budget agreement, as Poland is one of the main beneficiaries of the Recovery Plan, should provide additional support for growth.**

### THE SECOND WAVE OF COVID-19 WAS MORE SEVERE THAN THE FIRST

The curve of new Covid-19 cases and deaths suddenly worsened in October, with nearly 25,000 new cases a day. The Polish authorities responded by imposing a new lockdown as of November.

Limited primarily to retail stores, the new lockdown did not prevent manufacturing output from continuing to grow in November (5.1% year on year). It is now 3% higher than pre-Covid levels. This performance was mainly driven by automotive production and all of the sectors providing its inputs (plastics, metals, car suppliers).

The dichotomy between underperforming services and resilient manufacturing is expected to persist since the virus is still spreading actively and new restrictions were introduced in January 2021 (including the closing of schools for a month). Moreover, the vaccination campaign will be rolled out in several phases (with the healthcare workforce to be the first to benefit), which does not augur well for herd immunity before mid-2022 at the earliest, according to the timetable that was presented. This suggests that the most highly exposed sectors will continue to underperform in the quarters ahead.

### GROWTH SHOULD HAVE OUTPERFORMED IN Q4

Economic indicators have proven to be rather resilient. In terms of demand, exports seem to have been the main driver of Q4 growth (+9% y/y in September and October), thanks notably to the automotive industry. This is a remarkable performance considering that global exports of goods (excluding China) stagnated over the same period. Poland's strong performance is notably due to its attractiveness for non-resident investors in recent years, which developed both its export potential and the size of its domestic market.

As a result, the current account surplus swelled to 4% of GDP in 2020. During the year, there were no shocks to the country's capital flows (even foreign direct investment held up fairly well), and Poland managed to consolidate its foreign reserves, which facilitated the implementation of an accommodative monetary policy.

Household consumption also proved to be very resilient, levelling off in October and November near the September 2020 level, despite the shutdown of some retail segments. Poland is likely to be one of the rare countries in which Q4 consumption was stronger than pre-Covid levels. The European Commission survey on the opportunity to make major purchases also shows that Polish households have higher spending intentions than consumers do in most of the other EU countries.

**FORECASTS**

| | 2019 | 2020e | 2021e | 2022e |
|---|---|---|---|---|
| Real GDP growth (%) | 4.1 | -3.3 | 4.9 | 4.3 |
| Inflation (CPI, year average, %) | 2.4 | 3.4 | 2.4 | 2.7 |
| Gen. Gov. balance / GDP (%) | -0.7 | -9.0 | -5.0 | -2.8 |
| Gen. Gov. debt / GDP (%) | 46.0 | 58.0 | 60.0 | 58.0 |
| Current account balance / GDP (%) | 0.5 | 4.0 | 2.1 | 1.5 |
| External debt / GDP (%) | 59.4 | 56.8 | 50.0 | 46.0 |
| Forex reserves (EUR bn) | 114.5 | 127.1 | 133.3 | 137.0 |
| Forex reserves, in months of imports | 5.1 | 6.5 | 6.5 | 6.2 |
| Exchange rate EURPLN (year end) | 4.3 | 4.6 | 4.3 | 4.3 |

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

**MANUFACTURING PRODUCTION AND RETAIL SALES (LEVELS)**

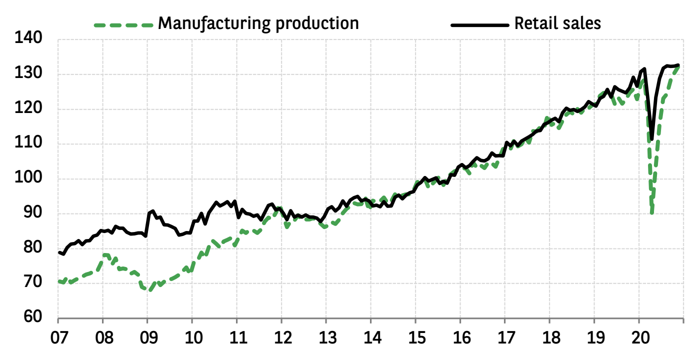


CHART 1 — SOURCE: CEIC

The labour market's relatively strong performance is a major support factor for the resilience of household demand: the unemployment rate was limited to 6.1% (vs a pre-Covid level of 5.4%) and wages have held up well. Consequently, unit labour costs rose sharply in Q2 (+10% y/y) before easing thereafter, although they are still holding at significant levels (+5.4% in Q3). Transport and logistics costs have also risen in the wake of the Covid-19 pandemic. Looking at December's manufacturing PMI, the record-high level of the input price component also illustrates the strong cost pressures. This has been partially offset by relatively low oil prices since March.

## THE POLICY MIX WILL REMAIN ACCOMMODATIVE, WHICH IS SUSTAINABLE

Poland entered the Covid-19 crisis with moderate public debt (46% of GDP in 2019). This should enable it to maintain economic support efforts in the short term, albeit smaller than those implemented last spring. The main difference is that the second wave of Covid 19 has had a smaller impact on activity in fall 2020 than in the spring (factories were allowed to remain open). The first economic stimulus plan was comprised of strictly fiscal measures equivalent to 4.5 points of GDP as well as a cumulative total of nearly 7 points of GDP of subsidised and/or state-guaranteed loans granted by the Polish Development Fund and by the state-owned bank BGK. All these factors drove up public debt to 58% of GDP in 2020.

Additional measures were rolled out in December for about 1.5% of GDP, but they were limited to the sectors hardest hit by the lockdown, such as the transport sector. These measures included the exemption of charges, subsidised loans and compensation for low activity (partial unemployment, assistance for households that have lost their jobs). Thanks to the smaller cost for public finances and positive nominal GDP growth, the increase in public debt should decelerate, to 60% of GDP in 2021.

As part of the European Recovery Plan, nearly EUR 19 bn (in subsidies) will be disbursed in 2021-2022 based on the assumptions published by the European Commission. The so-called "rule of law" clause is not applicable as long as the European Court of Justice (ECJ) has not ruled on the appeal filed by Hungary and Poland. Given the Court's usual delays in handling cases, this ruling is unlikely to disrupt the first disbursements.

The central bank (NBP) is not planning a new public securities purchasing programme. Under the first programme, it purchased the equivalent of 4.7% of GDP (i.e. more than 15% of the central bank's assets), which helped bring down 10-year rates from more than 2% before the Covid crisis to 1.25% in early 2021. Over the same period, the central bank has not changed its key rates since the rate cuts of spring 2020 (which brought the key policy rate to 0.1%). Even so, an accommodating bias remains in place with an implicit target of maintaining the zloty at relatively low level (PLN 4.6 for EUR 1 currently), even though the size of the current account surplus would justify a stronger currency.

## CREDIT RISK IS STILL MILD, BUT SHOULD RISE IN A MANAGEABLE WAY

The growth of bank lending to the non-financial private sector has dropped off sharply since the beginning of the Covid-19 pandemic. Loans outstanding amount to 50.7% of GDP. The increase in lending to the private sector (nearly 7 points of GDP) came from state-owned financial institutions (Polish Development Fund, BGK) and thus did not increase the exposure of the banking sector.

The first 6-month moratorium on the repayment of bank loans was initiated in March 2020 and ended in September. At the end of the first half of 2020, 12.3% of corporate loans and 8.4% of household loans were eligible according to NBP, although the banks determined eligibility on a case-by-case basis. The share of the loans eligible declined sharply thereafter, notably for households, as unemployment fears vanished rapidly. A new moratorium was introduced in mid-December 2020, but it is limited to corporate loans.and should not exceed 3 months for companies that already benefited from the first moratorium, and 6 months for the others.

10-YEAR GOVERNMENT BOND RATE (%)

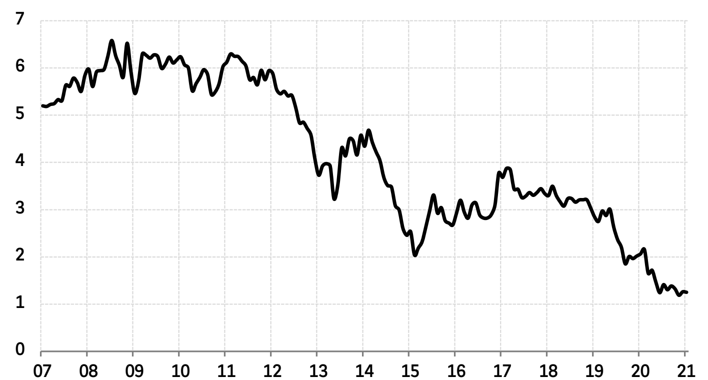


CHART 2 SOURCE: REFINITIV

By category, the share of late loan payments has not changed (5.7% of loan payments were late by more than 30 days), despite greater difficulties in the sectors' hardest hit by the pandemic. The increase in credit risk can be seen in the greater proportion of loans under close monitoring (which rose from 8% to 13% of corporate loans). These loans require provisions, which automatically affects bank profitability. The Return on Assets (ROA) diminished from 0.7% at year-end 2019 to 0.45% at the end of H1 2020. The restructuring of household loans previously granted in Swiss francs (CHF) also contributed to the decline in profitability: the ECJ ruled in favour of their cancellation, which meant that banks had to set aside provisions equivalent to 15% of their annual profit.

Against this background, the banks continue to be well capitalised (CET1 ratio of 16.9%) and should be capable of facing up to the risk of an increase in the non-performing loan ratio, which for the moment is holding at 3.8%.

*Completed on 11 January 2021*

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# CZECH REPUBLIC



## AN ACCUMULATION OF SHOCKS HAS HIT GROWTH

**Economic growth experienced several short-lived boom-bust wild swings in 2020, amplified by trade openness and the severity of the second wave of Covid-19 in the fall. However, the recovery in the 3rd quarter proved strong. Industrial production and exports both performed well, boosted by a stable exchange rate (and substantial foreign currency reserves). In addition, thanks to very modest debt levels, the government was able to offer rapid and substantial support to the economy.**

### AMONG THE WORST SECOND WAVES

The Czech Republic was one of the European countries hit earliest (the beginning of October) and hardest (75,000 active cases per million people) by the second wave of the Covid-19 pandemic. New lockdown measures were introduced, although these were less restrictive than in the spring of 2020 as industry continued to operate.

After improving slightly, the infection curve worsened again at the turn of the year, prompting the continuation of restrictions on movement and access to public spaces (as evidenced by the latest closure of restaurants on 18 December, after they had been allowed to reopen on 3 December). A vaccination programme has been announced, with the aim of vaccinating front-line health staff and the over-80s by the end of March. Once this phase is completed, anyone else will be able to register for vaccination and priority will be warranted along with the risk profile of each person.

The Czech lockdown strategy is relatively flexible. It is designed to limit contact between individuals whilst allowing the economy to continue to operate. It has several alert levels, allowing regular adjustment of the severity of restrictions, which so far has helped limit the number of businesses closed. However, the scale of the current 3rd wave suggests that restrictions in the 1st quarter of this year will be tough.

### FURTHER SHOCKS AHEAD IN 2021

Industrial activity was therefore able to continue to grow in the 4th quarter, and the sector even saw its manufacturing PMI climb to 57 in December 2020, its highest level since early 2018. The size of the automotive sector has been a fairly positive factor, as this sector saw both production and order books rise. This was a visible difference with the situation in the spring of 2020, when factories had to close their doors. Thus, manufacturing production in November 2020 was close to its pre-Covid level (up 3% in the case of the automotive sector).

Export growth was one of the engines of this performance: exports grew by 5% y/y in October and as much as 9.5% in November. Conversely, household consumption had to cope with stronger impacts from the resurgence of the Covid-19, with retail sales falling by 1.9% (month-on-month) in October and by 5.6% in November. As a result, consumption, which had regained its pre-Covid level in August, is now 8% lower, pointing to a very likely sizeable fall in GDP in the 4th quarter, under the effects of this resurgence.

Nonetheless, the Czech industry saw upward pressure on costs increase at the end of the year, a phenomenon driven by delays created by restrictions on transport, but also linked to high capacity utilisation rates. This has come on top of an increase in unit labour costs that had to be absorbed in the first half (9.5% y/y in the 2nd quarter), linked to the closure of factories and the fact that partial unemployment compensation did not fully offset the loss of activity.

FORECASTS

| | 2019 | 2020e | 2021e | 2022e |
|---|---|---|---|---|
| Real GDP growth (%) | 2.4 | -6.5 | 4.5 | 4.4 |
| Inflation (CPI, year average, %) | 2.8 | 3.2 | 2.5 | 2.4 |
| Gen. Gov. balance / GDP (%) | 0.3 | -7.5 | -6.5 | -3.1 |
| Gen. Gov. debt / GDP (%) | 30.2 | 40.0 | 42.0 | 41.5 |
| Current account balance / GDP (%) | 0.0 | 1.4 | 0.5 | 0.6 |
| External debt / GDP (%) | 77.3 | 78.3 | 68.5 | 64.4 |
| Forex reserves (EUR bn) | 113.0 | 132.0 | 138.0 | 142.0 |
| Forex reserves, in months of imports | 10.3 | 11.4 | 11.0 | 10.9 |
| Exchange rate EURCZK (year end) | 25.4 | 26.3 | 26.3 | 26.3 |

TABLE 1 e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

MANUFACTURING PRODUCTION AND RETAIL SALES (LEVELS)

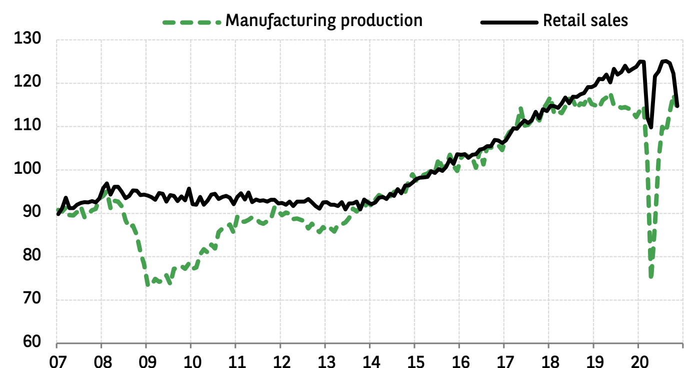


CHART 1 SOURCE: CEIC

Overall, the volatile pattern of growth in 2020 is likely to continue into 2021, although variations should be less extreme. This will delay the return to pre-Covid GDP levels to 2022, with growth over the whole of 2021 expected to be 4.5% (after a 6.5% contraction in 2020). The prospect of a global shortage of semiconductors will weigh on the automotive industry in early 2021. Given the size of the sector, it should have an impact on overall GDP growth.

## A SUBSTANTIAL LEEWAY TO EASE ECONOMIC POLICY

The Czech Republic has one of the lowest levels of government debt in Europe, at 30.2% of GDP in 2019. In 2020, automatic stabilisers and the implementation of a stimulus package worth 5.5 points of GDP did not threaten this situation, with debt still well below the 60% limit (40% at end-2020).

The stimulus package focused primarily on employment, through two mechanisms, one based on the payment of wages to workers exposed to partial unemployment (extended to the end of February 2021), the other (implemented in the 3rd quarter of 2020) on the suspension of payment of social security contributions by SMEs. Other measures were also introduced, including cuts in VAT on the most impacted sectors by Covid-19 and a mechanism for accelerated write-downs on investments made in 2020 and 2021, thus allowing a reduction in business tax bills. The European stimulus package is likely to help these efforts to support economic activity, with an expected initial payment of EUR 3.3 billion in grants (according to European Commission calculations). The government has issued 9 percentage points of GDP worth of potential guarantees on loans to the private sector in 2020 (a programme to be continued in 2021), whilst the period for which this guarantee will remain in force has been extended to April 2026.

Given the relatively low level of government debt, the central bank did not have to buy sovereign bonds, as there was no pressure on yields. The 10-year yield remained roughly around 1.25% in early 2021, slightly below the pre-Covid level. Monetary stimulus has therefore been concentrated on conventional measures, with cuts in the policy rate in the spring of 2020 (from 2.25% to 0.25%). The other pillar of the central bank's strategy has been to ease macroprudential ratios in a bid to support lending (increase in the loan to value ratio and a suspension of the debt to income ratio for households).

Indicators of debt (government and external) and liquidity (foreign currency reserves) have remained at comfortable levels despite last year's health crisis, which has helped limit financial tensions. The increase of the current account surplus and continued net capital inflows thus helped support foreign currency reserves. The decrease in the external debt ratio, interrupted in 2020 by the fall in nominal GDP, is likely to resume in 2021. All of this argues for a quite stable exchange rate for the koruna against the euro.

## BANKS ARE WELL CAPITALISED RELATIVELY TO THE FORESEEABLE INCREASE IN CREDIT RISK

Growth in banking sector lending to households held steady in 2020 at a rate of 6%, close to the 2019 level, whilst growth in lending to companies slowed to 3% (with relative stagnation from May).

The Czech authorities gave a 6-month moratorium on repayments on loans to the private sector (this expired in October 2020). In the end, this affected 16% of loans to non-financial companies, and 15% of loans to households. The authorities have not so far adopted a new moratorium, given the scale of those already granted in 2020.

Banks estimate that a share of the loans that benefited from this moratorium will become non-performing loans over the coming months, with an impact of 2 points on the non-performing loan ratio, which stood at 2.7% of total loans at end-September 2020. The greatest risk is related to non-financial companies, for which the central bank expects a non-performing loan ratio of 8.7% by end-2021. In addition, the central bank has observed that the households that made use of the moratorium were those with the highest debt and interest expenditure to income ratios. The expected increase in credit risk has resulted in a rise in provisions and a fall in profitability (in ROA terms) from 1.2% at end-2019 to 0.6% in the 3rd quarter of 2020.

FOREIGN CURRENCY RESERVES (EUR BN)

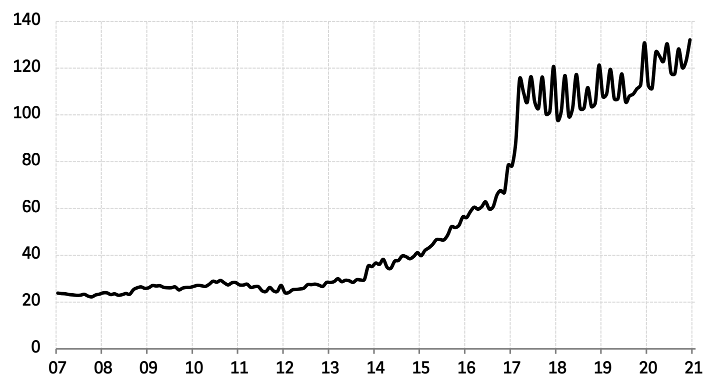


CHART 2 SOURCE: REFINITIV

At the same time, banks' capital has grown further, with a CET1 ratio of 20.7% in the 3rd quarter of 2020, demonstrating ample resources to deal with any shock.

*Completed on 11 January 2021*

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# ETHIOPIA



## DISRUPTED MOMENTUM

**Ethiopia is expected to report its lowest growth rate since 2003. Although the population has been relatively spared by the brunt of the Covid-19 pandemic, the cyclical economic environment has deteriorated sharply. The country has been hard hit by both a domestic shock and a decline in external revenues, which is squeezing its structurally low foreign reserves. Support from multilateral creditors will limit liquidity risk in the short term, but the current situation largely underscores the need for reforms. At the same time, political risk is rising with the emergence of socio-political tensions that pose significant challenges for Ethiopia's political and economic stability.**

### ECONOMIC MOMENTUM IS CUT SHORT

The Covid-19 crisis interrupted Ethiopia's growth momentum, which had averaged about 10% a year over the period 2004-2019. Driven by large-scale, debt-financed public investments, the country's growth model had already reached its limits and contributed to major imbalances. The current shock highlights these vulnerabilities and the need to accelerate reforms that aim to increase its reliance on foreign direct investment (FDI) through economic liberalisation. Although growth is expected to remain positive in 2020, it will sink to the lowest level ever witnessed since 2003.

The economic crisis is manifest in both the domestic and external shocks. Agriculture, which accounts for 80% of export revenues and nearly 40% of GDP, was especially hard hit by the sharp decline in harvests due to a massive locust invasion, military conflicts in the northern region and declining demand. The drop-off in external demand and the disruption of global supply chains also had major repercussions on exports of services.

At the same time, annual inflation soared to 20% in 2020. Fiscal and monetary measures to stimulate the economy helped drive up prices, but these measures are expected to wind down in the months ahead. In 2021, the economy is expected to continue slowing, with the latest forecasts calling for zero growth. Price inflation is expected to ease, but will remain high, with 2021 inflation estimated at 11.5%. The central bank should continue to make massive injections into the economy by participating in the financing of the public deficit.

FORECASTS

| | 2019 | 2020e | 2021e | 2022e |
|---|---|---|---|---|
| Real GDP growth (%) | 9.0 | 1.9 | 0.0 | 8.9 |
| Inflation (CPI, year average, %) | 15.8 | 20.2 | 11.5 | 8.0 |
| Central gov. balance / GDP (%) | -2.5 | -3.5 | -3.1 | -1.1 |
| Central gov. debt / GDP (%) | 56.9 | 56.6 | 55.8 | 56.9 |
| Current account balance / GDP (%) | -5.1 | -5.2 | -4.6 | -3.4 |
| External debt / GDP (%) | 31.1 | 32.2 | 34.4 | 35.8 |
| Forex reserves (USD bn) | 3.4 | 3.1 | 4.7 | 6.8 |
| Forex reserves, in months of imports | 2.4 | 2.1 | 2.7 | 3.3 |
| Exchange rate USDETB (year end) | 32.0 | 33.9 | 35.1 | 37.0 |

TABLE 1 e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

UNPRECEDENTED ECONOMIC SLOWDOWN AND RISING INFLATION

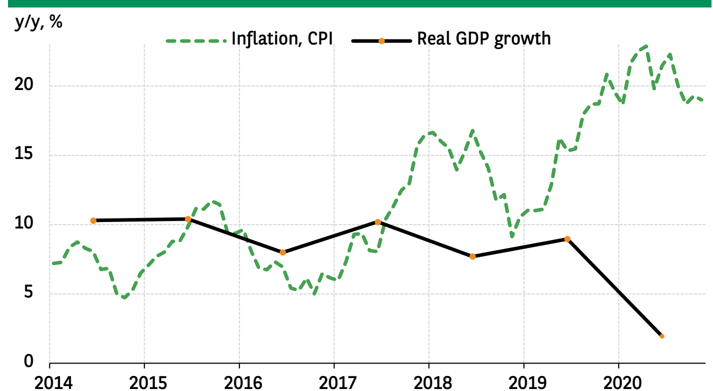


CHART 1 SOURCE: IMF, CENTRAL STATISTICAL AGENCY OF ETHIOPIA, BNP PARIBAS

### RESURGENCE OF POLITICAL AND MILITARY CONFLICTS

The downturn in economic prospects has been accompanied by a major deterioration in the political environment. The re-emergence of ethnic conflicts is a clear reminder of the country's fragile political situation. With the adoption of a new constitution in 2010 and the peace treaty signed with Eritrea in December 2018, the social-political environment entered a period of stabilisation. Abiy Ahmed's arrival as prime minister in April 2018 also made it possible to make some progress in terms of governance.

The social-political environment has deteriorated in recent months, however, due to growing discontent with the government. The arrest of prominent opposition leaders, the introduction of a law forbidding opposition members from serving as public officials, and heightened executive powers in the midst of a state of emergency sparked fierce criticisms. This frustration was expressed in popular protests and uprisings as well as in tensions within the government, and was only exacerbated by economic hardships, health restrictions and the postponement of general elections.

Tensions crystallised with the postponement of the general election, originally scheduled for August, and the extension of electoral terms. The deterioration in the political situation in the Tigre region in the northern part of the country is particularly concerning. The local authorities (Tigray People's Liberation Front, TPLF) decided to defy the postponement of the general election by holding elections in September. This move exacerbated the hostilities between the regional and federal authorities, resulting in the deployment of the military and armed conflict. These clashes risk sparking conflicts throughout the country

as ethnic demands emerge in other regions. The conflicts will not only have local consequences, but could have regional repercussions as well, since Ethiopia plays a major role in the region's security.

These tensions also add to the diplomatic disaccord with Sudan and Egypt concerning the finalisation of the Grand Ethiopian Renaissance Dam (GERD). Egypt and Sudan accuse Addis-Ababa of threatening their water supply, which is already irregular due to adverse weather conditions. Negotiations are still pending concerning the filling of the dam, which is likely to push back the project's completion, scheduled for 2023.

These factors are currently eroding any optimism about progress towards a real economic transition. The current environment is likely to hamper key reforms. Further tensions also risk delaying certain investments and privatisation projects by scaring off non-resident investors.

## EXTERNAL FINANCES COME UNDER GREATER PRESSURE

The postponement of foreign investment would be particularly harmful for the Ethiopian economy. The country suffers from a structural shortage of foreign currency, which is its main source of vulnerability. Its weak and volatile export base is largely handicapped by an overvalued exchange rate, and has been accompanied by growing import demand in recent years. This has reduced the amount of foreign currency revenues and increased liquidity risk.

Current levels are too low for the authorities to make adjustments to counter the shock. With the crisis, the current account deficit is expected to hold at about 5% of GDP. Despite the decline in imports of goods and services and improvements in the terms of trade (thanks notably to lower oil prices), exports are expected to cover only 18% of imports in 2020. Exports of services are expected to contract sharply (down an estimated 24% in 2020) given the sharp decline in tourism revenues, its main component.

The capital account is also expected to deteriorate in 2020 due to risk aversion and the lack of non-resident capital inflows. Net FDI has declined and covered only 40% of the current account deficit in 2020 (vs an average of more than 60% in 2015-2019).

The external financing need is estimated at USD 6.2 billion in 2020. The Debt Service Suspension Initiative (DSSI) is not included in this figure and will partially reduce this amount as well as next year's financial requirements. Still, foreign reserves are also very low, estimated at 2 months of imports. This leaves the authorities with very little manoeuvring room to deal with a massive liquidity shortage.

Despite efforts launched to develop the export base in the short term, imports are expected to increase more rapidly than exports and to widen the trade deficit.

The total stock of external debt is estimated at 30% of GDP in 2020 (60% of which is held by the central government). Although the level is still limited, the cost should continue to rise. The external debt servicing charge could swell to a third of exports, which would signal a state of alert. The currency's fixed exchange rate limits any adjustments to counter the shock.

Persistent current account deficits, low foreign reserves and the increase in external debt repayments therefore fuel external solvency risks.

SHALLOW LIQUIDITY DUE TO THE FOREX REGIME

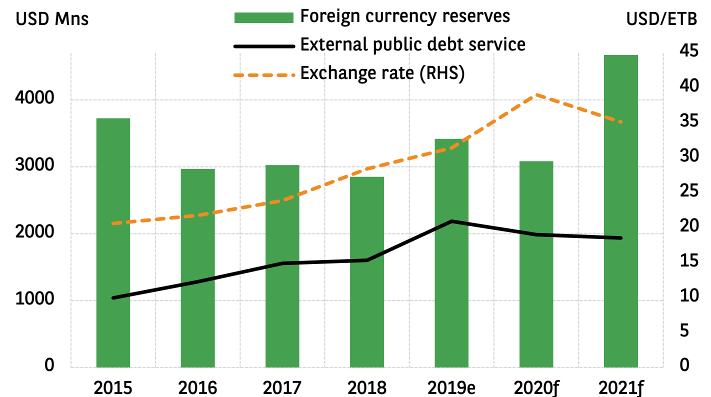


CHART 2 SOURCE: NATIONAL BANK OF ETHIOPIA, IMF, BNP PARIBAS

Fortunately, debt-restructuring agreements recently signed with China and the Debt Service Suspension Initiative (DSSI) with the Paris Club of creditors will help alleviate financial pressures in the short term. Emergency liquidity lines provided by the IMF and the World Bank are also a non-negligible source of funding. Yet given the large share of debt held by unofficial creditors and bondholders, sovereign risk in foreign currency is still very high: external debt accounts for more than half of total public debt (59%) and external debt servicing accounted for nearly 65% of foreign reserves in 2020. External public debt payments should increase in the years ahead with the refinancing of the USD 1 billion Eurobond maturing in 2024.

The IMF programme concluded in late 2019 is the key to shoring up the country's solvency and launching the structural reforms necessary to ensure the economy's attractiveness and debt sustainability. Adjusting the exchange rate is still one of the key short-term measures. Yet this reform would imply a short-term deterioration in the trade deficit, greater risk of inflation and a heavier debt burden. Although the country has some financial support, it is still walking on a tight rope.

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# TUNISIA



## ANOTHER HIGH-RISK YEAR

**With real GDP contracting by 8.5% in 2020, Tunisia was one of the region's most severely hit economies. The prospects of a recovery are highly uncertain. The economy is threatened by the resurgence of the pandemic, but the government no longer has the manoeuvring room that it had in 2020. The budget deficit and public debt have soared to alarming levels, which calls for a difficult consolidation of public finances. Although FX reserves have been stable, the country's external vulnerability is growing. The pandemic's shock has aggravated a structural deterioration in fundamentals. This could have lasting consequences.**

For a little more than a year, Tunisia has been faced with a triple whammy of overlapping political, health and economic crises. Since the legislative elections of October 2019, the country has already had three prime ministers. The cabinet that took office on 2 September 2020 has just been reshuffled and now needs to receive the approval of the parliament. Its ability to rule the country amid a highly fragmented political landscape remains to be seen. Yet there is an urgent need for action. A three-year financing agreement with the IMF seems highly necessary, although its signing has been pushed back by political paralysis. The IMF agreement could be adopted in Q1, but uncertainty remains high. The previous plan signed in 2017 was interrupted and it had to be replaced by emergency financial assistance following the outbreak of the Covid-19 crisis.

### PUBLIC FINANCES: GROWING PRESSURE

The deterioration in public finances is worrisome. Initially forecast at 3% of GDP, the budget deficit excluding grants is estimated to have reached more than 12% of GDP in 2020. About two thirds of the shock is due to the contraction in government revenue (5.5% of GDP). Meanwhile, spending was largely swollen by the payment of government arrears to state-owned companies and a new increase in the total wage bill for public-service employees (+15% compared to 2019), which has already been rising for several years. In 2020, it absorbed 67% of government revenue. The target of holding the increase in the wage bill below 5% in 2021 will be hard to reach in the face of strong social pressures. Other factors will continue to strain budget implementation in 2021, starting with the ongoing impact of the 2020 recession on fiscal receipts. To bring the fiscal deficit down to 6-7% of GDP, the government plans to withdraw several support measures introduced during the pandemic. Yet the situation is far from stable. In any case, covering financing needs will be challenging.

In addition to a high fiscal deficit, the government will also have to deal with significant debt amortization (see chart 1). Its borrowing strategy expects the amount of total loans to reach more than 16% of GDP – of which 70% are due to be external, the equivalent of 11.5% of GDP. This is 4 points higher than the average for the past five years. Tunisia is not currently benefiting from any IMF assistance and, without it, attracting support from international donors (which have provided more than half of its external financing since 2015) or tapping the international financial markets will prove to be difficult. There are also domestic financing constraints. For the first time, the government had to call on the central bank to directly finance part of its fiscal deficit in 2020. Although the amount was modest (2.5% of GDP), this strategy can hardly be replicated without undermining the monetary stabilisation gains that have been achieved over the past two years. This might be another sticking point in its negotiations with the IMF.

FORECASTS

| | 2019 | 2020e | 2021e | 2022e |
|---|---|---|---|---|
| Real GDP growth (%) | 1.0 | -8.5 | 4.0 | 2.6 |
| Inflation (CPI, year average, %) | 6.7 | 5.7 | 5.4 | 5.0 |
| Central Gov. balance / GDP (%) | -3.3 | -12.3 | -7.5 | -5.6 |
| Central Gov. debt / GDP (%) | 72.5 | 88.6 | 93.0 | 95.0 |
| Current account balance / GDP (%) | -8.8 | -7.2 | -8.1 | -7.4 |
| External debt / GDP (%) | 97.1 | 106.8 | 109.6 | 113.6 |
| Forex reserves (USD bn) | 7.4 | 8.0 | 8.2 | 8.0 |
| Forex reserves, in months of imports | 3.8 | 4.8 | 4.4 | 3.9 |
| Exchange rate USDTND (year end) | 2.80 | 2.71 | 2.90 | 3.05 |

TABLE 1 e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

GOVERNMENT FINANCING REQUIREMENT

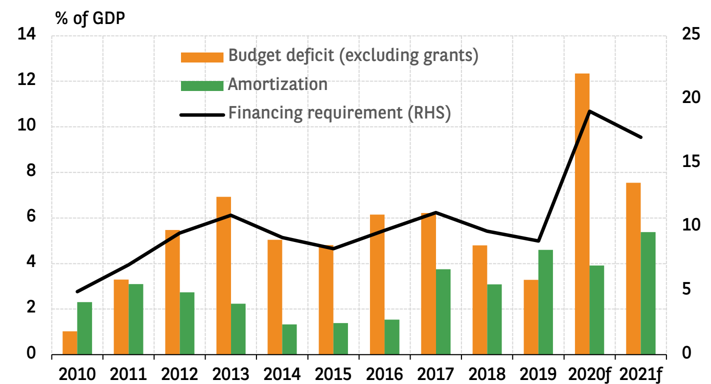


CHART 1 SOURCE: MOF, BNP PARIBAS

Moreover, a higher recourse to market financing would aggravate the increasingly alarming debt dynamics. Government debt is expected at 93% of GDP this year, 20 points higher than in 2019. Despite a debt stock that is still 45% owned by official creditors, the interest burden has risen rapidly. It absorbed 15% of government revenue in 2020, up from 10% in 2019, and it is bound to swell in the years ahead. With two-thirds of the debt denominated in foreign currency, the debt trajectory is also vulnerable to currency risk.

## EXTERNAL ACCOUNTS: A PRECARIOUS STABILITY

Tunisia has so far been able to absorb the external shock thanks to a significant fall in imports due to the contraction in economic activity and lower oil prices. Despite the collapse in tourism receipts and a downturn in manufacturing exports, the current account deficit has narrowed, FX reserves have been rebuilt and the dinar has remained stable against the euro, appreciating thus slightly against the US dollar. With FX reserves of USD 8.2 bn and external financing needs estimated at a little over USD 6 bn in 2021 (including the EUR 1 bn Eurobond in 2 tranches with an American guarantee), there is still a low risk of an imminent government default on its international bonds.

Yet the situation is fragile. Even though the current account deficit has narrowed, it remains high at about 7-8% of GDP. Meanwhile the spread of the pandemic continues to strain the main sectors that generate foreign currency. Moreover, as slow as it may be, the expected rebound in the Tunisian economy will fuel greater demand for imports. Foreign direct investment will also come under downward pressure and is unlikely to exceed 2% of GDP this year. This covers less than 25% of the expected current account deficit. Consequently, there is a significant gap to close, which could place new pressure on external liquidity and the dinar if international donors fail to provide sufficient financial assistance. Persistent external imbalances will also continue to drive up the external debt, which could approach 110% of GDP by year-end 2021, an increasingly unsustainable debt level.

## ECONOMIC GROWTH: PROBABLY A LASTING IMPACT

The capacity of the economy to rebound is highly uncertain. The year 2020 already got off to a bad start with real GDP declining by 2% year-on-year in Q1. Economic activity abruptly contracted by 21% in Q2 under the combined impact of strict lockdown measures, the collapse of the tourism sector, and the decline in European demand (75% of Tunisian exports). Despite the Q3 recovery, especially in the manufacturing sector, Tunisia reported one of the region's most severe recessions, with GDP contracting 9.6% on average in the first nine months of the year. The resurgence of the pandemic, both locally (with between 1,000 and 1,500 new cases each day since mid-October, compared to fewer than 50 cases during the first wave) and among its main trading partners, is also threatening the economy again. Major efforts have been deployed to secure vaccine supplies, thanks notably to the World Health Organization's Covax initiative. Yet the vaccination campaign will not start up before early Q2.

In the meantime, the government has virtually no fiscal manoeuvring room. Capital expenditure barely exceeds 3% of GDP in the 2021 finance bill, more than 2 points less than in 2019. CAPEX is likely to act as an adjustment variable in case of renewed pressure on Treasury's liquidity. In comparison, the total wage bill for public-sector employees is projected at 16.6% of GDP this year.

Monetary policy is also constrained. The continued decline in the inflation rate, in part due to the strong dinar, has certainly allowed the central bank to lower its key rate by 150 basis points to 6.25% (see chart 2). Yet its approach remains cautious, and real interest rates are still positive. Moreover, monetary easing will only marginally improve the poor health of the banking sector. With a non-performing loan ratio of 14% at year-end 2019 (of which provisions cover only 55%),

MONETARY ENVIRONMENT

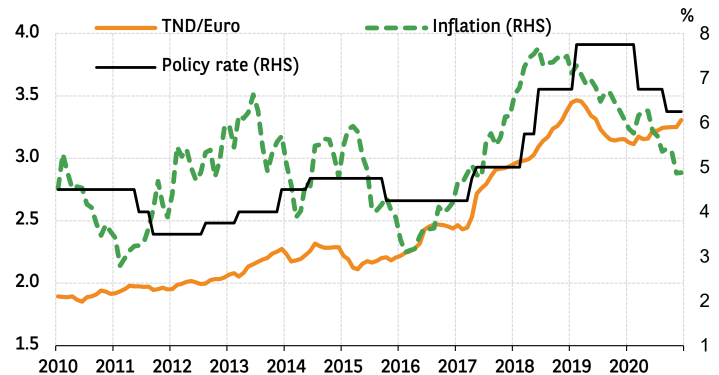


CHART 2 SOURCE: NATIONAL STATISTICAL OFFICE, CENTRAL BANK

the quality of bank loan portfolios was already deteriorated before the crisis, especially among state-owned banks (one third of the banking system). The moratorium on loan payments has so far helped limit the impact of the Covid-19 shock. Yet pressures on the banking system are bound to intensify due to its high exposure to the most vulnerable sectors (manufacturing accounted for 23% of loans outstanding at year-end 2019; commerce, 16.7%; and tourism, 4.8%).

The expected rebound in economic growth in 2021 remains hypothetical (forecasted at 4% after a recession estimated at 8.5% in 2020). Even if this is confirmed, real GDP would be still 4.8% below the 2019 level. The epidemic's shock could have a lasting impact because it slams an economy already weakened by a decade of sluggish growth (1.6% on average between 2011 and 2019). This has been the consequence of a declining trend in private-sector investment (from an average of 17.5% of GDP in 2000-2010 to 15.2% in 2011-2019) and the steady deterioration of fundamentals. In particular, the need to consolidate public finances means that new sources of economic growth will have to be found in order to reduce the unemployment rate, which has now reached 16.2%.

*Completed on 18 January 2021*

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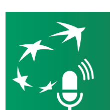

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