# ECO EMERGING

2nd quarter 2022

## EDITORIAL



ECONOMIC RESEARCH

BNP PARIBAS

The bank
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# EDITORIAL



## EMERGING COUNTRIES WILL BEND BUT NOT BREAK

**Emerging countries are now facing another major shock whereas the post-pandemic recovery has remained fragile. The war in Ukraine will impact emerging countries through its negative effects on foreign trade, capital flows and, above all, inflation. The indirect effect of soaring global commodity prices on inflation households' purchasing power may be particularly severe, and affect mostly low-income countries in Africa, Central Europe and the Balkan region. In spite of these gloomier prospects, we do not expect a broad-based worsening in sovereign and external solvency in emerging countries in the short term. However, a few governments, especially in Africa and the Middle East, may rapidly experience payment difficulties.**

Before the military confrontation in Ukraine, we were cautiously optimistic for Emerging Markets (EMs). Activity had recovered its Q4 2019 level in a majority of countries. In January-February, global economic activity was on a recovery path from the Omicron-led temporary drag and supply-chain constraints in the manufacturing industry were abating. However, caution was justified by the general acceleration in inflation and the new deterioration in the Covid epidemic curve in Europe, Asia and, most worryingly, in some industrial regions in China.

After the Covid shock in 2020-2021, EMs are now facing a second major shock whereas the post-pandemic recovery has remained fragile, especially for low-income countries (LICs). The military confrontation is basically a supply shock that will impact EM and LIC economies through various channels (trade, inflation, financial).

For EMs as a whole, the financial impact has been moderate so far. Exchange rates have either stayed stable or appreciated for commodity exporters. Spreads on foreign currency-denominated debt have widened only for non-investment grade borrowers. Equity markets have been resilient, not only in Asia (excluding China) and Latin America, but also in EMEA markets (excluding Russia), a region deemed to be the most impacted. Lastly, EM banks' exposure to Russia is very limited, even for Central European countries and Turkey that are the most exposed.

The direct demand impact of the huge contraction of imports from Russia and Ukraine should not be very significant, except for CIS countries and, to a lesser extent, Central European and Balkan countries (CEBCs) and Turkey.

### INFLATION RISK

The indirect impact of the surge in commodity prices on inflation should be more harmful as it will severely dent the population's purchasing power in all regions. The commodity price shock is comparable to previous shocks and is observed across-the-board (energy, metal and food prices). The commodity price shock will hit first and foremost LICs in Africa (whether commodity exporters or not) as 50% of them have an import dependency on cereals of close to 50% or more. As for commodity exporters, especially in Latin America, the negative inflationary impact on private consumption should be offset by the windfall gain in terms of trade. But this requires that governments implement a pro-active redistribution policy. Regarding commodity importers, CEBCs and Turkey are expected to be more severely impacted than Asian countries as they are characterized by a much larger share of imports of energy, metals and soft commodities from Russia and Ukraine. As a consequence, producers will face both supply constraints and the rise in energy prices. Households will also be comparatively more impacted as the weight of energy in CPI is larger than in Asian countries. As a consequence, monetary policies in CEBCs will be tightened further.

### SOVEREIGN RISK : ONLY A FEW COUNTRIES ON THE SPOTLIGHT

Despite these gloomier perspectives, we maintain our cautious and selective approach when assessing sovereign risk in emerging countries. Firstly, most EMs will face the new shock with a generally sound external liquidity and even an unscathed external solvency compared with the situation at end-2019 – with the exception of Argentina, Egypt and Turkey.

For commodity importers, the impact of the surge in commodity prices on external accounts will be obviously negative. But given the expected deceleration in import volumes, we do not expect a deterioration in the current account deficit to above 5% of GDP, except for Egypt, Morocco, Romania, Tunisia and Senegal. In Egypt, the deterioration in current account imbalances, the strong dependency on grain imports and the memory of the bread riot in 1977 and social tensions in 2008 have triggered a sell-off from foreign investors on the sovereign domestic debt market. Monetary authorities have been forced to devalue the pound and the government has asked for IMF support.

Secondly, beyond the across-the-board increase in public indebtedness between 2019 and 2021 (+10pp of GDP on average or on median), major indicators used to assess sovereign solvency have remained satisfactory or have deteriorated less than feared. Interest-to-revenue ratios have moderately increased (by about 1% on median), and the share of foreign currency-denominated debt and the share of domestic debt owned by non-residents have decreased. Countries for which both solvency and liquidity indicators are the weakest and/or have deteriorated the most since 2019 are almost exclusively in the Middle East & Africa region. Argentina remains very fragile with a public debt ratio unchanged and mostly in foreign currency, but it has obtained the rescheduling of its debt to the IMF and the current account surplus should consolidate.

Thirdly, despite the rise in domestic government bond yields and/or spreads on external borrowing, the gap between the cost of borrowing and GDP growth (the so-called "snowball effect") will remain negative, i.e. favourable, for debt dynamics – except for Egypt, Russia, South Africa and, to a lesser extent, Brazil. Turkey is an outlier but in a positive way as, despite the surge in domestic rates and the depreciation of the currency, the snowball effect will be even more negative provided that the country avoids recession.

In the short term, the key indicator to assess sovereign solvency remains repayments of international bonds and loans of sovereigns & quasi sovereigns compared with either official foreign reserves or net foreign assets of the sovereign (if they are larger than reserves). On the basis of this ratio, countries that need to be closely monitored are Bahrain, Angola, Croatia, Egypt, Oman and Turkey. For these countries, repayments represent at least 50% of official foreign-currency liquidity/assets. There is a second group of countries that deserve attention since the ratio ranges between 20% and 30% (Argentina, Indonesia, Ghana, Romania, Tunisia and Ukraine).

Angola, Argentina, Bahrain, Ghana, Indonesia and Oman should manage to fulfill their obligations thanks to the commodity price bonanza. Croatia, Indonesia and Romania still benefit from an affordable cost of external borrowing. Turkey and Egypt have managed to secure financing from Gulf States so far (credit lines for Egypt, international bond purchases for Turkey) but market financing is very costly now. Tunisia is in the weakest position as support from international financial institutions has been suspended pending an agreement with the IMF.

*Writing completed on 11 April 2022*

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# CHINA



## ANOTHER ABRUPT SLOWDOWN

**After a strong start in 2022, China's economic growth slowed in March. Headwinds are expected to persist in the very short term. Firstly, the rapid surge in the number of Covid-19 cases has led many regions to impose severe mobility restrictions. Secondly, the property market correction continues. Thirdly, producers and exporters will be affected by the impact of the war in Ukraine on commodity prices and world trade. Therefore, China's official economic growth target, which has been set at 5.5% for 2022, seems highly ambitious. The Chinese authorities are accelerating the pace of fiscal and monetary easing.**

After improving in the first two months of 2022, China's economic growth slowed again in March. According to the purchasing managers indexes (PMI) released in late March, activity has been eroding in the manufacturing and non-manufacturing sectors, and expectations for domestic and international demand have also deteriorated. The corresponding PMIs and their components have all declined, dropping below the 50 threshold (chart 1). The slowdown is bound to continue in the very short term due, domestically, to a new wave of the Covid-19 pandemic and the ongoing correction in the property market and, externally, to the impact of the war in Ukraine on commodity prices and world trade.

### A NEW SURGE IN COVID-19 CASES AND LOCKDOWN MEASURES

In the services sector, activity began to pick up in January-February (+4.2% y/y vs. +3.3% in Q4 2021), and growth in retail sales volumes also accelerated (+4.9% y/y vs. less than 2% in Q4). Yet this rebound was cut short in March ; activity in the services sector contracted by 0.9% y/y and retail sales volumes fell by nearly 5%.

Many provinces have introduced strict mobility restrictions to counter a very strong surge in the number of Covid-19 cases, as China maintains a zero-Covid strategy while vaccination coverage is insufficient (86% of the entire population had received 2 doses of the vaccine at the end of March, but only 82% in the 70-79 age group and 51% in the over-80 age group). In the first week of April, the cities and regions that had imposed total or very strict lockdown measures (including Shanghai and Jilin) accounted for about 12% of China's GDP. Cities imposing less restrictive measures accounted for more than 50% of GDP (up from 30% just two weeks earlier). Although the authorities should seek to limit the impact of these restrictions on factory output, some production sites are currently reporting disruptions. Above all, merchandise transport and a number of other services sectors (leisure, retailing, mobility, etc.) are being hard hit, a situation that could last for several more weeks.

The health crisis is not helping the property market. The correction let up somewhat in January-February thanks to the very slight easing of financing conditions, but it is worsening again. Average house prices are decreasing slowly (the average price for the 70 biggest cities has dropped by about 2% since July 2021) and transaction volumes continue to fall (-17% y/y in March vs. -10% in January-February), which is adding to the troubles of property developers.

After accelerating since October (+7.5% y/y in January-February, vs. 3.9% in Q4 2021), industrial growth slowed again in March (+5% y/y). It should remain hampered by anti-Covid measures and sluggish domestic demand, as well as by the slowdown in world demand and new supply chain disruptions triggered by the war in Ukraine. After an extremely solid performance in 2020 and 2021, exports are expected to slow significantly in 2022. High commodity prices will drive up the cost of imports, and China's trade and current account surpluses are bound to shrink rather quickly.

FORECASTS

| | 2019 | 2020 | 2021 | 2022e | 2023e |
|---|---|---|---|---|---|
| Real GDP growth, % | 6.0 | 2.2 | 8.1 | 4.8 | 5.1 |
| Inflation, CPI, year average, % | 2.9 | 2.5 | 0.9 | 2.4 | 2.7 |
| Official budget balance / GDP, % | -2.8 | -3.7 | -3.1 | -2.8 | -3.0 |
| Official general government debt / GDP, % | 38.6 | 45.9 | 46.9 | 49.8 | 52.2 |
| Current account balance / GDP, % | 0.7 | 1.9 | 1.8 | 0.5 | 0.8 |
| External debt / GDP, % | 14.5 | 16.3 | 15.5 | 16.1 | 16.3 |
| Forex reserves, USD bn | 3 108 | 3 217 | 3 250 | 3 210 | 3 230 |
| Forex reserves, in months of imports | 14.9 | 16.3 | 12.6 | 10.6 | 10.0 |

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

ECONOMIC GROWTH SLOWING AGAIN IN MARCH

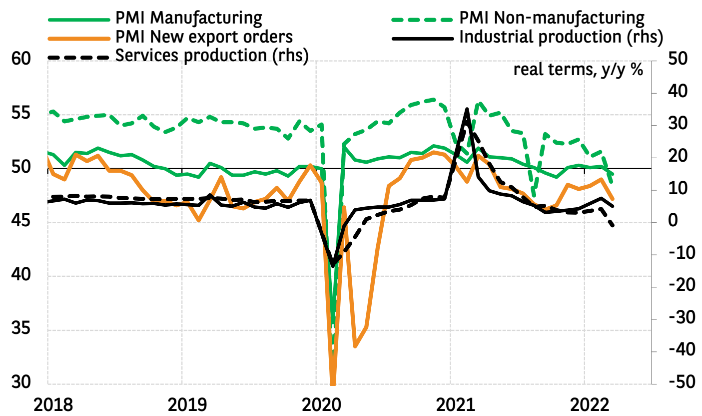


CHART 1

SOURCE : NBS

### REPERCUSSIONS OF THE WAR IN UKRAINE

The direct impact of the war in Ukraine on China's economic activity should be moderate. On the one hand, China's exports to Russia and Ukraine account for only 2.3% of total exports, while its purchases from these two countries account for only 3% of total imports. Trade and financial ties between Russia and China have increased over the past decade in an environment marked by US and European sanctions against Moscow. In 2020, nearly 20% of their trade flows was denominated in RMB.

Ties between the two countries are currently being maintained, but they are unlikely to be strengthened much in the short term. China has only limited capacity to increase imports of Russian goods given the current economic slowdown and also due to logistical constraints (lack of pipelines, cost of shipping goods). Moreover, even though Beijing officially denounces the international sanctions against Moscow, Chinese institutions are likely to comply with them out of fear of secondary sanctions by its main trading partners (the United States and the EU absorb 33% of Chinese exports).

On the other hand, the surge in global commodity prices should have only a mild impact on China's consumer price index (CPI) and household purchasing power in the short term, thanks notably to the existence of partial controls on energy and grain prices. China can also draw on its grain reserves, which are very comfortable (at year-end 2021, it was estimated that wheat stocks could cover at least a year of local consumption). Moreover, the decline in meat prices over the past year has maintained deflationary pressures on food prices (-3.1% y/y in Q1 2022). CPI inflation was only 1.5% in March (up from 0.9% in January and February) and should be comfortably below 3% in 2022.

In contrast, producer price inflation is expected to stay high (8.7% y/y in Q1), which should strain industrial activity. Some sectors will also face supply chain problems, at least for products coming from Ukraine. China is dependent on Ukraine for supplies of corn (over 50% of its total corn imports), barley (26%) and sunflower oil (59%). Meanwhile, imports from Russia are likely to operate more normally. About half of these imports are made of oil (which accounted for 14% of China's total oil imports in 2020). China also depends on Russia for supplies of timber (19% of total timber imports), fertilizers (22%) and industrial metals (about 7%).

## IMMEDIATE MEASURES TO BOOST GROWTH

During the annual National People's Congress meeting in early March, the authorities presented their macroeconomic goals for 2022. China's official economic growth target, which has been set at 5.5% for 2022, seems to be very ambitious in the current environment, especially after a mixed Q1 performance (real GDP grew by 4.8% y/y, reflecting two solid months of growth followed by an abrupt slowdown in March). Policy easing, which has been underway since Q4 2021, is expected to be accelerated in the weeks ahead.

Beijing set its official budget deficit target[1] at 2.8% of GDP in 2022, down from 3.1% in 2021. This reduction does not foreshadow any fiscal tightening, but should be seen more as an indication of the authorities' cautious approach and their determination to contain the slippage in public accounts. In fact, the government is considering major stimulus measures. They will be partly financed by the carryover of funds that were budgeted but not used in 2021. Moreover, as is often the case in China, stimulus measures will also be covered by "government-managed funds"[2] and other quasi- and extra-budgetary funds. In its 2022 budget report, the finance minister is projecting a general budget deficit[3] of 4.7% of GDP (vs. an actual deficit of 3.8% in 2021), a government funds deficit of 3.4% (vs. 1.4% in 2021), and a consolidated budget deficit for all government bodies[4] of 7.3% (vs. 4.4% in 2021). These figures give a more exact (but still incomplete[5]) idea of the significant size of the stimulus planned for 2022. The main measures will comprise new public infrastructure investment (especially in transport, water conservation, irrigation and digital facilities) as well as major subsidies and tax cuts notably aimed at supporting small and mid-sized enterprises and the manufacturing industry. The 2022 budget report also mentions measures to support households.

**SLIGHT EASING IN DOMESTIC CREDIT CONDITIONS**

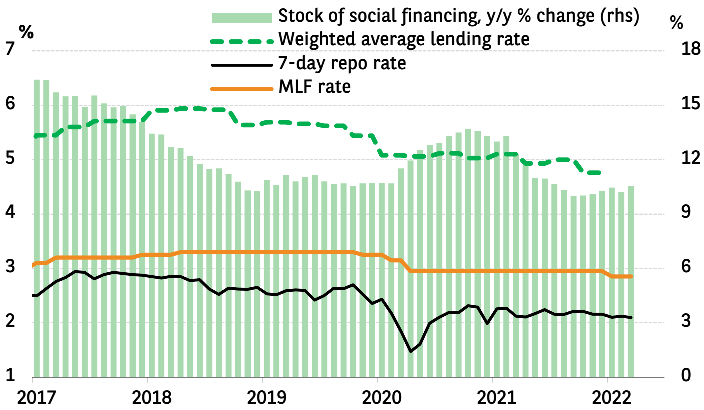


CHART 2 SOURCE : PBOC

Monetary policy and credit conditions have been gradually eased since Q4 2021, via targeted measures (such as lending programmes to support SMEs, rural area development and innovation), the reduction in reserve requirement ratios (which were lowered from 12% to 11.5% in December for the large banks) and interest rate cuts. Mortgage lending conditions and access to short-term financing for property developers were also eased slightly, the main goals being to help developers to complete existing development projects, reassure households and contain the crisis in the real estate sector. New interest rate cuts are expected in Q2 2022. Total social financing growth, which had slowed during the first three quarters of 2021, has barely picked up since October (chart 2).

Lastly, after months of regulatory tightening in the digital services sector, the authorities announced some policy adjustments in mid-March. This has reassured investors and might lift some of the obstacles to economic growth in 2021.

*Writing completed on 19 April 2022*

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1 For a definition of China's various fiscal balances, see "China's public finances, a tangled web", Eco Conjoncture, BNP Paribas, Sept. 2021.
2 These funds are managed outside of the general budget, essentially by local governments, and mainly financed through land sales proceeds and special bond issues.
3 The general government deficit (central government + local governments), excluding transfers from other public accounts.
4 General government budget + government-managed funds + budget of state capital operations + social security fund.
5 The budget report does not take into account extra-budgetary operations, which are notably covered by local governments' financing vehicles.

# INDIA



## NEW HEADWINDS

**The international economic and financial environment is not helpful for the Indian economy. Although India produces and exports wheat, it will suffer from surging commodity prices. Slowing growth is likely to hamper the government's announced fiscal consolidation. The government will be forced to increase fertiliser subsidies sharply if it wants to contain the increase in domestic food prices, which make up almost 46% of consumer spending. India will not be able to avoid a significant deterioration in its current account deficit driven by higher oil prices and downward pressure on the rupee, especially if recent portfolio investment outflows continue. The results of the recent regional elections should ensure a degree of political stability at least until the 2024 general election.**

### GROWTH ALREADY SLOWING BEFORE THE CONFLICT IN UKRAINE

In the third quarter of fiscal year 2021/22 (September-December 2021), India's economic growth flagged. Real GDP growth was only 5.4% y/y as opposed to 8.5% in the previous quarter. In calendar 2021, although growth rebounded by 8.1% relative to 2020, the increase compared with 2019 was a modest 1%.

Growth forecasts for the full fiscal year (ended 31 March 2022) remain favourable, but have been downgraded because of the international geopolitical situation and rising commodity prices. Economic indicators for early 2022 also remain mixed. It appears that growth began to slow well before the conflict in Ukraine.

Consumer spending remains particularly fragile. Since November 2021, automobile sales have been lower than pre-Covid levels. The labour market is struggling to regain its pre-pandemic impetus. In mid-April, the unemployment rate was 7.8% as opposed to 7.3% in 2019, and the employment rate was only 37.6% in January versus almost 40% in 2019. In addition, despite slowing domestic demand, inflationary pressure has remained significant. In February, inflation was 6.1% y/y, even though not all of the increase in oil prices filtered through to consumers in the form of higher petrol prices. Slower growth in domestic demand is confirmed by a slight decrease in VAT receipts in January and February compared with the previous months, although they were well above pre-Covid levels.

In February, industrial production slowed significantly relative to January, as did the pace of bank lending, although the latter remained faster it was than before the pandemic. Business confidence indices remain strong, with PMIs still showing an acceleration in demand, although they have fallen slightly from their November 2021 highs.

### LIMITED DIRECT IMPACT FROM THE CONFLICT IN UKRAINE...

The conflict in Ukraine will have a limited direct impact on India's economy, because India's trade with Russia and Ukraine is extremely modest. Its exports to those two countries make up only 1% of its total exports, and imports from them account for only 1.7% of the total.

### ... BUT MULTIPLE INDIRECT RISKS

However, there are significant economic risks. India is facing two external shocks, one from rising US interest rates and the other from rising commodity prices. Fortunately, India's external accounts are solid and it should be able to cope with the deterioration in its balance of payments. Its foreign exchange reserves are now much more comfortable than they were in 2013. They equal 20.1% of GDP – just over twice India's short-term borrowing requirement – as opposed to 16.2% at the end of 2012 (one times the borrowing requirement).

**FORECASTS**

| | 2019 | 2020 | 2021e | 2022e | 2023e |
|---|---|---|---|---|---|
| Real GDP growth, % (1) | 4.2 | -7.2 | 8.9 | 7.3 | 6.0 |
| Inflation, CPI, year average, % (1) | 4.8 | 6.1 | 5.5 | 6.7 | 5.5 |
| General Gov. Balance / GDP, % (1) | -7.3 | -13.7 | -10.6 | -9.3 | -8.5 |
| General Gov. Debt / GDP, % (1) | 73.7 | 84.0 | 83.6 | 82.5 | 82.4 |
| Current account balance / GDP, % (1) | -0.9 | 0.9 | -1.5 | -3.6 | -2.1 |
| External debt / GDP, % (1) | 19.9 | 21.6 | 19.7 | 19.4 | 18.7 |
| Forex reserves, USD bn | 457 | 580 | 633 | 650 | 675 |
| Forex reserves, in months of imports | 7.7 | 11.0 | 9.1 | 8.8 | 8.9 |

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

**CONSUMER PRICE INDEX**

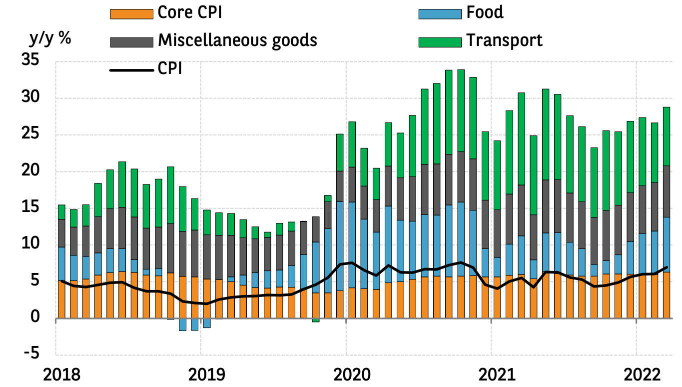


CHART 1

SOURCE : CEIC

Higher US interest rates could result in major capital outflows and cause the rupee to weaken, particularly if India's central bank (the RBI) maintains its loose monetary policy. Between December and February, net portfolio investment outflows attributable to foreign investors amounted to 1.5% of GDP annualised, whereas portfolio inflows totalled 1.2% in the whole of 2021. However, the rupee remained relatively stable (down 1.6% between December and February) due to central bank intervention in the forex market.

The sharp rise in commodity prices resulting from the conflict in Ukraine and sanctions against Russia represents a greater risk.

As regards food supplies, Ukraine is India's biggest foreign supplier of cereals (34.3% of imports) and oils (15.8%), and India imports most of its fertiliser from Russia (61%). However, sharply higher cereal prices should have a modest impact, because India's cereals imports are limited (except for maize). India produces and exports both wheat and rice. Conversely, it is a major consumer and importer of animal and vegetable oils. In March 2022, domestic food oil prices rose by almost 30%, pushing up retail price inflation by 12 basis points (bp). Finally and most importantly, India imports fertilisers, the price of which is closely correlated with gas prices. Higher fertiliser prices could drive up food prices further in the next few months, unless the government significantly increases subsidies.

India also imports a large amount of metals, particularly precious metals, and above all mineral fuels. Metals accounted for 12.3% of its imports in 2019 and mineral fuels 31.9%. The rise in energy prices (up 54.9% in the first three months of 2022) and precious metals prices (up 9.3%) is likely to widen India's current account deficit and lead to greater inflationary pressure.

In the three months from December to February, India's trade deficit in petroleum products was almost 30% higher than the annual average in 2019.

According to RBI estimates, a 10% rise in the crude oil price reduces growth by 0.2 points, increases inflation by 0.3 points and increases the current account deficit as a proportion of GDP by 0.4 points if it were passed on in full to the real economy.

To contain the impact of higher oil prices on real consumer incomes, however, the government could decide to cut taxes or increase subsidies. Taxes make up almost 50% of the petrol price paid by Indian consumers. By the end of March, the government had not announced any measures to support its economy. However, anticipating higher oil costs, it sharply increased crude oil purchases from Russia in February and March, at a heavily discounted price (USD 30 below the Brent crude price, excluding transport and insurance). However, those purchases (13 million barrels in two months, as opposed to 16 million in the whole of 2021) remain marginal compared with India's needs, since its oil imports totalled 4.9 million barrels per day in 2021.

As a result, assuming that international commodity prices remain high, the boost to inflation in 2022/23 could reach 1.5 points, and the current account deficit/GDP ratio could be 2 points higher.

## BUDGET AT RISK FOR FISCAL YEAR 2022/2023

The budget presented in February for the 2022/23 fiscal year ending 31 March 2023 is expansionary. The government is preferring to support growth rather than shore up its public finances. In particular, it is planning a 24.5% increase in public investment.

As a result, the government is expecting a modest reduction in its budget deficit (excluding the deficit of India's states) from 6.9% of GDP (revised budget for 2021/22) to 6.5%. However, that budget now looks optimistic. It was prepared before the conflict in Ukraine and includes a 27% reduction in subsidies (equal to 0.7 points of GDP) compared with the revised 2021/22 budget. Subsidies were to be cut on fuel oil, fertiliser and food in 2022/23, although they would still have remained higher than pre-Covid levels.

However, upward pressure on commodity prices and the downside risk to growth will probably force the government to increase its expenditure on subsidies, hampering the announced fiscal consolidation.

INDUSTRIAL OUTPUT

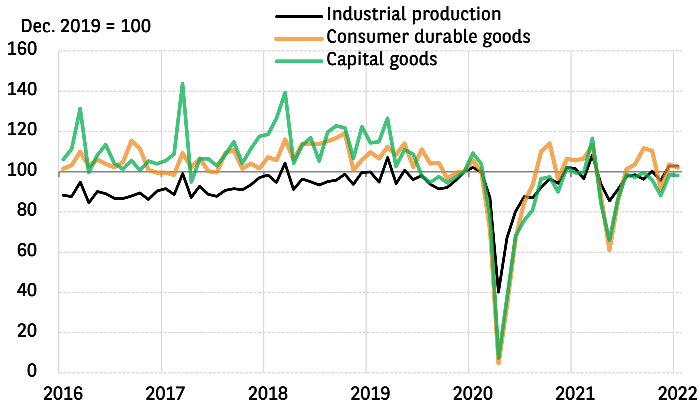


CHART 2 SOURCE : CEIC

## THE BJP'S VICTORY IN THE REGIONAL ELECTIONS

Narendra Modi's party, the BJP, maintained control over four of the five Indian states that held regional elections in February and March. Its victory in Uttar Pradesh (UP) is a good sign for the prime minister since it is India's most populous state and a good indicator of how the 2024 general election will go. However, the BJP's position in UP is less comfortable than it was 2017, since it won 251 seats there as opposed to 312 five years earlier.

The BJP also lost control of Punjab, finishing behind the Aam Admi Party (AAP), which won its first ever state. In Gujarat and Himachal Pradesh states, which the BJP currently controls, elections will take place in late 2022.

Overall, these election results should ensure a degree of political stability until the next general election and possibly beyond.

*Writing completed on 11 April 2022*

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# HONG KONG



## SHOCK FOLLOWS SHOCK

**The economic growth recovery has been unbalanced since the health shock in early 2020 and has rapidly lost steam. It was then interrupted in the first quarter of 2022, due to a very sharp rise in the number of Covid-19 infections and deaths linked to the Omicron variant. The epidemic wave is starting to recede, but Hong Kong will now have to face the effects of a slowing global trade, rising commodity prices and the tightening of US monetary policy. Despite these unfavourable conditions, sovereign solvency remains very robust and the government keeps a strong capacity to continue an expansionary fiscal policy.**

After two years of contraction, Hong Kong's economy grew by 6.4% in 2021. However, its recovery started to run out of steam in Q2 2021, and activity came to another sharp stop in Q1 2022 due to a major resurgence of the pandemic. Real GDP returned to its pre-Covid level of end-2019 last year, but it is unlikely to regain its end-2018 level (i.e., prior to the protest movements) until the second half of 2022.

### A STUTTERING RECOVERY IN 2021...

The Covid-19 shock in early 2020 hit an economy that was already in recession. After several quarters of contraction, private consumption, investment, tourism and goods exports all collapsed in H1 2020. Activity – with the exception of tourism – then recovered rapidly, supported by a large fiscal stimulus package, an easing of monetary conditions and the strong acceleration of foreign trade. However, the recovery has remained unbalanced and has rapidly lost steam, before being interrupted in Q1 2022.

While foreign trade recovered strongly after the shock in Q1 2020, boosted by the very solid performance of Chinese exports, domestic demand lagged behind despite the very accommodative policy mix. The investment ratio, which fell from 21.6% of GDP in 2018 to 17% in 2020, barely improved in 2021 (reaching 17.5%), held back by the territory's loss of attractiveness and worsening economic prospects. Private consumption (65.2% of GDP in 2021, down from 68.4% in 2018) faced significant constraints, notably including border closures (purchases by non-residents, primarily from China, represented nearly half of retail sales before the health crisis), a degraded labour market and low consumer confidence. The labour market has not regained its position from before the crises of 2019 and 2020, with the hardest-hit service sectors also being the most labour-intensive, such as restaurants and hotels. Between Q4 2018 and Q4 2021, real wages grew by less than 1% and total employment fell by 4.8%. The total population and the active population also fell over the same period, by 1.1% and 3.8% respectively. The unemployment rate climbed from 2.7% in December 2018 to a peak of 6.8% in February 2021, then fell back to 3.5% in January 2022 before starting to rise again (to 4.2% in February).

### ... INTERRUPTED BY THE OMICRON WAVE IN Q1 2022

Up until the end of 2021, Hong Kong was successful in controlling the Covid-19 pandemic, albeit at the cost of significant restrictions (notably at the border). However, the health situation has deteriorated rapidly since the arrival of the Omicron variant in late December 2021. The number of infections soared out of control, especially due to insufficient vaccination rates. By 6 April 2022, 86% of the population had received two vaccine shots, from just 65% at end-2021; and the vaccination rate was only 61% for those aged between 70 and 79 and just 35% for the over-80s. The number of new cases jumped from less than 100 in the last week of December to 450,000 in the first week of March (in a population of 7.4 million), and the mortality rate also rocketed[1] .

Between January and mid-March, the authorities introduced very stringent restrictive measures in Hong Kong. Mobility indicators, which had returned to pre-crisis levels by the end of 2021, collapsed and in early March were running at their lowest levels since the pandemic began.

**FORECASTS**

| | 2019 | 2020 | 2021e | 2022e | 2023e |
|---|---|---|---|---|---|
| Real GDP growth, % | -1.7 | -6.5 | 6.4 | 1.6 | 3.6 |
| Inflation, CPI, year average, % | 2.9 | 0.3 | 1.6 | 3.0 | 2.3 |
| Budget balance / GDP, % (1) | -0.6 | -9.4 | -1.4 | -3.5 | -2.0 |
| Government debt / GDP, % | 0.3 | 1.0 | 2.1 | 3.2 | 4.0 |
| Current account balance / GDP, % | 5.8 | 6.9 | 11.2 | 4.2 | 4.7 |
| Forex reserves, USD bn | 441 | 492 | 497 | 500 | 505 |
| Forex reserves, in months of retained imports | 41 | 51 | 44 | 38 | 38 |
| Réserves de change, en mois d'imports | 14.9 | 16.3 | 13.1 | 12.3 | 11.7 |

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

**CONSUMERS REMAIN DEPRESSED**

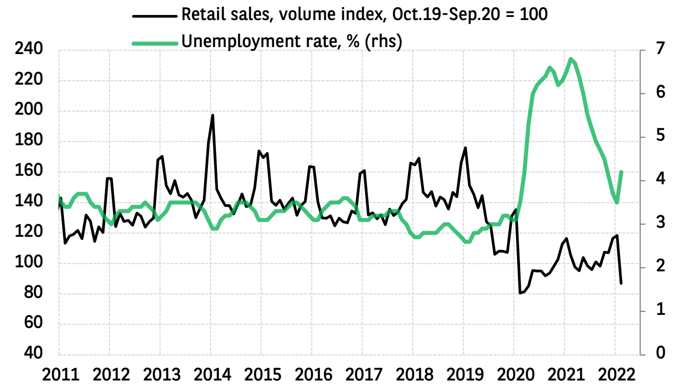


CHART 1

SOURCE: CSD

1 The average number of daily deaths per million population was below 0.1 in 2020 and 2021, but reached a record level of 38 in the second week of March. It had fallen to 9 a month later, but this is still the highest rate in the world at present. By way of comparison, this death rate peaked at 2.5 in Singapore in 2021 and at 10 in the US. Total Covid-related deaths in Hong Kong climbed from 213 at the end of 2021 to 9,069 on 15 April.

Retail sales fell sharply once again. Since mid-March, this wave of the epidemic appears to have eased and mobility conditions have started to improve. They are likely to see a very gradual return to normal over the next few months given the tough Covid-19 strategy.

## INTERNATIONAL CONDITIONS HAVE WORSENED

Hong Kong is now also facing other challenges, linked to the deterioration of international conditions. First of all, Hong Kong will suffer the indirect repercussions of the war in Ukraine through its effects on global trade and on commodity prices. Its direct trade with Russia and Ukraine is very limited, at 0.2% and 0.7% respectively of total imports and exports. However, because of its role as a regional trade hub, Hong Kong is vulnerable to the expected slowdown in world trade and disruptions to supply chains. These disruptions are expected to be exacerbated over the next few weeks by the consequences of the pandemic wave on industrial production and transport of goods in China. Therefore, in the short term, a slowdown in exports (of which 98% are re-exports) will add to Hong Kong's weak domestic demand.

Meanwhile, Consumer Price Inflation (CPI) is set to accelerate, driven by rising global commodity prices and supply difficulties. Pressures on food prices (which represent 27.4% of the consumer basket) have increased recently, with average food price inflation accelerating to 3.1% y/y in December-February from 2.2% over the previous six months. However, CPI is likely to remain moderate; it is projected to average around 3% in 2022, vs. 1.6% in 2021. It will be contained by the lack of wage pressure, weak domestic demand and slow growth in rent (rent makes up 40.3% of the CPI index). Moreover, government subsidies for energy and other utility bills, planned for this year, will limit households' loss of purchasing power.

The acceleration of monetary tightening in the US is another risk factor that could affect Hong Kong's economic growth in the short term. Because of its Currency Board regime, Hong Kong's monetary policy follows the policy decisions of the US Federal Reserve. Monetary tightening in the US is likely to continue at a rapid pace in order to contain fast-rising inflation. The US policy rate, which had been held at 0.25% since the onset of the Covid-19 shock in early 2020, was increased to 0.5% on 16 March and is likely to get close to 2% by the end of 2022. Hong Kong's base rate will follow suit; it was increased from 0.5% to 0.75% in March. However, inflation rates and economic cycles differ between the two economies. In Hong Kong, the increase in inflation will not counterbalance the expected rise in nominal interest rates in 2022, meaning that a greater tightening in monetary conditions.

## FISCAL POLICY LEEWAY REMAINS VERY COMFORTABLE

Fiscal policy will continue to support the economy in 2022. The recessions of 2019 and 2020 and the pandemic have caused a rapid deterioration of fiscal balances, but the solvency of the public sector and Hong Kong's external financial position remain very solid.

The fiscal balance became negative in the 2019/20 fiscal year (April 2019 to March 2020) for the first time in fifteen years. The deficit then jumped to 9.4% of GDP in 2020/21, following a fiscal stimulus package worth 12.3% of GDP. In 2021/22, some of the support measures have been partially renewed (representing some 3% of GDP). The deficit has fallen back rapidly (it is expected to be less than 2% of GDP), helped by the economic recovery. In 2022/23, the government will maintain its expansionary fiscal policy. Its latest budget, announced at the peak of the latest Covid-19 wave at the end of February, sets out a stimulus package worth around 6% of GDP. The deficit is thus likely to increase again and should exceed 3% of GDP in 2022/23.

INCREASING INFLATION, INCREASING INTEREST RATES

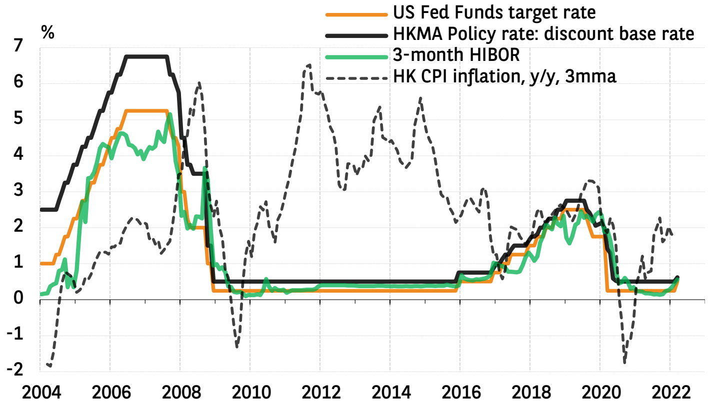


CHART 2 SOURCE: CSD, HKMA, US FEDERAL RESERVE

The government has implemented various measures such as increases in spending on health and vaccination (1% of GDP in 2020/21, 0.2% in 2021/22 and more than 2% in 2022/23) and measures aimed at supporting employment (3.4% of GDP in 2020) and creating temporary jobs (0.2% of GDP in 2021). It has also offered direct support to enterprises (subsidies, tax breaks, support for SMEs and sectors in crisis such as tourism) and to households, including cash payments to residents in 2020/21 (2.6% of GDP) and the distribution of consumer vouchers (1.3% of GDP in 2021/22 and an expected 2% of GDP in 2022/23), as well as various cost reductions (fees for public services, rents, etc.). The government is also projecting to develop a number of infrastructure projects. In the medium term, structural measures will also be necessary, to enhance social protection and housing affordability, and improve consumer confidence and demand.

The government has considerable fiscal leeway to introduce such support measures. It has drawn on its fiscal reserves to finance the deficits since 2020 and will continue to do so. Reserves fell from HKD 1,190 billion in March 2020 (43% of GDP and 23 months of government spending) to HKD 862 billion in December 2021. However, this has not affected the government's solvency: fiscal reserves still stand at around 30% of GDP and can cover 16 months of spending. In addition, government debt is very limited (and it is negative in net terms) and only a tiny portion is actually used to cover its budget financing needs (1% of GDP in 2020).

*Writing completed on 19 April 2022*

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# MALAYSIA



## ECONOMIC RECOVERY BARELY DESTABILISED

**After a modest growth in 2021, Malaysia's economy is set to recover more strongly in 2022. It will be supported by firm domestic demand, an expansionary fiscal policy and the reopening of Malaysia's borders to tourists. The country is an exporter of commodities – mainly oil and palm oil – and should benefit from higher international prices, without being directly affected by the conflict in Ukraine. Thanks to the additional revenue from higher oil prices, the government should be able to take on most of the burden of higher inflation to prevent problems for households whose finances have already been weakened by the 2020 crisis. Another key uncertainty regarding economic growth is how long and how severe Chinese lockdowns will be, since they could drag down Malaysian exports.**

### ECONOMIC GROWTH ACCELERATING IN 2022

In 2021, real GDP growth was only 3.1%, after a contraction of 5.6% in 2020. At constant prices, Malaysia's GDP ended last year still 2.7% lower than its pre-Covid level. The modest rebound in 2021 was mainly due to the various waves of the pandemic during the year, which badly affected domestic demand.

In 2022, economic output should rebound substantially. It will be supported by robust domestic demand, driven by i) higher public-sector investment, ii) a reduction in Covid-19 restrictions (with 80% of the population fully vaccinated in early April 2022), iii) a stronger labour market, which is still weaker than it was in 2019 but has improved significantly since the end of 2021, and iv) Malaysia's reopening to tourists from 1 April 2022 (income from tourism averaged 6% of GDP before the pandemic). Malaysia should also benefit from higher commodity prices, especially if the government limits the negative impact on households.

The main commodities exported by Malaysia (hydrocarbons and palm oil) account for 19% of its total exports. Higher global prices resulting from the conflict in Ukraine and the sanctions imposed on Russia will generate a windfall for exporters and the government. According to an AMRO study, a 10% rise in oil prices boosts Malaysia's economic growth by 0.4 points.

On the downside, however, constraints arising from the conflict in Ukraine have already lowered business confidence, with the manufacturing sector PMI falling to 49.6 in March.

The conflict's direct impact on the Malaysian economy will be extremely limited, because trade and financial links with Ukraine and Russia are weak: Ukraine accounts for only 0.06% of Malaysia's exports and Russia only 0.3%.

However, Malaysia will be indirectly affected by further disruption to global supply chains, particularly in the semiconductors market, which accounts for almost 22% of its exports. Palladium and neon, both of which are essential in chipmaking, are produced mainly in Russia and Ukraine.

In addition, the resurgence of Covid-19 in China in March and April has resulted in lockdowns: in early April, regions representing more than 60% of China's GDP were affected by restrictions of varying severity. This situation is likely to drag down Malaysia's exports (15.5% of which are to China) and further disrupt global supply chains.

Moreover, although exporting companies and the government are likely to benefit from higher commodity prices, this will not be the case for consumers. In particular, there are concerns about how higher food prices will affect households that were hit hardest by the 2020 crisis. Malaysia's poverty rate rose from 5.6% in 2019 to 8.4% in 2020. As of February 2022, the labour market had still not regained its pre-crisis position, with an unemployment rate of 4.1% vs. 3.3% in 2019. In addition, nominal wage growth in the private sector was only 0.4% following a 2.4% decline in 2020, and this is not enough to allow households to deal with this new inflationary shock.

FORECASTS

| | 2019 | 2020 | 2021e | 2022e | 2023e |
|---|---|---|---|---|---|
| Real GDP growth, % | 4.4 | -5.6 | 3.1 | 5.8 | 5.9 |
| Inflation, CPI, year average, % | 0.9 | -1.2 | 2.5 | 2.9 | 2.3 |
| General Gov. balance / GDP, % | -3.4 | -6.2 | -6.4 | -5.4 | -4.5 |
| General Gov. debt / GDP, % | 52.4 | 62.1 | 63.5 | 61.2 | 58.9 |
| Current account balance / GDP, % | 3.5 | 4.2 | 3.5 | 4.1 | 4.0 |
| External debt / GDP, % | 62.6 | 67.6 | 69.3 | 71.5 | 73.0 |
| Forex reserves, USD bn | 100 | 100 | 104 | 106 | 109 |
| Forex reserves, in months of imports | 5.7 | 6.2 | 5.7 | 5.6 | 5.7 |

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

CONSUMER PRICE INDEX

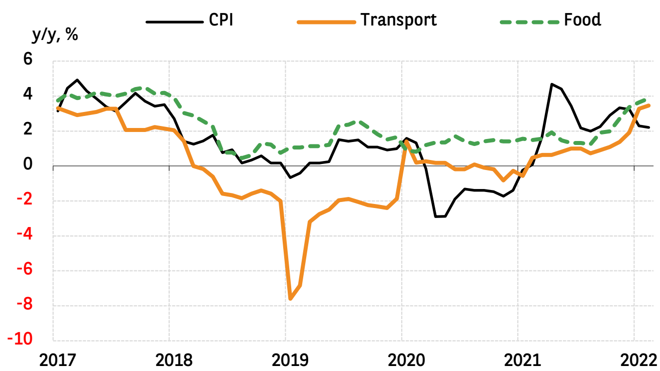


CHART 1

SOURCE: CEIC

## GOVERNMENT LIKELY TO LIMIT THE IMPACT OF INFLATION

In February 2022, overall inflation remained low at only 2.2% y/y. However, food and transport prices have been rising since the end of 2021.

Malaysia imports food – cereals, meat, fruit and vegetables – and fertiliser used in its domestic food production. Although cereal imports remain modest (0.6% of GDP in 2021), higher food prices arising from the conflict in Ukraine could push up inflation by an estimated 22 basis points (bp) in 2022, and rising fertiliser prices could also affect 2023 food prices. The elasticity of food prices to international prices is estimated to be 0.6, while food makes up 28.4% of consumer spending. However, for the poorest households, food accounts for 38.5% of spending. Food price inflation had already risen to 3.9% in February as opposed to 1.5% this time last year.

Higher oil prices could also push up domestic inflation by 60bp if they were passed on in full to consumers. So far, the government has kept prices of the main fuels (diesel and unleaded 95) unchanged to protect households worst affected by the Covid-19 crisis.

The increase in fiscal revenue arising from higher international oil prices could allow the government to bear the full brunt of that increase for consumers without weakening public finances. The government prepared its budget based on an average oil price of USD 67 per barrel. It was expecting to receive MYR 43.9 bn (2.7% of GDP) of oil revenue (in the form of direct and indirect taxes but also dividends paid by Petronas). With the oil price averaging USD 102 in the first three months of 2022, 52% higher than the figure included in the budget, oil revenue could amount to MYR 85 bn (5.2% of GDP), generating a surplus of MYR 41.1 bn compared with the initial budget. The government estimates that the additional cost of subsidies to keep the retail price of petrol unchanged would be MYR 17 bn relative to 2021. So even if it took on the entire burden of higher oil prices, the government would still have extra revenue equal to 1.4% of GDP compared with its forecast budget.

As a result, although no announcement has yet happened regarding food subsidies, it seems likely that the government will introduce support, at least for the most vulnerable households and especially since elections could take place in the second half of 2022. This follows the agreement reached by the government and opposition parties in September 2021 to ensure a certain level of political stability until July 2022.

## EXTERNAL ACCOUNTS SUPPORTED BY HIGHER COMMODITY PRICES

Malaysia's balance of payments is solid. In 2021, for the second consecutive year, the country's net international investment position showed a credit balance equal to 5.9% of GDP. In February, forex reserves amounted to USD 103 bn, the equivalent of 4.9 months of goods and services imports.

Malaysia has a structural current account surplus. In 2021, that surplus fell slightly, by 0.7 points to 3.5% of GDP, due to a larger deficit in the services account (linked to the collapse in revenue from tourism), but the trade surplus was 11% of GDP. Malaysia benefited from the rise in commodity prices and the rebound in global trade. In addition, foreign direct investment accelerated sharply to equal 4.7% of GDP, vs. only 2.7% of GDP on average in the five years preceding the Covid-19 crisis.

CURRENT ACCOUNT BALANCE

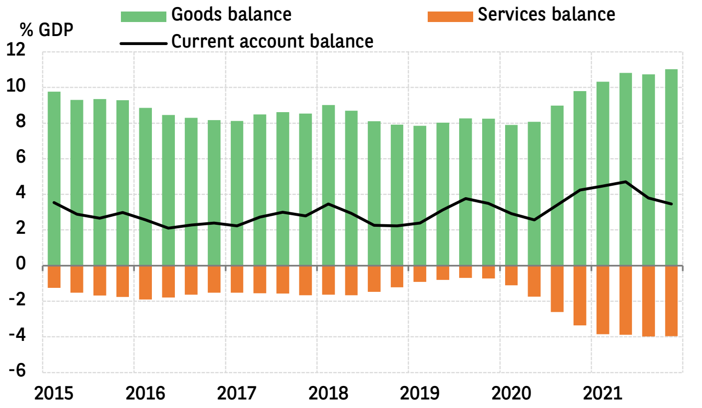


CHART 2

SOURCE: CEIC

Malaysia's external accounts should remain solid in 2022, supported by higher prices of exported commodities and by the reopening of the country's borders to tourists: the services account deficit was 4% of GDP in 2021 as opposed to only 1.4% on average between 2015 and 2019.

In the first two months of 2022, exports grew very quickly (by 20.2% seasonally adjusted), which helped increase the trade surplus. The sharpest rises were for fuel and animal and vegetable oils.

However, the current account balance does face some risk. The extent of the global inflation shock and the Covid-19 shock in China will drag down global demand. In addition, tourist numbers will be limited by the absence of Chinese tourists – who accounted for almost 18% of Malaysia's tourist income pre-Covid – and by the lower real incomes of consumers in all Asian countries (with ASEAN alone making up 50.8% of Malaysia's tourists).

Higher US interest rates could also result in capital outflows, especially if Malaysia's central bank maintains its loose monetary policy. Nevertheless, in February and March, Malaysia continued to see net portfolio investment inflows (according to IIF figures). Like most commodity exporters, Malaysia has benefited from an increase in investor confidence. As a result, and unlike most currencies of other ASEAN countries, the ringgit has been relatively stable against the dollar since the start of the year.

*Writing completed on 11 April 2022*

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# BRAZIL



## DISSONANCE

**Brazil ended 2021 on a stronger footing than expected, but the economic picture remains fragile. Activity tends to progress in spurts, curbed by internal brakes (Omicron wave, climatic vagaries, elections) and a more degraded external environment (war in Ukraine, trading partners' economic slowdown, etc.). Meanwhile, inflationary pressures are building up and raise the specter of continued monetary tightening. Since the start of the year, the improvement in Brazil's terms of trade and wide interest rate differentials with developed economies have fueled the rebound of the equity market and spurred a strong appreciation of the real. Such developments highlight a form of dissonance between the real economy and assessments of financial markets.**

### ACTIVITY: A SEE-SAW PATTERN

A clear trend is struggling to emerge from the Brazilian business cycle. In Q4 2021, the economy recovered more strongly than expected after two quarters of decline. Sequential real GDP growth (+0.5% q/q) was driven by a rebound of the agricultural sector (hampered previously by weather-related problems) and growth in the service sector. But it was essentially the carryover effect from the rebound in H2 2020 and into Q1 2021 that enabled the economy to post growth of 4.6% in 2021. In contrast, the statistical carryover for 2022 is small at some 0.3%. Despite a strongly undervalued currency, the contribution of net exports to growth was surprisingly negative to the tune of 0.8 percentage points.

Since the start of 2022, the Brazilian economy has been confronted with several shocks. These have led to a slowdown in activity in January and the concurrent erosion of confidence indicators. Output in the extractive industry and harvests were affected by heavy rains in the South of the country, while the strong resurgence of Covid-19 cases, linked to the Omicron variant, slowed down activity in services (bars, restaurants, etc.) and caused a fall in automotive production (rise in absenteeism). The effects of the war in Ukraine are also starting to be felt. In industry, the additional costs induced by the rise in the price of raw materials and transport are coming on top of persistent problems regarding the availability of inputs – a lasting consequence of the Covid-19 crisis. This new supply shock, although mitigated this time by the appreciation of the real, is particularly detrimental to confidence and output in the manufacturing sector (the manufacturing PMI was below 50 on average in the first quarter of 2022). i/The sharp slowdown in credit to businesses (linked to the end of emergency programmes), ii/ the continued process of monetary tightening, iii/ the limited need for companies to rebuild inventories (unlike the situation at the end of 2020), iv/ rising inflation, and v/ the deterioration of the external scenario (economic deceleration in Europe, renewed lockdowns and slower growth in China, widespread increases in inflation across the world and rising geopolitical tensions) are all weighing on growth prospects.

However, some positive developments deserve to be underlined. The risk of electric power rationing has greatly diminished (heavy rains have replenished hydroelectric reservoirs). The rise in commodity prices, in addition to its positive effects on fiscal revenues (increased royalties and dividends), is also beneficial to the agricultural sector and extractive industries through its favourable impact on income. This should drive an increase in capital expenditure on machinery and equipment once uncertainty dissipates. The upturn in services in March (the only sector where confidence rose) could also help offset losses in activity in certain segments of industry. The service sector experienced a strong rebound in March helped by the significant improvement in the Covid-19 situation[1] and the further easing of mobility restrictions including on travels. Survey data shows a sharp increase in hiring in the month and a desire to expand capacity in the short term. Also, even if higher interest rates are starting to weigh on purchases of durable consumer goods, credit growth to households has yet to slow down (11.1% in real terms in January versus 6.3% a year earlier). Finally, the authorities announced in early March a support package to cushion the impact of the inflationary shock on households' purchasing power (BRL 150 bn or 1.7% of GDP, consisting primarily of regulatory adjustments on accessing allowances with no direct impact on the budget).

**FORECASTS**

| | 2019 | 2020 | 2021 | 2022e | 2023e |
|---|---|---|---|---|---|
| Real GDP growth, % | 1.2 | -3.9 | 4.6 | 0.3 | 1.1 |
| Inflation, CPI, year average, % | 3.7 | 3.2 | 8.3 | 9.0 | 5.6 |
| Fiscal balance / GDP, % | -5.8 | -13.2 | -4.4 | -8.3 | -8.6 |
| Gross public debt / GDP, % | 74 | 88 | 82 | 83 | 87 |
| Current account balance / GDP, % | -3.5 | -1.7 | -1.8 | -1.2 | -0.9 |
| External debt / GDP, % | 37 | 45 | 43 | 40 | 38 |
| Forex reserves, USD bn | 357 | 356 | 362 | 356 | 350 |
| Forex reserves, in months of imports | 16 | 19 | 16 | 15 | 15 |

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

**EXCHANGE RATE AND INTEREST RATE DIFFERENTIALS (BRAZIL / USA)**

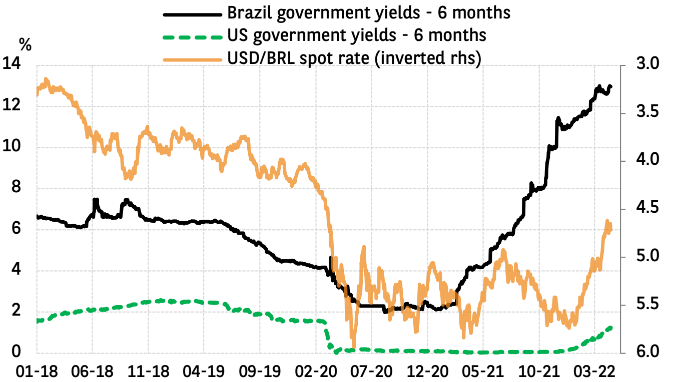


CHART 1 SOURCE: BRAZILIAN CENTRAL BANK, ANBIMA, US TREASURY

1Covid-19 cases peaked in late January, but both infections and hospital admissions have fallen sharply since then (with the exception of a slight increase around the time of Carnival). In early April, 86% of the population had received one vaccine dose, 76% two doses and around 36% a booster.

Combined with the increase in real wages since the start of the year[2] , declining unemployment and higher spending by Brazil's federal states (election year), these measures could offer an upward bias to growth forecasts.

## EXPOSURE OF THE AGRICULTURAL SECTOR TO RUSSIA

Brazil's trade exposure to Russia and Ukraine is limited but is not negligible due to the high concentration of certain products in trade ties. The combined share of Russia and Ukraine in Brazil's total imports and exports is just under 3% and 1% respectively. The strongest dependencies (measured as imports from Russia/Ukraine as a percentage of total imports of that product) are found in coal (14.9%), precious metals (13.8%), aluminium (10.1%) and fertilizers (23%, exclusively from Russia). Fertilizers alone account for around 60% of total imports from the zone[3] The agricultural sector – which also sources 7% of its imports of fertilizers from Belarus – has shown increased concern over prospective supply disruptions arising from the effects of the sanctions[4] . As a result, it has sought to secure greater supplies from countries such as Canada and Morocco over the next few quarters (import data already shows a strong increase in purchases in March). Disruption to Russian and Ukrainian cereal exports could create opportunities for Brazilian exporters of maize (3rd largest producer worldwide) and to a lesser extent wheat (1% of global sales in 2021/22).

## A POSITIVE FINANCIAL SHOCK FOR NOW…

From a financial point of view, Brazil's dependence on Ukrainian or Russian investments is almost nil. However, the conflict, by prompting a rebalancing of investment portfolios on a global scale and fuelling the rise of commodity prices has helped support Brazilian assets. The equity market is made up of nearly 70% of commodity-related stocks (energy and materials) and banking/financial stocks. These are benefitting from the improvement in the country's terms of trade and the sharp rise in interest rates. Compared to other net commodity exporters, Brazil also stands out because it offers investors positive real interest rates[5]. The large interest rate differentials between Brazil and most developed economies are, in particular, incentivizing carry trade flows, (investors borrow where the cost of credit is cheap and invest where real yields are attractive). The strong momentum in portfolio investment flows[6] has allowed the Brazilian currency to appreciate rapidly against the dollar in the first quarter (+20% approximately). In the short term, still wide interest rate differentials with developed countries and the expected improvement in Brazil's external accounts (projection of a record trade surplus of over USD 70 bn and anticipated decline in the current account deficit in 2022) should continue to support the currency. However, the real's rally should lose momentum and be subject to increased volatility as the October elections approach. The incumbent president is still trailing Lula in the polls, but the gap is narrowing. It is worth noting that ex-president Lula has chosen a centre-right politician as his running mate (Geraldo Alckmin, former governor of São Paulo and former presidential candidate). Sergio Moro, former justice minister in the Bolsonaro administration and ex federal judge responsible for Lula's imprisonment, is pulling out of the race (he was 3rd in the polls).

## … BUT ACCOMPANIED BY INCREASED INFLATIONARY PRESSURES

Despite the appreciation of the real and the easing of tensions over the electricity network, inflationary pressures remain well in place and are being further exacerbated by the conflict in Ukraine (increased tension on the prices of industrial goods prices linked to disruptions in global supply chains, rise in the price of energy and food). The consumer price index (IPCA) thus reached 11.3% (y/y) in March – a peak since October 2003. Price increases are widespread but affect particularly the price of food goods[7] (24% of the consumer basket), due to the increase in freight and fertilizer costs as well as weather-related events (drought in 2021, heavy rains in early 2022). The recent increase in the price of energy (10% of the consumer basket) is not yet entirely visible due to a later (and often only partial) pass-through of international prices to domestic prices. However, it should not take long to fully materialize. Petrobras, announced in March a 19% increase in the price of petrol and around 25% for diesel – a first adjustment by the national oil company in over two months. In 2021, fuel had contributed for a third of the 10.06% increase in the IPCA and according to calculations by the central bank (BCB) a 10% rise in oil prices in local currency terms will likely push the IPCA up by 0.31 to 0.43 points in 2022. Core inflation is also accelerating under : i/ the relaxation of price caps in some sectors introduced during Covid-19 crisis most notably in healthcare (pharmaceutical products) and education (tuition fees) ; ii/ inertia effects related to widespread indexation practices (wages but also residential rents), iii/ the passing on of rising costs to the price of services in order to protect profit margins.

**BRAZIL: HEADLINE CONSUMER INFLATION AND SELECTED SUBCOMPONENTS**

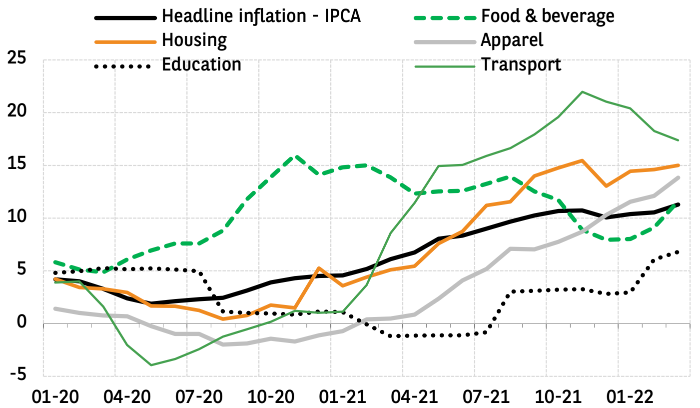


CHART 2 SOURCE: IBGE, BNP PARIBAS

Faced with the persistence of inflation and the slight de-anchoring of inflation expectations relative to the targets for 2023-24, rate hikes could continue this year. The BCB initially announced its intentions to halt its monetary tightening cycle in May after a final hike in the benchmark rate, the SELIC, by 100 basis points (bps) to 12.75%. Given that a 100 bps hike in the SELIC tends to increase average sovereign borrowing costs by 45-55 bps according to Moody's, interest payments on sovereign debt could very well exceed 7% of GDP this year – the highest level since 2015.

*Writing completed on April 14th 2022*

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2Real incomes fell sharply in the second half of 2021. However, despite the fall in disposable income, consumer spending continued to rise, as consumers drew more heavily on savings.
3 Brazil is the world's 4th largest consumer of fertilizers. It also draws on the external market for about 85% of its needs. A quarter of the fertilizers it uses goes to produce soybeans, Brazil's top export.
4 Brazil could see a fertilizer shortage by October in the case of inaction to address the situation according to Agriculture Minister Tereza Cristina.
5 Policy rates discounted by 12-month inflation expectations.
6 In 2021, net non-resident portfolio flows were positive for the first time since 2015.
7 Price increases are particularly affecting flour, bread and oils, along with fruit and vegetables (+46% for carrots, +15% for tomatoes and +6.3% for fruits in March).

# MEXICO



## RECOVERY LACKING IMPETUS

**The direct consequences of the war in Ukraine on the Mexican economy should remain limited, because trade links are almost non-existent. However, indirect consequences could have a significant impact on an economy that has already been weakened by the Covid-19 crisis. Higher commodity prices will increase inflation pressure and worsen the current account deficit in Mexico, which has been a net importer of energy since 2015. In addition, supply chain disruption arising from the conflict and new coronavirus variants could drag down exports. The investment outlook is continuing to deteriorate as discussions about reforming the energy sector continue.**

### LIMITED ECONOMIC GROWTH IN 2022

Although economic growth rebounded in 2021 (with GDP rising by 5.4% after falling 8.3% in 2020), this did not take Mexico's economic activity back to pre-Covid levels and the short-term growth outlook is relatively weak. The government and the central bank have also downgraded their 2022 growth forecasts recently, to 3.4% (from 4.1% in 2021) in the government's case and to 2.4% (from 3.2% in 2021) for the central bank. However, these figures are still too optimistic in our view. We expect real GDP growth of 1.2% in 2022 and 1.4% in 2023. At that rate, Mexico's economic output will not reach end-2019 levels again until the end of 2023.

The direct consequences of the conflict in Ukraine should remain relatively limited. Mexico's exports to Russia and Ukraine account for only 0.1% of its total exports, and its imports from those countries make up only 0.3% of the total. Exports to Europe have increased in the last 10 years but remain fairly limited, accounting for 5% of Mexico's total exports in 2021. The Mexican economy is more open than other Latin American countries – followed by Chile in second place – but its exports consist mainly of manufactured products (over 80%) and are mostly exported to the US (over 75%).

The risks remain clearly on the downside. Firstly, although vaccination rates have increased – with 62% of the population having received two doses by the end of March – Mexico remains vulnerable to potential new waves of infection. At the global level, rising Covid-19 case numbers in China and the measures taken to address them could further delay the re-establishment of supply chains.

Secondly, commodity price inflation has accelerated significantly since the end of February, creating a negative supply-side shock that could cause financial volatility for emerging market countries. The Mexican economy is highly financially integrated, and so, vulnerable to a sudden shift in sentiment among investors, both domestic and foreign. Mexico has also been a net importer of energy since 2015, which means that its current account balance will deteriorate in 2022.

FORECASTS

| | 2019 | 2020 | 2021e | 2022e | 2023e |
|---|---|---|---|---|---|
| Real GDP growth, % | 0.1 | -8.3 | 5.4 | 1.2 | 1.4 |
| Inflation, CPI, year average, % | 3.7 | 3.4 | 5.7 | 7.1 | 5.3 |
| Budget balance / GDP, % | -1.7 | -2.3 | -2.8 | -4.1 | -4.5 |
| Public debt / GDP, % | 46.4 | 50.8 | 50.8 | 50.5 | 50.6 |
| Current account balance / GDP, % | -0.2 | 2.4 | -0.4 | -0.7 | -0.7 |
| External debt / GDP, % | 37.7 | 43.1 | 39.4 | 39.1 | 38.5 |
| Forex reserves, USD bn | 180.0 | 195.0 | 202.4 | 208.1 | 206.5 |
| Forex reserves, in months of imports | 3.5 | 5.3 | 5.1 | 4.8 | 4.4 |

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

MEXICO: PRODUCTION & CONSUMPTION OF ENERGY

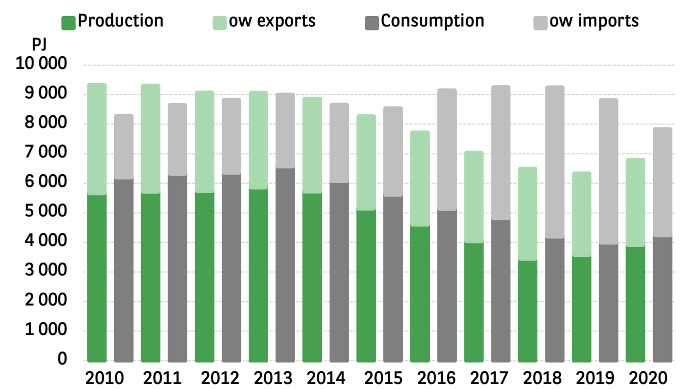


CHART 1

SOURCE: SECRETARY OF ENERGY

### INEVITABLE RISE IN INFLATION

Inflation had already risen significantly before the conflict between Russia and Ukraine broke out, because of several shocks arising from the pandemic such as supply shortages, delays in industrial production systems and supply chains, higher prices for certain commodities and a rebound in consumer spending. Inflation averaged 5.7% in 2021 but rose to over 7% on average in the first three months of 2022.

Inflationary pressure is likely to continue for at least the next few months because of supply shortages. Government subsidies aimed at offsetting the rise in commodity prices will not be enough to absorb the shock entirely. On average, inflation is likely to average 7.1% in 2022, and we expect further rate hikes in the near term. Mexico's central bank has already raised its key interest rate five times in 2021 and once in February 2022, taking it to 6.0%.

### LITTLE IMPACT ON THE PUBLIC-SECTOR DEFICIT IN THE NEAR TERM

The budget deficit and public sector debt levels have remained moderate in the last two years. Firstly, economic support measures amounted to only 1.1% of GDP in 2020, one of the lowest figures among emerging economies. Secondly, the government tapped Mexico's sovereign budgetary income stabilisation fund (FEIP), reducing the fund's assets to around 0.1% of GDP by the end of 2020 as opposed to almost 2% at the end of 2019. The public sector deficit equalled only 2.8% of GDP in 2021 (versus 2.3% in 2020) and debt remained contained at 50.8% of GDP in both 2020 and 2021.

Higher commodity prices are likely to have a limited impact on public finances in 2022. This year's budget means that diesel subsidies – with the government promising to limit the increase in consumer diesel prices to 5% – should be offset by additional revenue arising from royalties paid by the national oil company PEMEX. According to the government's announcements, surplus revenue should be used to replenish the FEIP sovereign fund.

However, medium- to long-term developments in public finances are a source of concern. Despite the president's commitment to continuing fiscal consolidation, spending is likely to increase significantly in the next few years. In addition, PEMEX's financial position has continued to deteriorate and repairing it will require large-scale, long-term financial support from the government, despite higher oil prices.

## INVESTMENT OUTLOOK STILL WORSENING

Finally, the investment outlook remains relatively weak in the short and medium term. Investment has fallen significantly since mid-2018 and in the first few months of 2022, it remained much lower than its pre-Covid level in December 2019 (chart 2). Investor confidence has been damaged by an unpredictable economic policy, the lack of government support in the last two years and the current debate about energy reforms. This is likely to remain the case at least until the current president's term of office ends, which is scheduled to be in 2024[1].

Energy sector reforms, first proposed by the government in March 2021, are on the table again, and the approach taken is likely to have a major influence on investor sentiment in the short and medium term. Broadly speaking, the president has proposed an overhaul of the electricity sector, which was part of his election manifesto. According to the March 2021 bill, state-owned electricity company CFE would increase the proportion of the country's electricity it supplies from less than 40% today to 54%, at the expense of private sector operators. The proposal also includes the cancellation of contracts under which private sector companies generate and supply electricity, and of renewable energy generation contracts. In addition, the president intends to scrap corporate governance arrangements at CFE and PEMEX, giving the government sole decision-making power.

In the next few months, a number of debates about this reform are scheduled to take place in Mexico's Congress. The Senate and Supreme Court will also rule on the president's proposal, made in October 2021, to amend the parts of Mexico's constitution that mention private sector involvement in the energy sector. It seems unlikely that the bill will be enacted in its current form, but the extent of any forthcoming amendments remains unclear. If the final version is only slightly different from the one put forward by the president, this would increase the downside risk in several areas. If existing contracts with the private sector were cancelled, this would create reputational risk as well as the risk of legal action in Mexico and abroad, and there would also be a risk that private sector investment (domestic and foreign) would decline over the long term. Aside from its impact on the energy sector itself, the bill could pose a risk for public finances if government spending on CFE and PEMEX were to increase significantly again.

MEXICO: INVESTMENT INDEX

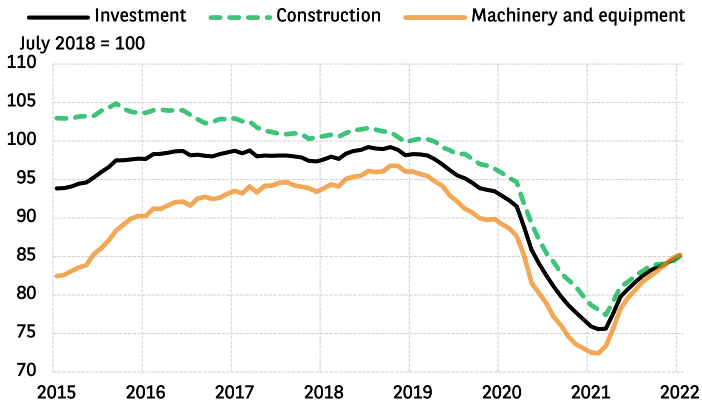


CHART 2 SOURCE: NATIONAL INSTITUTE OF STATISTICS AND GEOGRAPHY

*Writing completed on 13 April 2022*

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1 The president held a referendum in April to decide whether he should see out his term of office. The question asked was «Do you agree that the president should have his mandate revoked due to loss of confidence or that he should continue in the Presidency of the Republic until his period concludes?» Over 90% of people voting said that he should continue, but turnout was very low at less than 20%.

# POLAND



## THE STRONG MAN OF CENTRAL EUROPE

**Poland is well equipped to deal with the economic consequences of the conflict in Ukraine. Its economy had fully absorbed the shock from Covid-19 by the end of 2021. Output was 5% higher than in late 2019, the recovery was well balanced and the unemployment rate had returned to a frictional level. In addition, Poland's budget deficit fell sharply in 2021 and its public debt/GDP ratio remained well below the Maastricht limit due to a substantial gap between growth and interest rates. The current-account balance is in deficit again, but still comfortably covered by non-debt generating capital flows. The only cloud on the horizon is the acceleration in inflation which has prompted the central bank to tighten monetary policy more aggressively since autumn 2021. Growth will inevitably slow in 2022, but from a high level, and the risk is on the upside given the economy's resilience.**

### A FIRM, BALANCED RECOVERY

Before the shock caused by the conflict between Russia and Ukraine, Poland's economic recovery was proceeding at a good pace. Real GDP growth accelerated slightly in H2 2021 (2% per quarter) as opposed to 1.7% in H1. The recessionary shock caused by Covid-19 is now a thing of the past, since economic output in Q4 2021 was 5% higher than two years previously. In terms of its recovery, the Polish economy is leading the way in Central and Eastern Europe.

In 2021, growth was driven mainly by domestic demand, since the contribution from net exports of goods and services turned sharply negative. But that was not due to export performance: the 12% rise in exports was much larger than the 9% rise in imports from EU countries, which are Poland's main trading partners. Imports simply rose in line with domestic demand, with an apparent elasticity of 2.

The recovery has been well balanced, with similar growth rates for consumer spending and total investment (respectively 6% and 7%), but also for capital goods investment (excluding transport equipment) and construction investment (6% each). In addition, the increase in public-sector consumption has remained moderate at 2%. Another positive factor is that household borrowing has increased, but not excessively, rising 5.2% year-on-year in February 2022 as opposed to 6% in late 2019. Indeed, growth in consumer loans (up 2.1% year-on-year in February 2022) is particularly low given the 10% increase in wages at end-2021 and a labour market that is almost at full employment: the unemployment rate is only 3%, back to its late-2019 level, with no reduction in the labour force.

### TWIN DEFICITS NO LONGER CAUSE FOR CONCERN

Strong growth allowed a marked decline in the central government budget deficit from 3.7% of GDP in 2020 to only 1% in 2021, with lower spending accounting for two thirds of the reduction. The general government deficit (central government, social security and local authorities) has increased by 3.5 points of GDP in the last two years, because some of the measures adopted under the extensive support plan (EUR 74.5 bn budgeted, equal to 14.5% of GDP) was financed off-budget, in particular via the PFR development fund. At the end of 2021, the central government debt-to-GDP ratio was almost back to its pre-crisis level (43.7% versus 42.4% in late 2019). According to OECD estimates, the general government debt, in Maastricht definition, increased by 11.4 points of GDP to 57% at the end of 2021. The difference lies in local authority debt (3.5% of GDP) and, since 2020, the PFR's debt issuance. However, the debt-to-GDP ratio remains under control because Poland's nominal growth rate far exceeds the yield on its sovereign bonds. This means that, assuming a balanced primary budget, the ratio will decrease by at least 2 points per year.

The current-account balance has fallen back into deficit due to faster real growth in imports and the surge in commodity prices. In H2 2021, the deficit amounted to 3.2% of GDP. However, it was still very comfortably covered by net FDI inflows (2.6% of GDP in H2 2021) and EU

**FORECASTS**

| | 2019 | 2020 | 2021e | 2022e | 2023e |
|---|---|---|---|---|---|
| Real GDP growth, % | 4.7 | -2.4 | 5.6 | 3.6 | 2.5 |
| Inflation, CPI, year average, % | 2.1 | 3.4 | 5.1 | 10.0 | 8.0 |
| Gen. Gov. balance / GDP, % | -0.7 | -7.1 | -4.6 | -2.5 | -2.0 |
| Gen. Gov. debt / GDP, % | 45.6 | 57.4 | 57.0 | 53.4 | 50.3 |
| Current account balance / GDP, % | 0.5 | 3.4 | -1.0 | -1.7 | -1.5 |
| External debt / GDP, % | 59.3 | 61.9 | 57.0 | 52.0 | 50.0 |
| Forex reserves, EUR bn | 114.5 | 125.6 | 146.9 | 148.0 | 150.0 |
| Forex reserves, in months of imports | 5.1 | 5.9 | 6.0 | 5.8 | 5.6 |

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

**POLAND: WAGE BILL AND BANK LOANS TO HOUSEHOLDS**

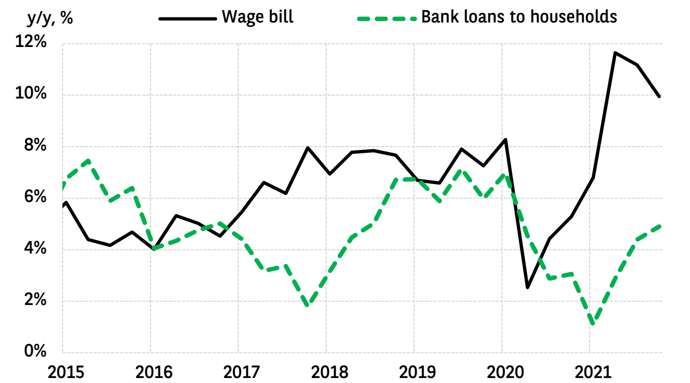


CHART 1 SOURCE: INS, BNR, BNP PARIBAS

funding (equivalent to 2.5% of GDP per year). Central bank reserves have strengthened with no increase in external debt. The latter even fell both absolute and relative terms (i.e., as a percentage of GDP or G&S exports).

Inflation is the only cloud on the horizon, rising by 6.5 points over the course of 2021, i.e., from 2.3% in December 2020 to 8.8% in December 2021. Energy and food prices accounted for 4.4 points of the increase, since official core inflation (slightly different from inflation excluding energy and food) rose by only 1.6 points. The smaller increase in core inflation is due to the fact that there is no strong evidence of a price-wage spiral, given i/ wages growing at a double-digit rate and ii/ very low unemployment. The central bank was also fairly slow to raise official interest rates, only starting in the fourth quarter of 2021 and raising them by a total of 165 bp over the year.

## HIGHLY RESILIENT TO THE UKRAINIAN SHOCK

In late 2021, therefore, Poland's economy was looking good, with strong growth and limited imbalances. In January and February 2022, economic indicators – PMI, industrial production, exports and retail sales – remained well oriented. The only negatives were a fall in consumer confidence caused by rising Covid-19 case numbers, rising inflation and the central bank's much more aggressive monetary tightening, with a further 275 bp of rate hikes since the end of 2021 taking the official interest rate to 4.5%.

The outbreak of the conflict in Ukraine, along with Russia's threats to the whole international community if its invasion is hampered, has affected confidence among businesses and consumers. The zloty has fallen 3% against the euro since mid-February. So far, however, the bond market has held out well given i) the extent of monetary tightening (since mid-February, bond yields have increased by 1.1 times the increase in official interest rates, as opposed to a ratio of 2 or more for comparable emerging-market countries that have delayed monetary tightening for as long as possible) and ii) the fact that Poland, like most countries in the former Soviet bloc, is regarded as vulnerable to this new external shock.

Industrial output is likely to suffer a supply-side shock, if not because of supply -chain problems or shortages, then at least due to higher prices of intermediate goods. Like other Central European countries, Poland imports oil, gas, agricultural products and fertilisers from Russia and Ukraine. In late March, the Polish government urged its European partners to impose an embargo on imports of Russian oil, gas and even coal: Russia supplies 75% of Poland's coal, which is a major source of energy for the Polish economy, covering 20% of its needs. So far, the EU has only adopted an embargo on coal.

Households will suffer a further rise in inflation, because food and energy make up 40% of the consumer basket. However, households' real income has risen very substantially in recent years, including in 2020 and 2021. Between 2015 and 2021, real wage growth averaged 4% per year. In addition, households have since January benefited from redistributive fiscal measures: the personal income tax threshold has been raised and exemptions have been introduced for retired people and large families, along with the reduction in VAT on energy and food products until July. Inflation has also stabilised at 9% since January.

The consensus is that the war in Ukraine will reduce Polish growth by 1-1.5 points in 2022. This is probably on the pessimistic side, because fiscal support for households should offset the decline in real incomes, and households can dip into their savings. In addition, funding to support refugees – of whom there have been 4 million since the start of the conflict according to the UNHCR – is expected to total between EUR 2.2 bn (official estimate) and EUR 5.2 bn (Bank Pekao estimate), i.e., between 0.4% and 1% of GDP. As a result, consumer spending may not slow at all.

The defence budget has been increased, although the impact of higher public-sector demand on output will be felt more in 2023 than in 2022.

The main drag on growth is likely to come from exports, and indirectly from investment. Sales to Russia and Ukraine account for 3.4% of Poland's total exports. However, the Polish economy is less dependent on foreign trade than those of its neighbours: its openness rate – i.e., exports plus imports, divided by two, as a proportion of GDP – was 52% in 2019 as opposed to 80% for the Czech Republic and 95% for Hungary and Slovakia. An export shock could have a significant potential but under extremely pessimistic assumptions. If exports to the warring countries fell to zero, it would also require growth in exports to the eurozone and the rest of the world (excluding Russia and Ukraine) to fall by a third to produce a negative multiplier effect equal to 2 percentage points of GDP. In addition, that impact could be mitigated by market share gains. Since 2015, Poland's export performance has been much better than that of its close competitors (including Turkey), both in the European market and in other geographical zones. One of the reasons for this is the relatively moderate increase in unit labour costs as a result of firm productivity growth (4% per year on average between 2015 and 2020).

*Writing completed on 12 April 2022*

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# ROMANIA



## POLICY MIX DIFFICULT TO CALIBRATE

**Romania's economy slowed sharply in H2 2021, with rising inflation causing wages to decline in real terms for the first time since 2010. Growth also remained imbalanced and both public- and private-sector debt increased between 2019 and 2021. Monetary tightening started too late in 2021 and has remained very limited since the start of 2022. The external shock caused by the conflict in Ukraine will only make the slowdown worse. Any improvement in the budget deficit will be delayed by the cost of dealing with refugees. It will be the task of monetary policy to ensure financial stability in the current exceptional circumstances.**

### GROWTH IS STALLING AND REMAINS IMBALANCED

Romania's economic recovery has stalled. After rebounding between mid-2020 and mid-2021, GDP growth slowed significantly in Q3 and activity was flat in Q4. Unlike other Central European countries that are EU members, Romania has seen a decline in domestic demand. The contribution of foreign trade has become positive again, mainly due to a fall in imports. Weaker GDP growth is mainly due to a slowdown in consumer spending. Wage growth slowed from 8.1% y/y at the end of 2020 to 7.1% at the end of 2021, while inflation surged from 2.1% in December 2020 to 8.2% a year later. The increase in Covid-19 case numbers between January and September last year also affected consumer confidence.

Moreover, slowing growth remains imbalanced, with falling exports and investment partly offset by private-sector consumption and general government spending. Private and, above all public indebtedness have increased. In 2021, loans to households rose much more quickly than nominal wages (11% versus 7%), and the gap between the growth rate in lending to businesses and nominal GDP growth was even larger (21% versus 10%). Fortunately, between 2015 and 2020, gaps were inverted so debt ratios fell significantly.

Now, the public-sector debt ratio is much higher than it was in the mid-2010s. That is largely due to the 2020 recession and the fiscal plan. However, in 2021, the general government budget deficit remained too high to stabilise the debt ratio, despite nominal growth exceeding sovereign bond yields. In addition, not even the economic contraction was able to reduce the current-account deficit, which continued to deteriorate, rising to almost 8% of GDP in H2 2021.

At the end of 2021, therefore, the twin deficits were well above warning thresholds. For the moment, they are covered by surplus domestic savings (the ratio of bank deposits to bank loans was 109% in September 2021 as opposed to 104% at the end of 2019, producing additional resources equal to 2% of GDP between those two dates), as well as by EU funding and FDI flows (3% of GDP each). External liquidity is not a source of concern because the usual metrics (coverage of imports and of short-term debt by foreign exchange reserves) remain satisfactory. However, the general government's external debt has significantly increased since 2019 – from EUR 39.8 bn in December 2019 to EUR 47.6 bn in September 2021 – in order to fund the budget deficit. It now makes up around 45% of total public-sector debt as opposed to around 40% at end-2019.

### THE DRAG ON GROWTH WILL LAST

The war in Ukraine has not adversely affected Romania's exchange rate, since the RON has remained practically stable against the euro since mid-February. However, the local currency 10-year sovereign bond yield has risen by 140 bp to 6.8%. That increase is 2.7 times the increase in official interest rates, which reflects both the presence of non-resident investors in the domestic debt market and their more selective approach in times of stress.

As for most countries in Central Europe and the Balkans, the conflict in Ukraine is likely to have a greater direct effect on foreign trade than in most of emerging countries. However, unless major contagion effects are seen within the EU, the impact on Romania's economy could be limited, because exports to Russia and Ukraine amount to only 3% of total exports.

**FORECASTS**

| | 2019 | 2020 | 2021e | 2022e | 2023e |
|---|---|---|---|---|---|
| Real GDP growth, % | 4.1 | -3.4 | 5.8 | 1.5 | 3.0 |
| Inflation, CPI, year average, % | 3.8 | 2.6 | 5.0 | 10.0 | 5.0 |
| Gen. Gov. balance / GDP, % | -4.4 | -9.3 | -8.0 | -6.9 | -6.6 |
| Gen. Gov. debt / GDP, % | 35.3 | 47.3 | 50.5 | 53.0 | 55.6 |
| Current account balance / GDP, % | -4.6 | -5.2 | -6.2 | -7.0 | -6.5 |
| External debt / GDP, % | 49.2 | 57.7 | 56.0 | 55.0 | 52.0 |
| Forex reserves, EUR bn | 31.7 | 36.2 | 37.1 | 36.0 | 36.0 |
| Forex reserves, in months of imports | 4.5 | 5.6 | 4.9 | 4.2 | 4.0 |

e: ESTIMATE & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

**ROMANIA: RATIO OF NET AVERAGE WAGE TO INFLATION**

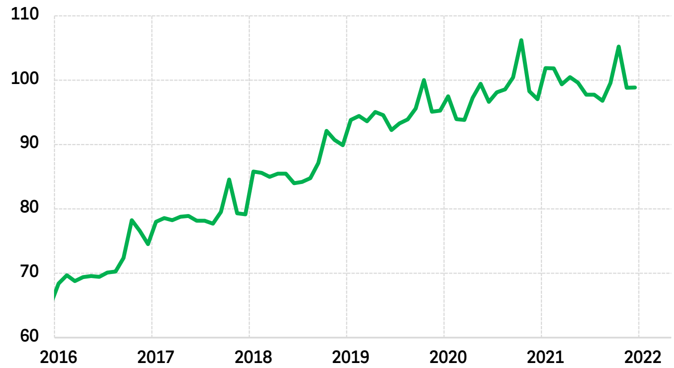


CHART 1 SOURCE: INS

However, inflation is likely to remain a drag on growth, since it has continued to rise, reaching 10.2% in March 2022. Yet, the unemployment rate hit a historically low level of 2.7% in March 2022, which suggests that a price-wage spiral could emerge again. The central bank did not start raising its key interest rate until early October 2021. It has only increased it by 175 bp so far, whereas inflation has risen 810 bp since the end of 2020.

## UNJUSTIFIED HESITANCY IN MONETARY POLICY

The difficulty for the government and the monetary authorities is to calibrate economic policy correctly so as to bolster growth, reduce the current-account deficit, limit the budget deficit and thereby stabilise the public-sector debt ratio. Standard models for open economies with flexible exchange rate regimes suggest an accommodative monetary policy, because this stimulates growth while limiting the deterioration in external accounts due to the effect of currency depreciation on the trade balance in real terms (Romania's openness rate is relatively high at 57%). In the short term, however, a monetary policy of this kind requires a fiscal tightening to contain consumption (stimulated by low or negative real interest rates) and therefore mitigate the immediate increase in the import bill caused by currency depreciation and higher energy prices. In Romania's case, the tight labour market makes it reasonable to adopt this sort of compensatory fiscal policy, even in the current context of slowing global growth. In addition, foreign currency debt - not just the one of the State but also the one of corporates and households (respectively 32% and 17% of bank loans) - requires a stable exchange rate. Finally, there is very little scope for safely maintaining a loose monetary policy, which could potentially damage the solvency of all Romanian economic agents.

It is even less justified taking into account the budgetary stance and the exceptional public spending made necessary by the Ukraine conflict. Yet, before the war broke out, no major improvement was expected from budget laws and fiscal deficit forecasts. In November 2021, the European Commission forecasted a fiscal deficit equal to 6.9% of GDP in 2022 (6.3% according to Romania's revised budget law) and 6.3% in 2023. However, between 70,000 and 100,000 Ukrainians, mainly women and children, have now sought refuge in the country. The Romanian government will have to foot the bill – including accommodation, basic essentials, medical assistance and schooling for children – at least temporarily, until the EU's EUR 17 bn of emergency refugee funds[1] is paid to countries on the "front line" (including Poland and Romania). Although complacency is still be required of investors in Romanian sovereign debt this year, fiscal consolidation will have to take place in 2023. In the meantime, however, it will mainly be the task of Romania's monetary policy to ensure financial stability in the current exceptional circumstances.

*Writing completed on 19 April 2022*

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ROMANIA: INTEREST RATES & INFLATION

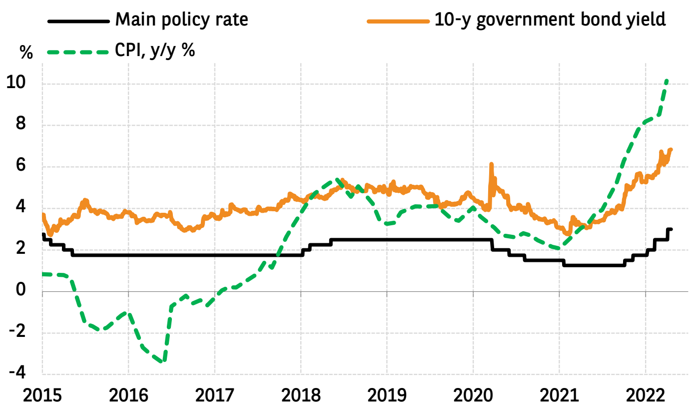


CHART 2

SOURCE: INS, BNR, MACROBOND

1 Exceptionally, 100% of the cost will be covered by cohesion funding (versus the usual 85%) until June 2022, funding provided for in the 2014-2020 budget but still unused is being released, and other earmarked funding is being reallocated (ERDF, REACT-EU).

# SERBIA



## TEMPORARY HEADWINDS

**The impact on Serbia's economy caused by the war in Ukraine is likely to remain moderate. However, the war will adversely affect all macroeconomic indicators. Growth forecasts have been downgraded because of sharply higher inflation, trade exposure to Russia and a weaker European economy. Serbia's central bank has carried out only moderate monetary tightening so far, expecting that the jump in inflation will be short-lived. External accounts are likely to deteriorate because of the wider current account deficit and a possible slowdown in foreign direct investment flows, but the central bank should still be able to defend the dinar stability. This is crucial for Serbia's macroeconomic stability given that commercial bank balance sheets and government debt are highly exposed to the euro. Current circumstances mean that it will take longer to shore up the publicsector accounts, but the rise in public sector debt should remain moderate.**

### WEAKER GROWTH PROSPECTS

The Serbian economy has been growing rapidly for several years, and has been moderately affected by the pandemic. GDP fell by only 0.9% in real terms in 2020. The sharp rebound in 2021 (7.5%) was mainly driven by robust domestic demand. Consumer spending (+7.7%) was supported by higher real wages (+4.6%), lower unemployment (9.8% at end-2021 versus 12.8% in March 2021) and credit growth (+11% for household credit). The government maintained several measures of direct support for households and corporates at around 2.3% of GDP in 2021. Investment also recovered strongly (+12.8%), due in particular to the construction sector.

For 2022, we have cut our growth forecast to 3.5%. The direct impact on output caused by the war in Ukraine is likely to be moderate. Serbia is mainly dependent on Russia for energy, since a quarter of its oil imports, two thirds of its gas imports and 10% of its coal imports come from Russia, which gives Serbia favourable prices. Serbia's energy mix is highly dependent on fossil fuels (87% versus the EU average of 72%) and particularly on coal, which accounts for half of the energy that the country consumes. For the time being, the Serbia government has not joined in with the sanctions against Russia and its energy supplies have not been disrupted. In terms of exports, Ukraine and Russia account for 6.5% of Serbian exports, mainly food and capital goods. Those exports could be affected by the conflict, at least in the near term.

The indirect consequences of the war in Ukraine are likely to be more significant. Sharply higher inflation is set to hold back growth in household purchase power, and the sharp increase in building materials prices will probably hamper the construction sector. Exports are likely to suffer from slower growth in Europe – Serbia's main trading partner – and particularly from difficulties in the automotive sector, which accounts for around 10% of total exports. The extent of the 2023 rebound will depend to a large extent on inflation. Our core scenario is that inflation will ease gradually in the second half of 2022, helping GDP growth to accelerate slightly to 4% in 2023.

FORECASTS

| | 2019 | 2020 | 2021e | 2022e | 2023e |
|---|---|---|---|---|---|
| Real GDP growth, % | 4.3 | -0.9 | 7.5 | 3.5 | 4.0 |
| Inflation, CPI, year average, % | 1.9 | 1.6 | 4.1 | 10.3 | 4.0 |
| Central Gov. balance / GDP, % | -0.2 | -8.1 | -4.3 | -4.6 | -3.2 |
| Central Gov. debt / GDP, % | 52 | 57 | 57 | 56 | 55 |
| Current account balance / GDP, % | -6.9 | -4.1 | -4.5 | -6.9 | -3.9 |
| External debt / GDP, % | 66 | 71 | 71 | 68 | 65 |
| Forex reserves, EUR bn | 13.4 | 13.5 | 16.5 | 16.6 | 17.8 |
| Forex reserves, in months of imports | 5.7 | 6.1 | 6.0 | 5.6 | 5.9 |

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

SERBIA: CONTRIBUTION TO REAL GDP GROWTH

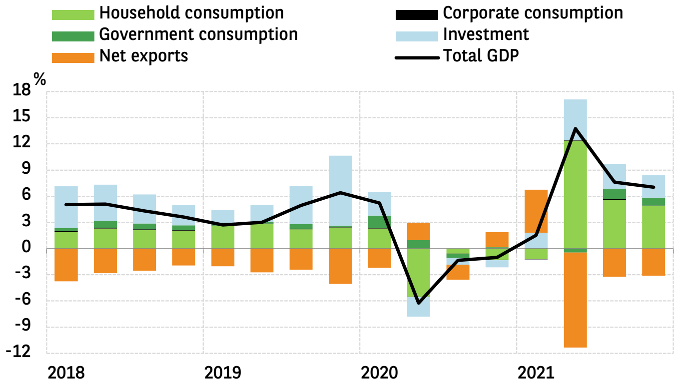


CHART 1

SOURCE: STATISTICAL OFFICE, BNPPARIBAS

### MODERATE MONETARY TIGHTENING

Consumer price inflation has increased in the last six months, reaching 9.1% y/y in March, mainly because of higher food and energy prices. Producer prices are currently surging (+17% y/y in March), and this is likely to drive consumer prices higher in the next few months. However, core inflation remains moderate at the moment (4.4% in March). The central bank expects inflation to ease for the rest of the year, due in particular to the stable exchange rate and the deflationary impact on food prices caused by Serbia's own agricultural output. However, we expect inflationary pressure on commodity prices to remain in place for the whole of 2022. With regard to locally produced agricultural products, high fuel and fertiliser prices (made using natural gas) will keep food price inflation high. In addition, Serbia's agricultural output is vulnerable to water stress, and another year of drought (as in 2021) would have a major inflationary impact. In 2022, consumer price inflation is likely to average 10.3%.

Since this is well above the upper end of its target range (1.5-4.5%), the central bank has started tightening monetary policy. It raised its key interest rate by 50 basis points to 1.5% in April and has more than doubled its open market operations since the start of the year. This liquidity absorption policy was equivalent to 7% of the M2 money supply in March 2022, as opposed to 2.5% in December 2021. In addition, the recent rate hike has widened the gap relative to the ECB's deposit facility rate from 1.5 to 2 points. This will support the dinar at a time when its external accounts are expected to deteriorate. Given the euroisation of a large portion of Serbia's economy (more than 60% of bank balance sheets) and government debt (58% of total debt), maintaining a stable exchange rate against the euro is a major objective for Serbia's central bank. Monetary tightening is likely to continue in the near term, but should remain moderate.

## DETERIORATING EXTERNAL ACCOUNTS

Serbia's current-account deficit is likely to increase fairly sharply this year, reaching 6.9% of GDP. Although prices of several commodities should remain stable – particularly Russian gas imports, the price of which should remain lower than the market price, at least in the first half of 2022 – prices of imported food, raw materials, metals and chemicals (around 35% of total imports) are set to rise sharply. With regard to exports, the economic slowdown in Europe and a possible decline in exports to Russia and Ukraine (6.4% of total exports in 2020) are likely to drag down income. Traditionally, Serbia's current account deficit has been covered by foreign direct investment (FDI) and issuance of foreign currency sovereign debt. So far, increased geopolitical tensions have not caused a sharp rise in risk aversion concerning Serbian assets. The risk premium on Serbian eurobonds has increased by a moderate 50bp since the end of February.

Net FDI has averaged 4% of GDP in the last five years and is likely to decline to around 3% of GDP this year because of the less favourable regional environment. Sovereign bond issuance is expected to remain substantial because Serbia is still showing a budget deficit, albeit a moderate one. Serbia's external accounts show fairly limited exposure to volatile capital flows: it is estimated that foreign investors hold the equivalent of around EUR 2 billion of short-term dinar-denominated government debt, equal to 13% of the central bank's currency reserves in late 2021. We expect a very slight increase in currency reserves, which should reach EUR 16.6 billion at the end of 2022, equal to 5.6 months of goods and services imports. This should help keep the dinar stable against the euro. The main risk to this scenario is a further sharp rise in commodity prices, which would widen the current account deficit and could cause a reduction in currency reserves.

## DELAYED REDUCTION IN THE BUDGET DEFICIT

Serbia's budget deficit fell in 2021 because of the economic upturn and a 20% y/y increase in tax revenues. The latter were driven in particular by higher VAT receipts, also up 20%, which make up a quarter of the government's revenue. However, the budget deficit remained fairly large at 4.3% of GDP in 2021 because of ongoing exceptional pandemic-related expenditure. In 2022, the sharp slowdown in economic growth is likely to prevent the government reducing the deficit, which is expected to equal 4.6% of GDP.

SERBIA: CPI INFLATION

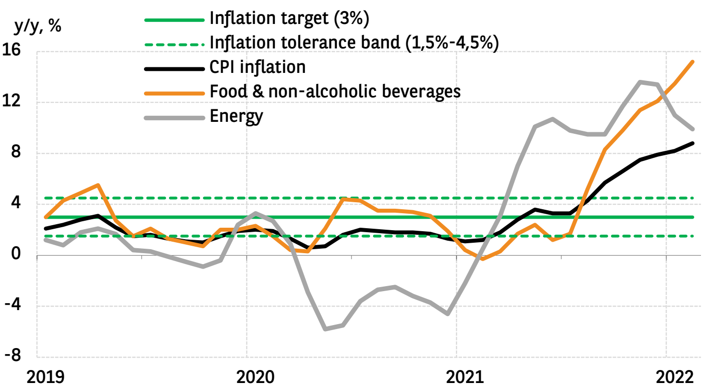


CHART 2

SOURCE: CENTRAL BANK OF SERBIA, BNPPARIBAS

Government debt was an estimated 57% of GDP in 2021 and is likely to fall very slightly in 2022 and 2023. Government debt service remains moderate, with interest payments equalling 4% of budget income in 2021. However, the composition of debt is a source of vulnerability, because 71% is denominated in foreign currencies, including 14% in currencies other than the euro. As a result, improvements in the public-sector accounts are dependent to a large extent on the central bank's ability to limit exchange rate volatility.

*Writing completed on 19 April 2022*

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# SOUTH AFRICA



## A WEAK FISCAL SITUATION

**At year-end 2021, the South African economy had not returned to pre-Covid levels of activity. The upturn in the price of its main export products provides the country with a welcome boost in the short term. This is illustrated by the latest budget forecasts, which are more optimistic than those published in late 2021. Yet structural vulnerabilities persist and are exacerbated by the health crisis. Although South Africa has few direct trade ties with Ukraine and Russia, it faces, like other emerging economies, soaring inflation that will strain domestic demand. The swelling public-sector wage bill and financial support for state-owned companies continue to be strong headwinds for reducing the fiscal deficit. Even if the government manages to balance the primary deficit by 2023-2024, its debt ratio will continue to rise. This risks creating a crowding-out effect that hampers growth while the economy was already facing stagnation risk before the two recessionary shocks.**

At the end of 2021, unlike most emerging countries, the South African economy had not returned to its pre-Covid level of activity. The country faces the new shock of the Ukraine war in this context of incomplete and fragile recovery. This increases uncertainty even though South Africa (SA) has limited direct economic ties with the two belligerent countries. SA will certainly benefit from a slight increase in its export revenues, but the overall economic impact will nevertheless be negative. Rising commodity prices, disruptions in value chains and higher uncertainty are likely to affect the country's economic outlook.

### THE FRAGILITY OF THE FISCAL SITUATION EXACERBATED BY THE PANDEMIC

South Africa's public finances have deteriorated rapidly in recent years against a backdrop of anaemic growth, declining productivity and continuously rising public spending. All of these factors have driven up the fiscal deficit, which swelled from -4.1% of GDP in FY2014/15 to -6.1% in FY2019/20. Hopes for a fiscal turnaround with the arrival of the Ramaphosa government in 2018 were quickly dashed. The situation has deteriorated constantly, with notably a steady increase in debt servicing (+12.5% a year) and the public sector wage bill (+6.5% a year between FY 2014/15 and FY 2019/20).

Fiscal slippage has accelerated over the past three years. In 2019, the rescue plan for Eskom, the state-owned power company, for nearly ZAR 60 bn (1% of GDP) further widened the deficit. In 2020, faced with an unprecedented economic recession, the authorities extended the expansionist economic policy with a vast stimulus plan. Estimated at ZAR 500 bn (USD 27 bn, 10% of GDP), the emergency measures considerably increased public spending (at an average annual rate of +9% between FY2018/19 and FY2019/20, compared to the previous fiscal year). Over the same period, revenues declined at an average rate of -4%, feeding concerns about fiscal deficit and debt dynamics.

The deficit swelled to -9.9% of GDP in FY2020/21 and public debt reached nearly 71% of GDP. The deficit was easily financed at a reasonable cost thanks to increased support from official creditors via low-interest credit lines and greater use of government bond issuance on the domestic market. In 2021, in the context of recovery, the deficit was slightly reduced but the public debt ratio continued to rise.

### OPTIMISTIC BUDGET FORECASTS NEED TO BE TONED DOWN

For the coming fiscal year, the government released at the end of February more favourable budget forecasts than those published in late 2021. Yet this optimism was mainly fuelled by cyclical factors, while structural vulnerabilities persist.

**FORECASTS**

| | 2019 | 2020 | 2021e | 2022e | 2023e |
|---|---|---|---|---|---|
| Real GDP growth, % | 0.1 | -6.4 | 4.6 | 1.3 | 1.2 |
| Inflation, CPI, year average, % | 4.1 | 3.3 | 4.5 | 6.5 | 4.5 |
| Central Gov. balance / GDP, % (1) | -6.1 | -9.9 | -5.2 | -4.2 | -4.0 |
| Central Gov. debt / GDP, % (1) | 57.4 | 70.7 | 72.4 | 78.4 | 81.3 |
| Current account balance / GDP, % | -2.6 | 1.8 | 3.8 | 1.3 | 0.8 |
| External debt / GDP, % | 42.6 | 47.8 | 55.8 | 45.8 | 40.8 |
| Forex reserves, USD bn | 55.1 | 55.5 | 57.6 | 58.0 | 57.3 |
| Forex reserves, in months of imports | 8.4 | 6.6 | 5.9 | 5.6 | 5.2 |

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

**SIGNIFICANT BUDGET DEFICIT**

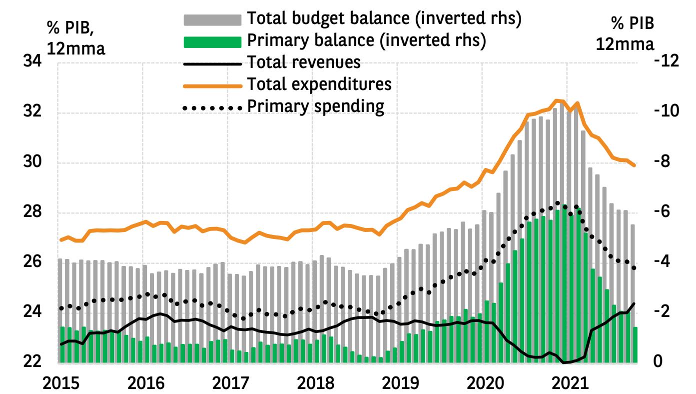


CHART 1
SOURCE: STATISTICS SOUTH AFRICA, BNP PARIBAS

The deficit for FY2021/2022 was revised downwards thanks to the stronger-than-expected growth in fiscal revenue, driven by the upturn in the prices of mining products.

For the fiscal year 2022/23, high prices for South Africa's main export products (aluminium, gold and diamonds) should result in an even bigger fiscal windfall. In contrast, the government is surprisingly unlikely to raise fuel taxes since it does not want to aggravate the increase in crude oil prices on pump prices.

On the spending side, the government maintained its proposal to control current expenditures, with a 4% increase compared to the previous year. This is in line with the increase in social welfare programmes and the extension of the one-time welfare allowance, set up during the pandemic. For the moment, the ZAR 350 subsidy has been extended through March 2023, for a total cost estimated at ZAR 44 bn (0.7% of GDP). The strategy for consolidating spending depends primarily on controlling public sector wages (which account for nearly 35% of total current expenditures) and the absence of additional transfers to support state-owned companies. The cost of debt servicing remains the fastest-growing expense (+12% a year on average in FY 2022/23 and FY 2023/24), far outpacing the expected nominal growth rate. Consequently, the budget is based on optimistic projections of GDP growth in real terms of 1.9% in FY 2022/23 and 1.7% in FY 2023/24. Yet since the budget was elaborated before the outbreak of the war in Ukraine, we esteem that actual growth will be slower (+1.5% and +1%, respectively, in FY 2022/23 and FY 2023/24 according to our estimates) mainly due to the decline in domestic demand.

The war in Ukraine is triggering higher inflation, which is likely to erode domestic demand. South Africa has few direct trade ties with Ukraine and Russia (0.8% of total imports in 2020), but its status as a net importer of hydrocarbons and grains exposes the country to a general increase in prices and supply chain disruptions. Already present through the impact of the global recovery via higher energy prices, inflation pressures are beginning to spread to other items such as food. Consequently, we have drastically revised our inflation forecasts: we are now looking for inflation of 6.5% in calendar year 2022 and 4.5% in 2023.

In spite of the rise in inflation, the debt ratio should increase and reaches more than 72% of GDP according to our forecasts. Such a high debt burden will make it hard to stabilise, despite a moderate fiscal deficit excluding interest charges, and forecasts calling for a return to a balanced budget as of FY 2023/2024. The significant gap between real interest rates and GDP growth is fuelling a snowball effect (see chart 2) in which debt servicing accounts for nearly 15% of total spending (more than 4% of GDP). Moreover, the cost of borrowing could rise for the government at a time of monetary tightening.

For the moment, the structure of the debt (average maturity of 12 years, only 10% of which is denominated in foreign currency, while the share of debt in the local currency held by non-residents has been reduced from 37% to 28% since 2019) will soften the impact of rate increases and currency depreciation, and limit refinancing risks. Nonetheless, the international environment is bound to increase risk aversion and force the government to refinance in the short term, which would only accelerate the snowball effect.

## KEY CHALLENGES

In addition to the various repercussions of the war in Ukraine, three sources of pressures could thwart the fiscal consolidation plans.

First, the local population is increasingly dissatisfied with higher prices in an already tense social climate. Given the pressures created by income inequality and historically high unemployment (more than 35% at year-end 2021), the subsidy may have to become permanent and other subsidies may have to be implemented as well. For the moment, the government has only decided to reduce the fuel tax (–40%), which should have a neutral impact on the budget thanks to the sale of strategic oil reserves.

Second, the current environment could force the government to scale back its plans to bring the public sector wage bill back under control.

PERILLOUS DEBT TRAJECTORY

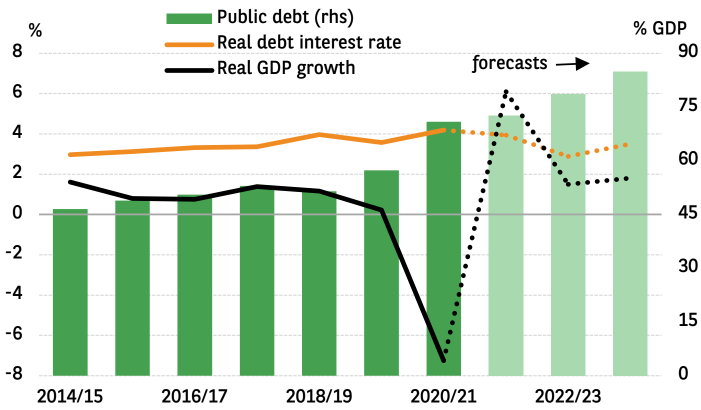


CHART 2

SOURCE: NATIONAL TREASURY, BNP PARIBAS

Unions are asking the government for an annual nominal wage increase of nearly 8% (which corresponds to the inflation rate plus 2 percentage points) compared to a wage increase of just over 2.6% provided in the FY 2022/23 budget. Although the government has some flexibility to offer a slightly higher nominal wage increase than budgeted, the raise demanded by the unions would require additional measures to contain spending and/or reduce staff. From this perspective, the current talks will be decisive.

Lastly, the difficult financial situation and poor performance of state-owned companies could require the government to make new capital injections. The liabilities of state-owned companies are a major fiscal burden with state-backed guarantees accounting for more than 9% of GDP. For example, the potential assumption of Eskom's debt would account for ZAR 329 bn (USD 25.8 bn). Debt restructuring decisions have been constantly delayed, and the 9.6% electricity tariff increase in FY2022/23, which was well below the 20.5% requested, will continue to add to the financial hardships of the company.

Just recovering from the pandemic crisis, South Africa's fiscal prospects remain extremely fragile. In the short term, temporary revenue growth could be offset by the impact of weaker-than-expected growth and fiscal adjustments that will widen the deficit. In the medium term, the crowding-out effect of fiscal imbalances on investment spending are likely to persist and continue to strain growth. From this perspective, South Africa's economic prospects appear tilted to the downside.

*Writing completed on 11 April 2022*

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# A SHORT-TERM RELIEF FOR EXTERNAL LIQUIDITY

**Egypt's economic prospects have worsened with the outbreak of war in Ukraine and its consequences for commodity prices. The widespread increase in prices will result in a significant drop in consumer purchasing power and will thus stall the main engine of economic activity. The erosion of foreign currency liquidity has accelerated over the last month, with massive outflows of capital and an expected widening of the current account deficit due to the difficulty in reducing imports, a drop in tourist frequentation and the limited effect on exports of the Egyptian pound's depreciation. This highlights the continued vulnerability of the economy to external shocks and its reliance on external support. The support already in place from the Gulf states, and the expected package from the IMF, will give the country a little time, but foreign investors will remain cautious against a background of deterioration in the public finances.**

## GROWTH PROSPECTS WORSEN

Despite the substantial rebound in economic activity in the first half of the 2022 fiscal year (FY), with growth of over 8% y/y, economic growth over the year as a whole is likely to be below expectations. Consumer spending, the main driver of economic activity, is likely to be particularly hard hit by the consequences of the war in Ukraine. Although prices for certain foodstuffs (including bread, which is the staple food of most of the population) are likely to remain under control due to government subsidies, rising commodity prices on global markets will push all prices upwards and will thus eat into household purchasing power a bit more. Investment could also slow down as prices for construction materials rise.

The effects on international trade are less clear cut. Exports could benefit from European demand for gas and, for manufactured goods, from the pound's recent depreciation. But these effects will be constrained by reduced additional capacity for gas exports, after the rapid recovery in 2021, and the limited competitiveness of non-hydrocarbon exports. Moreover, exports of certain food products and raw material have been banned for at least six months to avoid supply disruption.

In addition, any recovery in tourism has been compromised in the short term, given that Russian and Ukrainian tourists account for some 30% of total visits. All of these factors linked to the crisis in Ukraine will have a particularly harsh effect on the final quarter of the current fiscal year.

Even so, given the strong recovery in the first part of the year, growth should reach 5.5% in FY 2022. But economic growth will slow over the first half of the calendar year, and we are expecting only a very modest growth in FY 2023. Our central scenario incorporates continued high prices for energy and agricultural goods at least until the end of 2022. Household consumption will thus continue to be hampered by high prices during the first half of FY 2023. Meanwhile, the constraint of expenditure that cannot be compressed, or only to a limited degree (wages, debt interest), limits the government's scope to support economic activity. Even in the event of a recovery in the second half of FY 2023, GDP growth for the year is likely to be just 3.9% at best.

## A SHARP INCREASE IN INFLATION

Consumer price inflation has accelerated significantly since the start of the year. It climbed from 6% y/y in December 2021 to 10.5% y/y in March 2022, with core inflation (10.1% in March) following the same trend. The impact of the pound's depreciation on the price of imported goods will only be partly offset by the setting of a specific exchange rate (EGP16 per USD) to be applied to some essential goods. The currency effect adds to the high level of commodity prices on international markets, and we are expecting an acceleration to 13% y/y in April. The month of Ramadan is traditionally associated with an inflationary surge. On average, we expect inflation for FY 2022 to hit 8.2%. Assuming that commodity prices remain high until at least the end of 2022, consumer price inflation could average 10.1% over FY 2023.

FORECASTS

| | 2019 | 2020 | 2021e | 2022e | 2023e |
|---|---|---|---|---|---|
| Real GDP growth, % | 5.6 | 3.5 | 3.3 | 5.5 | 3.9 |
| Inflation, CPI, year average, % | 11.0 | 10.2 | 7.2 | 8.2 | 10.1 |
| Central. Gov. balance / GDP, % | -8.0 | -8.0 | -7.4 | -7.9 | -8.6 |
| Central. Gov. debt / GDP, % | 84 | 90 | 95 | 95 | 97 |
| Current account balance / GDP, % | -3.6 | -3.1 | -4.5 | -5.1 | -5.0 |
| External debt / GDP, % | 36 | 34 | 35 | 37 | 40 |
| Forex reserves (excl. gold), USD bn | 42 | 34 | 36 | 32 | 30 |
| Forex reserves, in months of imports | 6.4 | 5.4 | 5.4 | 4.2 | 4.6 |

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

EGYPT: CONSUMER PRICE INDEX, CONTRIBUTIONS TO INFLATION

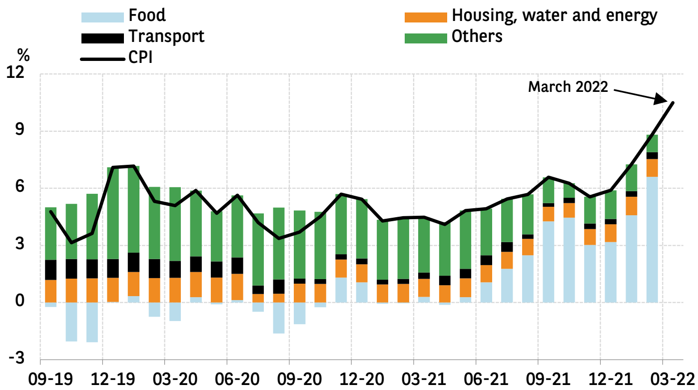


CHART 1

SOURCE: CENTRAL BANK OF EGYPT, BNP PARIBAS

Against this background, inflation could significantly overshoot the average target of 7% +/-2% set by the monetary authorities for Q4 2022. The rate raising process initiated by the Central Bank of Egypt (CBE) in March is therefore likely to continue throughout 2022.

## DETERIORATION OF EXTERNAL ACCOUNTS

Having begun in mid-2021, the erosion of foreign currency liquidity accelerated following the outbreak of the war in Ukraine. In the second half of 2021, a widening current account deficit and more risk aversion amongst international investors (risk premiums on foreign currency sovereign debt doubled between September and December of 2021) resulted in a deterioration of the balance of payments. Although the CBE's currency reserves remained more or less stable over the year at around USD36 billion (excluding gold), the net external debt of commercial banks jumped to USD11.5 billion by the end of 2021, having been nil six months earlier. The vulnerability of the Egyptian economy to the consequences of the conflict in Ukraine has resulted in significant capital outflows. In March 2022, the CBE's currency reserves fell by USD4.8 billion, whilst Tier 2 reserves (designed to tackle outflows of volatile capital) fell by USD7.4 billion.

Against this backdrop, the CBE allowed the pound to depreciate by 15% relative to the US dollar, and official discussions were opened with the IMF. In parallel, Saudi Arabia increased its deposits with the CBE by USD5 billion and an Emirati sovereign wealth fund acquired nearly USD2 billion of assets on the Egyptian stock market (equivalent to around 5% of total market capitalisation). This substantial support, in addition to the expected assistance from the IMF, should help limit downward pressure on currency reserves in the very short term.

Even so, we remain cautious about short-term and medium-term prospects. The Ukraine crisis has demonstrated once again the vulnerability of Egypt's balance of payments to external shocks and its reliance on substantial external support under such conditions. We expect the current account deficit to grow over 2022 and 2023. Even though import volumes are falling fast, the gains will be offset by higher commodity prices. The country has been a net importer of crude oil since 2015, and the current account deficit on hydrocarbons is likely to hit USD1 billion in 2022 and 2023 (from an average of USD0.4 billion over the previous three years). As far as food imports are concerned, although imports can be limited for a few months thanks to levels of wheat stocks and the beginning of the country's own harvest (meeting around 25% of demand), the difficulties of accessing Russian and Ukrainian wheat (80% of Egypt's wheat imports) and the high prices throughout the value chain (fertilisers, energy, transport) look set to maintain upward pressures on wheat prices until at least the end of 2022. For exports, the competitiveness improvements expected from the devaluation of the pound are far from guaranteed, given first that some categories of goods are covered by export bans, and secondly that global trade is expected to slow down. In all, the trade deficit could exceed USD50 billion (11% of GDP) for the first time ever in FY 2023. Revenues from the Suez Canal are likely to continue to grow, thanks in particular to an increase in fees, but these account for only some 6% of total current receipts. The long-awaited recovery in tourism is likely to be delayed by several months. The only truly positive point, remittances from expatriate Egyptians (one third of current receipts) are likely to remain strong, thanks to buoyant economic conditions in the Gulf states and the attractive interest rates on pound certificates of deposit offered by the two main public sector banks (18% per year). In FY 2023, the total external financing requirement (current account deficit and repayments on foreign currency debt) is likely to approach USD30 billion. International financing, whether multilateral (IMF) or bilateral (Gulf states) will cover part of this requirement. However, flows of portfolio investments are both more uncertain and more costly. In particular, risk premiums on sovereign debt have risen by 150 points over the past year.

EGYPT: FOREIGN ASSETS OF THE BANKING SYSTEM

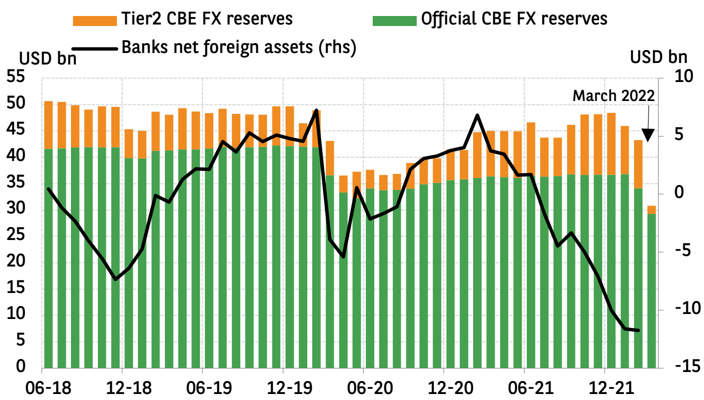


CHART 2 SOURCE: CENTRAL BANK OF EGYPT, BNP PARIBAS

## THE BUDGET DEFICIT IS GROWING AGAIN

The efforts to consolidate the government's budget, seen since 2015, will be interrupted. Due to higher food subsidies and a slower tax collection process, the budget deficit is likely to reach 7.9% of GDP this year, with the primary balance remaining in surplus by 0.1% of GDP. The deterioration in economic prospects since the start of the year has caused the government to review its 2023 budget. The measures announced include a widespread increase in social security spending and increases in public sector wages and pensions, coupled with tax cuts on financial transactions, which are likely to benefit foreign investors in particular. We estimate that these measures could represent around 5% of GDP. At the same time, the combination of higher short-term interest rates at the CBE and persistent inflationary pressures are likely to increase the government's cost of financing across all maturities. In all, we expect a primary deficit of 0.4% of GDP in FY 2023 and an increase in interest costs (51% of receipts in FY 2021).

*Writing completed on 11 April 2022*

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# MOROCCO



## POLICY MIX UNCHANGED

**Morocco's heavy dependency on oil and wheat imports mean that it will suffer consequences from the conflict in Ukraine. However, it will be able to absorb the trade shock thanks to comfortable FX reserves. Moreover, the rise in energy and food subsidies does not compromise the expansionary fiscal policy, and the central bank plans to maintain its accommodative stance despite strong but still under control inflationary pressure. Government support remains crucial at a time when the economy is facing a significant drop in agricultural output, and therefore real GDP growth. In the short term, state solvency and external liquidity are not at risk. However, there is a high level of uncertainty about how large the shock will be and how long it will last.**

### HIGHLY VULNERABLE TO THE COMMODITY PRICE SHOCK

Morocco will be hard hit by the indirect consequences of the conflict in Ukraine. Trade relations are limited, since Russia and Ukraine account for only 3% of Morocco's external trade, and almost non-existent for tourism activity and investment. However, around 20% of Morocco's cereal imports come from the two countries, which means it will have to find new sources at a time when global prices are soaring and when Morocco's domestic production is about to fall dramatically because of a serious drought during the winter. Morocco depends on external supply to cover around 60% of its needs. In addition, the weight of food in the consumer price basket is heavy (37.5%). Although Morocco has relatively large wheat reserves (five months), the higher cost of cereals will put serious pressure on Morocco's trade position and inflation. The energy shock may be even greater. With hydrocarbon imports over 6% of GDP in the last five years, Morocco's economy is one of the most vulnerable to oil price movements in the MENA region. Nevertheless, it is also one of the most robust to deal with the shock.

### EXTERNAL LIQUIDITY: SIGNIFICANT BUFFERS

Morocco's external stability is not under threat. Although imports are expected to rise sharply – each $10 increase in the Brent crude price raises energy imports by 1% of GDP – exports will also perform well. This is due in particular to high global prices for phosphates (20-25% of Morocco's exports). They rose 67% in 2021 to their highest level since 2012, and the outlook is well oriented in tandem with the strong dynamic of agricultural commodity prices. Morocco is the world's fifth-largest exporter of fertilisers and could even gain market share. Other factors should also be taken into account, starting with the rebound of tourism. Although the Covid-19 pandemic still represents a risk, the progress of vaccination programmes in both Morocco and Europe gives grounds for hope that tourism will start to recover after two difficult seasons. A rise in tourism receipts by 50-60% is thus hoped this year before moving back close to its pre-pandemic level in 2023. Receipts were still 56% below that level in 2021. In addition, remittances from the Moroccan diaspora will continue to play a shock-absorbing role, although they could fall from the record of MAD93.2 billion (10.7% of GDP) seen in 2021.

In the circumstances, the current account deficit is expected to widen significantly to 5.7% of GDP in 2022, before narrowing to 4.8% in 2023. Although the widening of Morocco's sovereign spreads on foreign currency bonds has remained limited at 260bp compared with 350bp for the average of emerging countries, external financing conditions are also likely to be less favourable than in the last two years. However, the Moroccan economy has some significant buffers. FX reserves currently cover seven months of goods and services imports. Limited exposure to portfolio investment flows is also a stabilizing factor in the current context. In addition, the authorities are not ruling out asking the IMF for a new precautionary and liquidity line should pressure on the balance of payments becomes too strong. At the moment, that pressure appears manageable. The fluctuation of dirham does not point out any particular sign of stress chart 1). Its fall against the US dollar just after the conflict broke out is mainly linked to the weakening of the euro against the dollar. The dirham also remains within fluctuating bands and forward rates show limited currency risk at this stage.

**FORECASTS**

| | 2019 | 2020 | 2021e | 2022e | 2023e |
|---|---|---|---|---|---|
| Real GDP growth, % | 2.6 | -6.3 | 7.1 | 0.7 | 4.5 |
| Inflation, CPI, year average, % | 0.2 | 0.6 | 1.4 | 4.6 | 2.1 |
| Central Gov. balance / GDP, % | -4.0 | -7.6 | -6.4 | -6.3 | -5.5 |
| Central Gov. debt / GDP, % | 64.8 | 76.4 | 74.5 | 76.6 | 76.7 |
| Current account balance / GDP, % | -4.1 | -1.5 | -2.5 | -5.7 | -4.8 |
| External debt / GDP, % | 45.6 | 57.1 | 49.2 | 50.4 | 50.7 |
| Forex reserves, USD bn | 25.3 | 34.7 | 34.3 | 32.4 | 31.4 |
| Forex reserves, in months of imports | 5.5 | 9.0 | 7.1 | 5.8 | 5.5 |

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

**MOROCCO: NOMINAL EXCHANGE RATE**

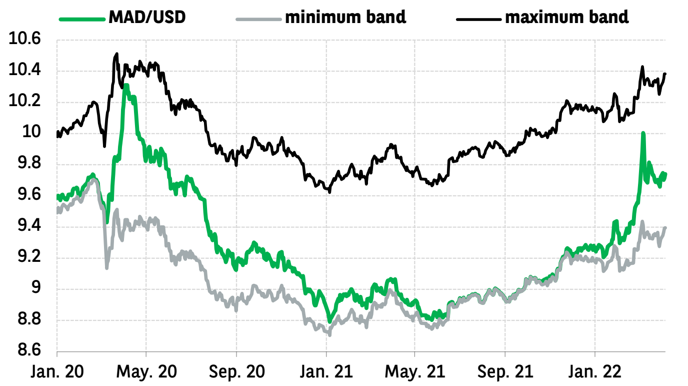


CHART 1

SOURCE: CENTRAL BANK

## NO CHANGE IN FISCAL POLICY...

Public finances also offer some room for manoeuvre, at least in the short term. Unlike other countries in the region, the Moroccan government has not been subsiding petroleum prices since 2015. It has announced targeted measures to support transport companies, but these remain limited to 0.2% of GDP. However, subsidies for butane and wheat flour will increase sharply. According to the latest estimates, they are likely to reach 2.4% of GDP this year against 1.4% initially budgeted, and this additional cost will come on top of other support measures for the tourism and agriculture sectors. In response, the government is planning to mobilize additional revenues thanks notably to excellent performances of state-owned phosphates producer OCP.

The deficit target of 6.3% of GDP in 2022 (5.9% including privatisation proceeds) remains unchanged. Although some assumptions are still fragile, the government has already declared that a supplementary financing bill will be not necessary. There are also no plans of spending reallocations despite the historically high public investment of more than 20% of GDP – including state-owned enterprises, local authorities and the Mohammed VI strategic fund- budgeted in 2022 and the launch of the social protection extension, which will cost an estimated 1.5% of GDP per year in the next five years. The fact that the government is not planning to use the SDRs (0.9% of GDP) allocated by the IMF in August 2021 is another sign of confidence. In any case, the government will still be able to rely on a liquid, captive domestic market in order to continue accessing funding at favourable conditions. Although the central government debt is high at 75% of GDP, interest payments absorb only 12% of revenue thanks to one of the lowest apparent interest rates in the region (3.3%). The debt structure is also favourable, with 77% denominated in local currency and held by Moroccan residents, limiting vulnerability to external shocks.

## ... AND MONETARY POLICY FOR THE MOMENT

By deciding to leave its key interest rate unchanged at 1.5%, Morocco's central bank has wanted to send a reassuring signal. Inflation is accelerating, as it is all around the world, but the surge is recent and relatively mild (chart 2). In 2021, consumer prices rose at an average annual rate of only 1.4%. In February 2022, they were up 3.6% y/y and the situation will only get worse given the pressures on global commodity markets and the drop-off in national agricultural production. Three quarters of the acceleration in inflation in recent months reflects higher prices for food (+5.5% in February 2022) and transport (+6%), essentially due to external factors. Excluding these two categories, the growth in prices was less than 2%. Domestic pressures are mild. Average private sector wages grew only 1% in nominal terms in Q4 2021, while bank lending to the economy was up 3.3% y/y in February. Both of those increases are lower than the inflation rate. Moreover, with an unemployment rate at 11.9%, up from 10.2% in Q4 2019, the economy has not fully recovered job losses induced by the pandemic shock while the cycle is deteriorating again. Although inflation is expected to be 4.6% this year and there is a lot of risk on the upside, the central bank thus has a strong case for maintaining its accommodative stance.

MOROCCO: CONTRIBUTION TO INFLATION AND KEY POLICY RATE

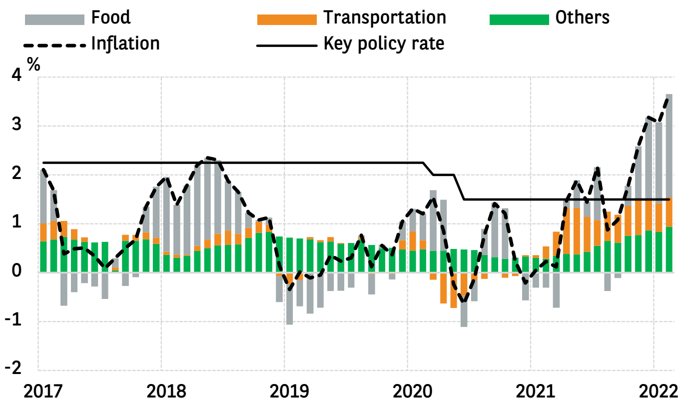


CHART 2 SOURCE: CENTRAL BANK, HIGH COMMISSION FOR PLANNING

## GROWTH: ABRUPT HALT AND RISKS

After the strong rebound seen in 2021, growth will come to an abrupt halt this year. The central bank has just cut its growth forecast to only 0.7% because of the 20% drop in value added in the agricultural sector. Although late rainfall could help to save the crop somewhat, the primary sector's poor performance will inevitably drag down growth given its significant weight into the economy (10-12% of GDP). Non-agricultural activity could also be hit hard by developments in the global economy. Downward revisions have been limited so far. Growth outside the agricultural sector is expected to slow because higher inflation will affect household consumption. But it should remain relatively solid at around 3% thanks to monetary stimulus and expansionary fiscal policy. On the sectoral side, the expected rebound in tourism activity should also support economic growth. Nevertheless, there is limited visibility due to the high level of uncertainty about how large the shock will be and how long it will last. If the European economy contracts sharply, this could seriously hold back Morocco's manufacturing sector, which was crucial to the 2021 upturn. Above all, the authorities could be forced to change their policy priority if purchasing power falls too sharply or if the public finances come under persistent pressure. Spending could be reallocated, or monetary policy tightened, which would weaken further a convalescing economy.

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