# ECO EMERGING

4th quarter 2020

## EDITORIAL



ECONOMIC RESEARCH

BNP PARIBAS

The bank for a changing world

# EDITORIAL



## LOSS OF MOMENTUM

**The recovery in economic activity that began at the end of the spring continued through the summer, with China leading the way, and oil and metals prices have picked up. But doubts are emerging as the pace of the recovery seems to be slowing, as reflected by exports recent loss of momentum. Above all, there are currently worries regarding the persistence of the pandemic and the risk of lockdown extensions or even new lockdowns in several countries. There are, however, some factors of support: continued easing of monetary policies, market tolerance of rising budget deficits and a reduction in the debt of the most vulnerable countries by official lenders. However, the effect of these factors should not be overstated.**

Over the summer, emerging economies bounced back as had been prefigured by business surveys from April onwards. The growth tracker published by the Institute for International Finance (IIF) shows annualised moving average growth over three months of 5.3% in August, from -1.3% in June. The recovery seems fairly solid, as the three components of the index (activity indicators, business surveys and financial indicators) have all contributed since July. In China, GDP has returned to pre-crisis levels and the recovery has become more broadly based.

However, for a large majority of other countries, activity indicators such as industrial production, exports and retail sales had not returned to their end-2019 levels by July. By region, Latin America still lags behind Asia and the EMEA zone, with the IIF indicator down 2.2% in Latin America, but up by 8.1% in Asia including China and 5.1% in the EMEA region.

Disparities between countries and a lack of information means that it is not possible to say whether the recovery is being driven by internal or external factors. In general terms, the recovery in exports seems to be in advance of that in imports, but on the face of it industry can run down inventories to meet demand, whether domestic or external. We might just note that for Brazil, Turkey and central European countries, the recovery has largely been based on household consumption boosted by public transfers (in Brazil and Turkey) or the resilience of the labour market and wages (in central Europe).

### LOSS OF MOMENTUM

Once the mechanical rebound in activity is over, might the recovery run out of steam? Many observers fear so, for various reasons.

The recovery in exports has now stalled in many countries. The year-on-year trend in exports (that is, comparing to pre-Covid times) remains negative. In particular, the very negative gap, which between the low point in March/April and June started to close rapidly, is now proving harder to address. The possibility of a lasting slowdown in international trade due to a reorganisation of value chains and the relocation of businesses remains a major unknown for the recovery scenario.

Several countries have decided to extend or reintroduce lockdowns across the whole country (Israel) or in urban areas (Argentina, Indonesia). Latin America still faces the highest ratios of victims to total population (Brazil, Chile, Mexico, Peru). But the spread of the pandemic seems to be slowing. However, new cases are still on the rise in India, whilst the curve of new cases in several EMEA countries has got significantly steeper. Lastly, only Asian countries have succeeded so far in tackling the first wave and introducing measures to shorten the second wave.

The recovery in portfolio investment seen from the end of May to mid-July has fizzled out. Between mid-July and mid-September, net outflows came to USD13 billion (USD5 billion excluding China) according to IIF figures. This withdrawal of investors was particularly noticeable in Brazil and Turkey.

### A FEW SUPPORTIVE FACTORS

A reversal of activity in Q4 and in 2021 is not the most likely scenario. With the notable exception of Mexico, PMI indices for August had regained or exceeded their Q1 levels. Over and above these advance indicators, there are factors of support, even though these are fragile and the likely impact is limited.

Some 40 countries have applied for the G20's DSSI initiative to suspend repayments of public external debt due to bilateral creditors. The potential amount covered by this deferral of debt payments is USD 11.5 billion between October and December 2020, with an extension of the initiative to December 2021 representing an additional reduction of USD 16.6 billion. The Chinese government seems to be playing an active part, as indicated by the restructuring of Angola's debt. It is also worth noting the agreement Argentina has reached with its private international creditors. This helps provide the breathing space needed to avoid a multiplication of sovereign defaults.

Commodity prices have firmed up although the scale of their recovery is limited due to high inventory levels. Oil and gas prices have benefited from OPEC+ members respecting production quotas, whilst metals prices have been bolstered by China's measures to promote infrastructure and construction investment.

Meanwhile, monetary easing has continued in a dozen emerging nations, such that interest rates on sovereign debt in local currencies have continued to fall, at least in Asia. The markets are still not reacting negatively to the sharp increases in budget deficits. Elsewhere, the withdrawal of non-resident portfolio investments has in particular affected equity markets, but had little effect on local-currency sovereign debt markets.

The two exceptions are Turkey and, to a lesser extent, Brazil. The lira and the real have not gained ground against the US dollar, despite the fact that the former has weakened against major currencies since July. The Turkish central bank has been forced to tighten monetary policy, resulting in a significant increase in the government's borrowing costs.

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# CHINA



## HOUSEHOLDS ARE STILL WORRIED

**The economy continues to recover. Initially driven by a rebound in industrial production and investment, the recovery broadened over the summer months. Exports have rebounded and activity has also picked up in the services sector. Yet it continues to be strained by the timid rebound in household consumption, which is far from returning to normal levels. The unemployment rate began to fall right again after the end of lockdown measures, but this decline has been accompanied by an increase in precarious jobs and large disparities, with the unskilled and young college graduates being particularly hard hit.**

Whereas the economic recovery since March has been initially driven by the rebound in industrial production and investment in public infrastructure and real estate, there has been a more widespread strengthening in activity since the summer. Exports have posted a solid rebound and growth in the services sector has gained momentum. Although private consumption has shown some signs of recovering, households remain very cautious. In the months ahead, whether the economic recovery consolidates will depend largely on the authorities' stimulus policy as well as on export performance and labour market trends.

### A BROADER RECOVERY

Industrial production has continued to strengthen, rising 5.6% year-on-year (y/y) in August in volume terms (+3.6% in value), up from 4.8% in June and July. In the first eight months of 2020, industrial production slightly exceeded the level reached in the same period in 2019 (+0.4%). Activity seems to have returned to normal in a large number of industrial sectors. Yet many corporates still remain severely weakened following the losses reported in Q1 2020. Although profits of industrial enterprises have rebounded over the past four months, they were still 8% lower in January-July 2020 than in the same period in 2019. In the services sector, activity has continued to pick up slowly (+4% y/y in August, vs 3.5% in July and 2.3% in June). After a more drastic downturn than in industry during the Q1 lockdown, the recovery since March has proved to be slower.

On the demand side, the rebound continues to be fuelled by domestic investment. In the first eight months of 2020, investment was only 0.3% below the level reached in the same period in 2019. It remains driven by new projects in public infrastructure and real estate. Manufacturing investment also rebounded in August; yet, in the first eight months of 2020, it was still 8.1% below the level reached in the same period in 2019. In the short term, investment in infrastructure should remain dynamic, bolstered by a still expansionist fiscal policy stance. In contrast, monetary policy is expected to be less supportive, which should contribute to slower growth in real estate investment. In the manufacturing sector, the rebound in investment should gain momentum if corporate profits continue to improve and export performance remains solid. Even so, corporates will probably maintain a cautious approach, due to possible financial difficulties and because uncertainty over the recovery in world demand and US-China tensions continue to strain export prospects.

After declining rather moderately over the period March-June, merchandise exports rebounded by 7.3% y/y (in USD) in July and 9.5% in August (Chart 1). This strong performance is mainly due to high demand for medical devices and equipment and technological goods, as well as to China's advantageous position in the Covid-19 crisis: as the first country to reopen after the lockdown and to start up production, it has been able to respond rapidly to demand from its trading partners as soon as it began to rebound. As a result, China has managed to increase its share of global exports (to about 14% in H1 2020 from 13.3% in 2019). As total import value has declined (volumes have increased but price effects have remained negative), the trade surplus has grown in recent months.

**FORECASTS**

| | 2018 | 2019 | 2020e | 2021e |
|---|---|---|---|---|
| Real GDP growth (%) | 6.7 | 6.1 | 2.5 | 7.5 |
| Inflation (CPI, year average, %) | 2.1 | 2.9 | 2.8 | 2.3 |
| Official budget balance / GDP (%) | -2.6 | -2.8 | -3.6 | -3.0 |
| Central government debt / GDP (%) | 16.3 | 17.0 | 19.6 | 20.8 |
| Current account balance / GDP (%) | 0.2 | 1.0 | 2.0 | 1.6 |
| Total external debt / GDP (%) | 14.3 | 14.3 | 14.1 | 13.5 |
| Forex reserves (USD bn) | 3 073 | 3 108 | 3 168 | 3 208 |
| Forex reserves, in months of imports | 14.5 | 15.0 | 16.6 | 15.4 |
| Exchange rate USDCNY (year end) | 6.9 | 7.0 | 6.8 | 6.6 |

TABLE 1

e: ESTIMATES AND FORECAST
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

**A STEADY EXPORT REBOUND**

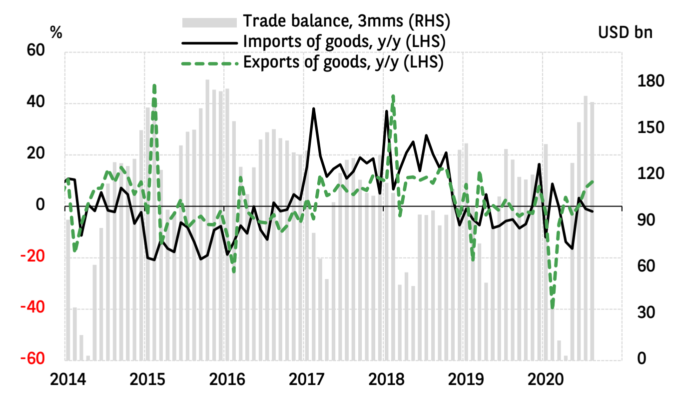


CHART 1

SOURCE: GENERAL ADMINISTRATION OF CUSTOMS

China is far from reaching the level of purchases of US goods stipulated in the Phase 1 trade agreement signed with Washington earlier this year (imports in the first seven months of 2020 would have accounted for a little less than half of the target for the period according to estimates by the Peterson Institute for International Economics), but neither party is presently calling the trade deal into question.

## PRIVATE CONSUMPTION IS STILL RESERVED

Private consumption has shown signs of recovery but still seems far from returning to normal. In value terms, retail sales reported slightly positive growth in August (+0.5% y/y) for the first time this year, but they were still down 1.1% in volume terms. In the first eight months of 2020, retail sales were still well below their 2019 level (-8.6% y/y). E-commerce has continued to make inroads. The amount of online retail sales of goods increased 16% y/y in August, and accounted for 36% of retail sales in H1 2020, vs 25% in 2019. Evidently, households are still worried. Consumer confidence indexes began to recover in July, after plummeting throughout the first half, but they are still holding below 2018-19 levels. This mistrust can be attributed principally to health risks and labour market trends.

## THE CRISIS LEAVES ITS MARK ON THE LABOUR MARKET

The main official unemployment rate (based on people registered at the local employment service agencies) has not increased much, rising from 3.62% in Q4 2019 to 3.84% in Q2 2020 (equivalent to 10.1 million individuals). The unemployment rate estimated by the National Bureau of Statistics (NBS) based on survey data is considered to be more exhaustive; it increased more sharply from 5.3% in December 2019 to 6.2% in February (Chart 2). It has fallen again since March (to 5.6% in August) but remains higher than the pre-crisis unemployment rates.

However, these official unemployment rates largely underestimate the shock that has hit the population. First, the scope of calculation is limited since: 1) it only takes into account the urban labour market, and 2) it excludes a large number of migrant workers who lost their jobs in urban areas during the lockdown, many of whom returned to their rural residence. According to the most common estimates, at least 80 million individuals throughout the country had lost their jobs at the end of February (out of 775 million jobs in 2019, of which 291 million were held by migrant workers).

The labour market began to improve as of March as the unemployment rate fell and migrant workers began to return to urban areas. However, the situation remains very difficult for certain categories of individuals. Average unemployment rates mask high disparities, with the unskilled and recent college graduates being hit hardest. In 2020, 8.7 million young college graduates must enter the labour market, mostly during the summer. As a result, the unemployment rate for the 20-24 age group continued to rise in August according to the NBS (it would be close to 20%). The government is particularly alarmed by this situation and has asked local governments and state-owned enterprises to strongly step up their hiring this year. Lastly, the downturn in the job market is also illustrated by the significant rise in precarious jobs (part-time work, self-employed, online retailers...) which is partially encouraged by the authorities.

As a result of these dynamics, the average disposable income per capita declined by 1.3% y/y in real terms in H1 2020 (the 3.9% contraction in Q1 was followed by a slight rebound in Q2). This trend has resulted from the decline in real wages and the collapse in net business income (for self-employed). The loss of earned income has strained private consumption even more since it has mainly affected low-income households, and has not been offset much by an increase in social welfare benefits. The authorities have introduced a few measures to directly support households, but yet their stimulus plan has focused primarily on programmes to support corporates and public investment.

The improvement in labour market conditions, observed as soon as lockdown restrictions were lifted, could continue in the short term thanks to public-sector construction projects and most importantly if export performance remains strong, thus supporting activity in the manufacturing sector. This is still uncertain, however, as it will depend on external conditions. At a time when the squeeze on household income could continue to be felt for some time to come, the strengthening in China's social welfare system increasingly appears to be necessary to stimulate private consumption in the short and the medium terms.

OFFICIAL UNEMPLOYMENT RATES UNDERESTIMATE THE Q1 SHOCK

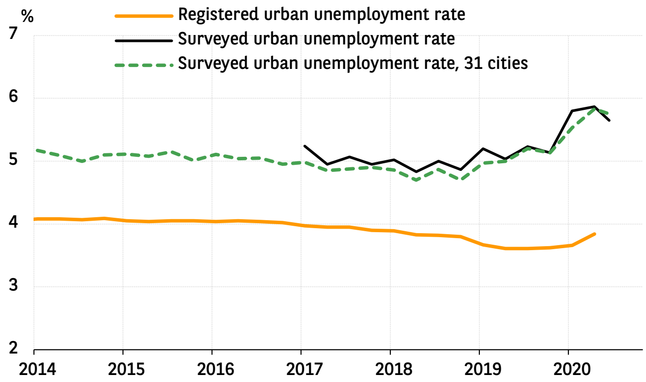


CHART 2

SOURCE: MINISTRY OF HUMAN RESOURCES AND SOCIAL SECURITY, NBS

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# SOUTH KOREA



## RESILIENT

**Once again, South Korea seems to be withstanding the crisis better than developed nations generally. The effective management of the health crisis and the government's massive stimulus package paved the way to a shallower recession than in other countries in the first half of 2020. However, the new social distancing measures introduced at the end of August and the persistent weakness of exports will hold back growth over the coming months. In the short to medium term, macroeconomic fundamentals are likely to remain very solid: government deficit and debt levels remain modest, inflation is under control and external vulnerability is very low.**

### A SHALLOWER RECESSION

Compared to other developed nations, the recession expected in South Korea in 2020 is likely to be moderate. GDP is likely to contract by 1.3% in 2020, having grown by 2.0% in 2019 and an average of 2.8% per year over the past five years.

On the one side, effective management of the health crisis (with the government electing in January to pursue a policy of mass testing, contact tracing and isolation of cases) allowed a relaxation of restriction on the movement of individuals and on economic activity earlier than in other countries and for a national lockdown to be avoided.

On the other side, solid macroeconomic fundamentals (at the beginning of 2020 government debt and the deficit were modest, inflation was under control and external vulnerability was very low) allowed the government to step in to support the economy: a number of programmes (four so far) have been announced by the government since March, including both short-term measures (to support the most vulnerable households and SMEs) and other more long term actions. Announcements in July included most notably the "Korean New Deal": a 5-year investment plan, which aims to "digitalise" the economy, promote "ecological and environmental" projects and improve social coverage for the whole population. All in all, including both direct and indirect support (such as the extension of guarantees for companies and deferred payments of taxes and social security contributions), the measures taken are worth some 20% of GDP. At the same time, the Central Bank has cut its policy rate by 75 basis points since March (to 0.5%), announced several financial support packages (notably for vulnerable companies) and undertaken to provide substantial liquidity to companies.

All in all, GDP fell by 'only' 0.7% y/y in the first half, and private sector demand proved fairly resilient: private consumption fell by 4.5% y/y in the first half, whilst investment grew by 3.3% y/y, illustrating the flexibility of the Korean economy. To no great surprise, however, exports collapsed rapidly in the second quarter (down 13.0% y/y in real terms), despite the support provided by growth in semiconductor exports. The latter was driven by strong demand for chips (components in laptop computers and networking equipment) in response to the rapid growth in remote working.

FORECASTS

| | 2018 | 2019 | 2020e | 2021e |
|---|---|---|---|---|
| Real GDP growth (%) | 2.7 | 2.0 | -1.3 | 2.7 |
| Inflation, CPI, year average (%) | 1.5 | 0.4 | 0.4 | 1.1 |
| Gen. gov. balance / GDP (%) | 1.4 | -0.6 | -4.4 | -4.3 |
| Gen. gov. debt / GDP (%) | 39.5 | 39.5 | 44.0 | 44.3 |
| Current account balance / GDP (%) | 4.8 | 3.6 | 1.0 | 2.5 |
| External debt / GDP (%) | 25.6 | 28.4 | 30.1 | 30.4 |
| Forex reserves (USD bn) | 398 | 404 | 400 | 402 |
| Forex reserves, in months of imports | 7.2 | 7.5 | 7.5 | 7.3 |
| Exchange rate USDKWR (year end) | 118 | 1 158 | 1 210 | 1 210 |

TABLE 1

e: ESTIMATES AND FORECAST
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

GDP (%, YOY) AND COMPONENTS (IN PERCENTAGE POINTS)

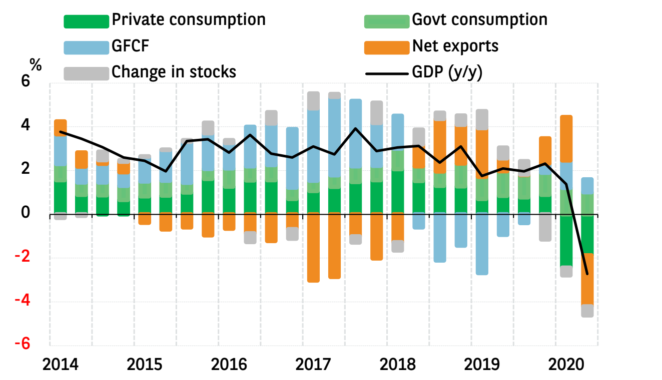


CHART 1

SOURCE: NATIONAL ACCOUNTS

### A GRADUAL RECOVERY RATHER THAN A REBOUND

The economic recovery will be gradual. The indices of industrial production and retail sales have recovered steadily since April, but there are several factors that constrain the recovery in the short term. We expect GDP growth of 2.3% in 2021.

First, the government reintroduced social distancing measures at the end of August after a fresh increase in the number of cases. New cases hit 400 per day at the end of the month, compared to an average of 44 between 15 March and 15 August. In the first wave of the epidemic the peak came on 29 February with 909 new cases. The restrictions were eased in mid-September (when the number of new cases had stabilised at around 100 per day), but remained at 'level 2' for an indefinite period in the Seoul region (remote working and remote learning where possible, limitations on meetings and so forth). Over the next few days, the government is due to present the new national measures to establish a *"cautious strategy balancing economic growth and tackling the virus"*. These measures will hit private consumption in the final quarter (particularly demand for services) and at the beginning of 2021 – but probably less hard than in the first half of this year.

Secondly, although exports may recover in the very short term, global demand will remain lastingly weakened, which will hit Korean exporters accordingly. The tensions between the USA and China will hit Korean exports particularly hard, given both the high level of Korea's integration in regional value chains, and the importance of the two countries as trading partners (as sources of final demand). A sign of this vulnerability came in the 10% y/y (in current dollars) fall in Korean exports in 2019 as Sino-US tensions rose, whilst Taiwan's exports fell by only 2% over the year (and Chinese exports fell only very slightly). Similarly, although Chinese and Taiwanese exports recovered in the summer of 2020, Korean exports continued to fall (down 9% y/y in July and August). Korean exports to China fell by 16% in 2019 and then by 5% in the first 8 months of 2020.

Tourism revenue will also be weak over the next few quarters, although the effect on growth will not be as significant as for other countries in the region. In the strict sense of the term, tourism revenue accounts for 2% of Korean GDP, compared to nearly 12% for Thailand for example.

Lastly, in the absence of any further stimulus measures, the contribution of public consumption to growth is likely to decline. In its budget proposals, set out in mid-September, the government allowed for an increase in spending of only 1% relative to the total for 2020 (which saw an increase of nearly 15% relative to 2019, after the four successive stimulus packages are taken into account).

## SOLID MACROECONOMIC FUNDAMENTALS HELP ABSORB THE CURRENT PRESSURES

South Korea's macroeconomic fundamentals look set to remain solid over the short term. External vulnerability remains extremely low. The current account is likely to worsen but remain in surplus (with an expected surplus of 1% of GDP, from 3.6% in 2019). Moreover, the external financial position has improved continuously since 2010 and was close to 36% of GDP at the end of Q2 (from just below 20% at the end of Q4 2019), creating strong protection against episodes of capital flight.

Meanwhile, the public finances were on a very sound footing before the four stimulus packages announced this year, so should come under only limited pressure. The first reason for this is that the private sector (including financial institutions) will make a substantial contribution to the financial support provided to companies. Secondly, as early as the 2019 budget, the government was setting out an economic policy of "income-driven growth", the aim of which was to improve redistribution by increasing public spending. The "Korean New Deal" set out in July continues this work. The total government deficit is likely to be 4.4% of GDP in 2020, from 0.6% in 2019. Government debt is likely to rise from 39.5% of GDP in 2019 to 44% in 2020. If the government applies the programmes it has announced effectively, we would expect that deficit and debt will stabilise at around these levels over the next few years.

The profile of government debt is favourable: the maturity of treasury bonds is long (more than 10 years) and the investor base is diverse both domestically and internationally. Lastly, the share of treasury

NET EXTERNALPOSITION (% GDP) AND ITS COMPONENTS (USD BN)

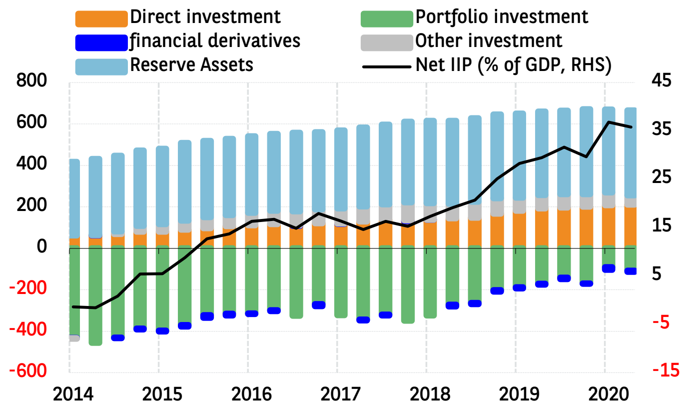


CHART 2

SOURCE: CENTRAL BANK

bonds held by foreign investors has recently risen slightly, but remains moderate (at 17% in July 2020, having been stable at around 15% since 2015). In addition, the contingent debt relating to public companies remains high (estimated at 26% of GDP at end-2019), but has declined steadily since the introduction of the restructuring plan in 2013, when contingent debt stood at over 35% of GDP.

Lastly, the banking system taken as a whole is solid and well-placed to absorb a temporary deterioration of asset quality. Bank profitability will decline over the next few quarters, but the support measures introduced by the government and central bank will help them absorb the shock. All this said, there are still a number of possible weaknesses that will need to be watched: the vulnerability of several regional banks has increased (in the regions where social distancing measures have been stricter) and the same is true of certain export sectors (notably the automotive and shipbuilding sectors). In addition, although the associated risk is considered moderate in the short term, household debt is high (103% of GDP at the end of Q1 2020). The macroprudential measures introduced in 2017 have slowed the growth in lending to households, but the profile of their debt remains a source of vulnerability, particularly as 50% of this debt is still in the form of floating-rate loans.

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# INDIA



## THE RECOVERY WILL BE SLOW

**Between April and June 2020, India's economy contracted by nearly 24% compared to the same period last year. This unprecedented contraction can be attributed to the collapse of domestic demand. Although the economy has rebounded since June, it is still fragile and well below pre-crisis levels. The capacity of the central bank and the government to support the economy, which was already limited, has been further eroded by increasing prices and the drop-off in fiscal revenue. Public debt is expected to swell to 89% of GDP, and will strain the country's future development projects, especially given that government spending contributed to nearly 30% of economic growth last year.**

### AN UNPRECEDENTED ECONOMIC CONTRACTION

In the first quarter of FY 2021 (April-June 2020), India's real GDP contracted 23.9% year-on-year (y/y). With the exception of government spending, there was an unprecedented contraction in all components of domestic demand, triggered by the general lockdown of the population through 1 June. Household consumption, the main growth engine, declined 26.7% y/y. At the same time, investment fell by more than 47% y/y. Under these conditions, imports declined more sharply than exports, and net exports ended up making a positive contribution to growth. On the supply side, the contraction was especially severe in industry (down 33.8%), and to a lesser extent in services (down 24.3%), with a freeze on construction and transport activities as well as hotel and food services. As mild as it may have been, agriculture was the only sector to report positive growth (3.4% y/y).

The first economic indicators available for the second quarter of FY2020/21 confirm a rebound relative to the previous quarter, although activity is still a far cry from pre-crisis levels, prior to the outbreak of the coronavirus pandemic. Although industrial activity accelerated, the same cannot be said for services. In July, industrial production and merchandise transport both rebounded strongly compared to previous months, even though they were still in decline compared to the same period last year. The industrial production index rose to 118.1 after falling to a low of only 54 in April. Yet this is still more than 10.4% below the July 2019 figure, reflecting the persistently sharp contraction in capital goods and durable consumer goods (down 22.8% and 23.6% y/y, respectively). The rebound was especially strong for non-durable consumer goods.

This catching-up movement is expected to continue. In August, after four months of contraction, the PMI business sentiment index rose above 50, the threshold separating expansion from contraction. There were higher expectations for new (domestic) orders.

### YET THE RECOVERY IS STILL FRAGILE

First, the services PMI rose compared to previous months, but the index was still at only 41.8 in August.

Second, bank lending to companies is still growing very moderately even though real interest rates are low (the average interest rate on new loans deflated for consumer price inflation was only 1.6% in August 2020, compared to 6.6% the previous year). New start-ups in Q2 2020 were down more than 88% compared to the year-end period. Moreover, foreign trade statistics for July show that capital goods imports amounted to only 62% of pre-Covid levels.

Third, the recovery in household consumption should remain gradual. In August, automobile sales were still down 4.7% y/y. Household confidence is still depressed, even though the latest survey data show that households are becoming more optimistic about the future.

**FORECASTS**

| | 2018 | 2019 | 2020e | 2021e |
|---|---|---|---|---|
| Real GDP growth(1) (%) | 6.1 | 4.2 | -11.4 | 9.6 |
| Inflation (1) (CPI, year average, %) | 3.4 | 4.8 | 5.5 | 3.4 |
| General Gov. Balance(1) / GDP (%) | -6.3 | -7.3 | -12.2 | -8.5 |
| General Gov. Debt(1)/ GDP (%) | 69.9 | 72.2 | 88.7 | 87.1 |
| Current account balance(1) / GDP (%) | -2.1 | -0.8 | 0.0 | -1.0 |
| External debt(1)/ GDP (%) | 20.0 | 19.9 | 20.0 | 20.0 |
| Forex reserves (USD bn) | 393 | 457 | 541 | 590 |
| Forex reserves, in months of imports | 6.5 | 7.7 | 11.0 | 9.1 |
| Exchange rate USDINR (year end) | 71.0 | 71.3 | 73.4 | 73.9 |

(1): Fiscal year from April 1st of year n to March 31st of year n+1
e: ESTIMATES AND FORECAST
TABLE 1
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

**INDUSTRIAL PRODUCTION**

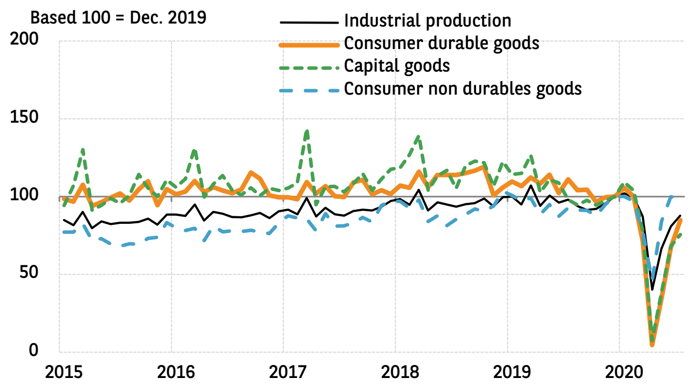


CHART 1
SOURCE: RBI

According to the Centre for Monitoring India's Economy (CMIE), the unemployment rate continued to decline, to 7.3% in mid-September, from a high of 23.5% in April, which suggests a rather rapid normalisation of the labour market. Yet this figure does not incorporate the informal market, which accounts for 80% of employment in India.

## INFLATIONARY PRESSURES RISE SHARPLY

Despite the collapse of domestic demand, the July consumer price index rose to levels last seen in 2014. Prices rose 6.9% y/y, compared to only 3.1% the previous year. This acceleration is mainly due to higher food prices (which make up nearly 46% of the consumer basket of Indian households), especially for protein-rich foods. To a lesser extent, it can also be attributed to higher prices for transport (due to a gasoline tax increase), communications equipment and imported goods following the disruption of global supply chains. Yet even excluding food and energy prices, core inflation still rose to 5.9% y/y in July 2020, up from 4.3% a year earlier. Higher gold prices made a one-half point contribution to the increase in the core price index, excluding food and energy prices.

In the face of rapidly rising prices, the central bank halted its monetary easing. With its inflation target range of of 4% +/-2%, the central bank maintained its key rates unchanged at 4% following August's monetary policy committee meeting.

## SEVERE EROSION OF PUBLIC FINANCES

In the first 4 months of FY 2020/21 (ending 31 March 2021), the government's fiscal deficit was 50% higher than in the same period last year, and accounted for 103.1% of the government's full-year target, which it set at 3.5% of GDP in February 2020. The very sharp erosion of public finances reflects the collapse of fiscal revenues (down 41.7%), which only reached 11% of the full-year target due to the contraction in economic growth. VAT revenues were down nearly 35%, while income tax revenues contracted by nearly 30%. At the same time, although spending was capped, it still rose 11.3% (35% of the full-year target). In FY 2020/21, the government deficit could swell to 8% of GDP (compared to 4.6% in 2019/20).

## THE FISCAL SITUATION OF THE STATES HAS ALSO DETERIORATED SHARPLY

In August, the Minister of Finance announced that he will not be in a position to fully offset the loss of VAT revenues by the States, which they estimate at INR 3 trillion. The government attributes the shortfall essentially to the consequences of the Covid-19 pandemic (and not to the adoption of a single VAT rate in 2017). He announced that he would only pay out INR 650 billion to the states (via the luxury goods tax)[1]. To face up to the decline in VAT revenues (INR 2.35 bn), the government has asked the States to finance the shortfall in VAT revenues through debt issues (partially issued to the central bank at preferential rates), albeit without surpassing an amount equivalent to between 5.2% and 5.5% of GDP (depending on whether they partially or fully finance the financial loss), compared with 3% of GDP previously. On the eve of the opening of the GST Council, which brings the States and the government together to decide on the amount of compensation by 5 October 2020, ten States have already refused its two proposals. Moreover, regardless of the Council's outcome, at the end of FY 2020/21, the total general government deficit could amount to more than 12% of GDP, while the combined debt of the government and the States could approach 89% of GDP (vs 72.2% of GDP in FY 2019/20).

CONSUMER PRICE INDEX

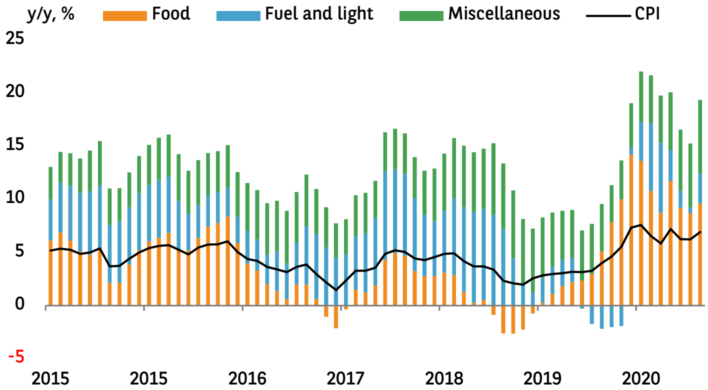


CHART 2

SOURCE: RBI

Looking beyond the risks of a deterioration in public finances and the downgrading of its sovereign rating (Moody's lowered India's sovereign rating by a notch last June, with a negative outlook), the government's tepid support for the economy is a source of concern for the recovery: last year, without a health crisis, government spending contributed nearly 30% to economic growth.

## EXTERNAL ACCOUNTS ARE HOLDING UP WELL

India has consolidated its external accounts since the beginning of the year. As a net oil importer, India has benefited from the sharp drop in crude oil prices. Moreover, imports have contracted in conjunction with the erosion of domestic demand, offsetting the decline in exports.

In the first 5 months of FY 2020/21, the trade deficit narrowed by more than 72%. Over the period Avril to June 2020, the current account balance recorded a surplus equivalent to 3.9% of GDP.

The slight upturn in activity since June fuelled an acceleration in imports in July, which rose to 72% of pre-crisis levels. Yet consumer goods imports accelerated faster than imports of capital goods.

Despite a massive outflow of portfolio investment in March 2020, the exchange rate of the rupee against the US dollar was only 2.7% lower than at year-end 2019. Foreign reserves swelled to a high of USD 537 bn, nearly twice the country's short-term financing needs. For the moment, despite sluggish growth prospects, foreign direct investment continues to flood in.

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1 In 2017, the States agreed to adopt a single VAT rate for all States and to centralise VAT revenues through the central government. The Minister of Finance pledged to increase their VAT revenues by 14% each year thanks to tax revenues levied on luxury goods (through the end of FY 2022/23).

# INDONESIA



## A DIFFICULT RECOVERY

**For the first time since the 1998 crisis, Indonesia is expected to enter recession in 2020. In Q2 2020, the economy contracted by more than 5%, and the recovery should be slow. Domestic demand is struggling to pick up, and Jakarta has just been put under a partial lockdown again. Fiscal support has been slow in coming: planned fiscal spending still hasn't materialised in the first seven months of the year. Even so, the deficit is under control and the central bank is acting as the lender of last resort. In H2 2020, the government hopes to consolidate the recovery via a massive support package for low-income households. Even though inflation is under tight control, the poverty rate could reach 11.6% according to the World Bank (vs 9.2% in 2019).**

### GDP GROWTH: A DIFFICULT RECOVERY

In the first half of 2020, GDP contracted 1.3% compared to the year-earlier period. For the first time since the 1998 crisis, Indonesia will be in recession this year.

In Q2 2020, the economy contracted 5.3% year-on-year (y/y) due to declining domestic and external demand. All of the components of demand contracted. Household consumption, which contributes more than 54% of growth, declined 5.5% y/y following partial lockdowns in numerous regions, including Jakarta, starting in March. Investment contracted even more sharply (-8.6% y/y), especially for machinery and capital goods purchases. Government spending was down by nearly 12% y/y despite the announcement of massive plans to stimulate growth, which have not been implemented yet. Net exports made a positive contribution to growth because the contraction in imports (-17%) more than offset the decline in exports (-11.7% y/y).

By sector, the contraction was especially sharp in the transport sector (-30.8%) and to a lesser extent in construction and industry. In contrast, agriculture and information & communications services continued to report positive growth.

Activity indicators for Q3 2020 suggest a recovery, albeit a slow one differentiated by sector. In July and August, domestic demand rebounded slightly but still 13% below pre-Covid levels. Vehicle and motorcycle sales continued to decline in July, down 59% and 44.5% y/y, respectively, while retail sales fell 10.7% y/y in August. Household confidence has improved since June, but is still depressed. Tourism has collapsed, down 89% in July 2020. Capital goods imports contracted by more than 29.2% y/y in July, reflecting the persistently sharp contraction in corporate investment. The only positive point is business sentiment, which returned to expansion territory in August (PMI of 50.8). Yet the slight recovery in domestic demand could be throttled by the reintroduction of partial lockdown measures in the Jakarta region as of 14 September, after a very strong surge in the number of new Covid-19 cases.

According to the World Bank, in a worst-case scenario the poverty rate could rise to 11.6% by the end of the year (from 9.2% in September 2019) if the government fails to distribute funds to support the most vulnerable households in an optimal manner. Fortunately, price increases have been extremely mild so far, but by late July, the government still had not paid out the social welfare benefits provided in the budget.

### A RESILIENT BANKING SECTOR

Like in all the Asian countries with the exception of India, inflationary pressures are extremely mild in Indonesia, providing the central bank with substantial leeway to ease monetary policy and stimulate growth (although this is not one of their official targets, contrary to the wishes of certain members of parliament). In August, inflation was limited to only 1.3% y/y, compared to the central bank's target of 3% give or take 1%. Under this environment, the central bank lowered its key rates by 100 basis points to 4%. This reduced corporate and consumer lending rates by only 67 bp and 27 bp, respectively, and these rates remain high even in real terms (at an average of 8% and 9.7%, respectively). The growth of bank lending continued to slow to only 1% y/y in July

**FORECASTS**

| | 2018 | 2019 | 2020e | 2021e |
|---|---|---|---|---|
| Real GDP growth (%) | 5.2 | 5.0 | -3.0 | 5.4 |
| Inflation (CPI, year average, %) | 3.2 | 2.6 | 1.9 | 1.7 |
| Gen. Gov. balance / GDP (%) | -1.8 | -2.2 | -6.1 | -3.4 |
| Gen. Gov. debt / GDP (%) | 30.1 | 30.4 | 36.4 | 37.1 |
| Current account balance / GDP (%) | -2.9 | -2.7 | -1.6 | -2.5 |
| External debt / GDP (%) | 36.0 | 36.0 | 37.3 | 37.4 |
| Forex reserves (USD bn) | 115 | 122 | 130 | 137 |
| Forex reserves, in months of imports | 6.3 | 7.1 | 7.3 | 7.6 |
| Exchange rate USDIDR (year end) | 14 496 | 14 017 | 14 500 | 14 100 |

TABLE 1 e: ESTIMATES AND FORECAST
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

**PRIVATE CONSUMPTION**

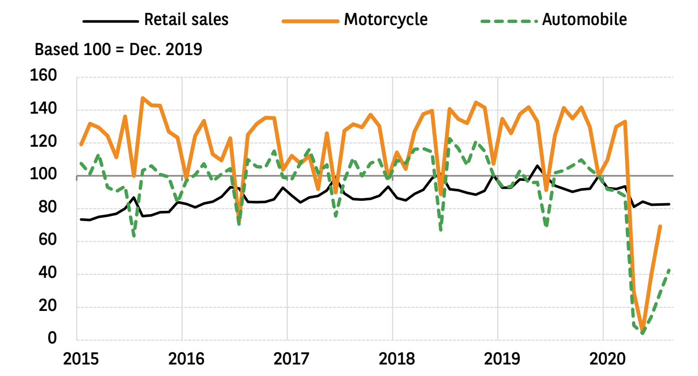


CHART 1 SOURCE: BI

2020, vs 9.7% a year earlier.

Yet monetary easing is still restrained by one of the central bank's other targets: stabilisation of the rupiah. With the number of Covid-19 cases surging again in August, the currency came under such fierce downward pressure that the monetary authorities did not change their key rates at the most recent monetary policy committee meeting.

Despite a tough macroeconomic environment, Indonesia's banking sector seems to be holding up well in the current crisis. Credit risk was on the rise at the end of June, but still under control. The doubtful loan ratio was only 3.1% (up from 2.5% at the end of last year), while special-mention loans, i.e., those with late payments of less than 90 days and/or susceptible of becoming doubtful loans, had declined to 5.2% after peaking at 6.9% in April. These strong figures are partially due to the fact that banks have the possibility of waiting until Q1 2021 before classifying loans in the "doubtful loan" category. The banks still have very satisfactory capital adequacy ratios (22.5% in June) and abundant liquidity, with a loan-to-deposit ratio of 89% in June. In contrast, profitability indicators have deteriorated sharply in line with higher provisions and falling interest rates: the return per asset and per security was only 1.9% and 12.7%, respectively, at the end of June (vs. 2.5% and 16.2% a year earlier).

## PUBLIC FINANCES: A LIMITED DEFICIT IN THE FIRST 7 MONTHS

In the first 7 months of the year, the government's fiscal deficit remained under control. It amounted to only 31.8% of the full-year target, which the government revised to 6.34% of GDP in June 2020. The public accounts have held up relatively well despite a 13.2% decline in revenue compared to the same period last year, which is essentially due to a very tight grip on public spending. Spending increased only 1.3% and amounted to only 45.7% of the full-year target. Yet the government claims that it will resort to public spending in the second half.

Government debt issues were 62.4% underwritten by private banks and 25.4% by public banks. Although central bank purchases were on the rise, they have been relatively limited so far (10.4%). Yet the expected increase in spending in the second half of the year will be mainly financed by zero interest rate bond issues purchased by the central bank on the primary market for a total of IDR 575 trillion (i.e. 47.1% of the provisional full-year deficit). Officially, the government has announced that only social and healthcare spending will be covered by the central bank. Yet the central bank will remain the government's lender of last resort for all of 2020.

At the end of June 2020, government debt was still low at 35.5% of GDP, even though it had increased by 5 percentage points since the beginning of the year. The debt structure is more risky, however, compared to other countries such as India. Indeed, 37.9% of Indonesia's debt is denominated in foreign currencies, and 58.2% is still held by non-resident investors. For the moment, the Indonesian government has been highly dependent on foreign investors to ensure its debt financing, because the domestic bond market has not been sufficiently developed (17.4% of GDP).

## THE RUPIAH IS UNDER PRESSURE DESPITE THE CONSOLIDATION OF EXTERNAL ACCOUNTS

Indonesia's external accounts are still solid. In Q2 2020, the balance of payments (excluding the change in foreign reserves) showed a surplus of USD 9.2 bn, the equivalent of 3.8% of annualised GDP.

**IMPORTS**

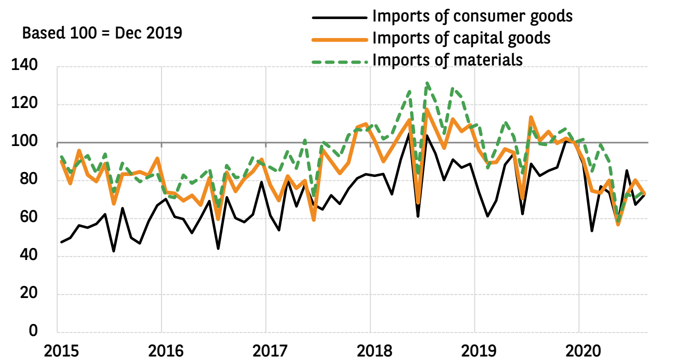


CHART 2 SOURCE: BI

The current account deficit continued to contract in Q2 2020, despite a sharp decline in exports[1], to an annualised rate of only 1.2% of GDP (vs 3% of GDP in Q2 2019). The decline in the current account deficit is mainly due to the sharp contraction in imports of oil-based products, but also of capital and consumer goods, in keeping with the contraction in domestic demand. The first statistics available for the third quarter confirm the strength of the trade surplus. In full-year 2020, the current account deficit should be limited to 1.2% of GDP according to the Indonesian central bank.

In Q2 2020, the financial account surplus increased, buoyed by an increase in portfolio investment after the massive capital outflows reported in Q1 2020. Already moderate, foreign direct investment declined further to reach only 1.7% of GDP in Q2 2020, although this was still enough to cover the current account deficit. In the first two quarters of 2020, the base balance showed a surplus for the first time after nine quarters of deficits.

Although external debt rose 5% y/y in Q2 2020, it was still under control at 36.5% of GDP (2019). The country had a net external debit position of 22.5% of GDP, but this mainly reflects the stock of foreign direct investment (18.2% of GDP). At the end of July, foreign reserves amounted to USD 127 bn, USD 5 bn more than at year-end 2019. This is equivalent to 7 months of imports and 1.5 times the country's short-term financing needs. Even so, Indonesia is still vulnerable to capital flight: in 2019, portfolio investment flows amounted to 2% of GDP, which is higher than the amount of foreign direct investment (1.5% of GDP). During periods of high financial market volatility like we have seen in recent months, Indonesia reports massive capital outflows that make the rupiah extremely volatile. At the end of September, the rupiah was still down 6.7% against the dollar compared to its value at the beginning of the year.

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1 In the first 8 months of 2020, export commodity prices fell by 4.7% on average (-17.3% for coal, -11.4% for rubber, -8.7% for aluminium, and -5% for copper).

# BRAZIL



## SOME DIFFICULT CHOICES LIE AHEAD

**The epidemic remains in full swing, but has shown some signs of deceleration. The recovery in Q3 has been stronger than expected. However, the picture varies considerably from one sector to the next. The central bank has paused its monetary easing cycle for the first time since mid-2019. At the same time, it has adopted a more active communication stance through the embracement of forward guidance. The emergency aid programme – which will push the budget deficit to a record high – has meanwhile helped President Bolsonaro witness a resurgence in popularity. Negotiations over the 2021 budget are likely to crystallise tensions across the executive and Congress. Difficult choices lie ahead as the authorities will need to arbitrate between supporting the most vulnerable and resuming the process of fiscal consolidation. The currency, over and above its weakness, continues to suffer from considerable volatility. The return of foreign investors to Brazilian markets remains timid overall.**

Six months after the start of the epidemic in the country, Brazil has seen more than 140,000 deaths (665 per million people) and more than 4.72 million confirmed cases. The toll is grim, but the epidemic has started to show signs of slowing down: the rolling 7-day average death tally has been falling for several weeks, after stagnating for a number of months. The contagion rate ($R_0$) has also returned to around 1 (the country had an $R_0$ of 2.81 in May, the highest rate in the world). This slowdown has come as the easing of containment measures has spread across the country. Schools are soon set to reopen in Sao Paulo and Rio de Janeiro.

### A FASTER THAN EXPECTED RECOVERY BUT HIGHLY UNEVEN

National accounts data showed a heavy drop in economic activity in Q2, with GDP contracting by -9.7% q/q (-11.4% y/y). Output losses were however less pronounced than expected, and the recovery initiated in May has proved to be more vigorous than anticipated.

On the supply side, Q2 figures showed a sizeable contraction in industrial activity as well as in services. Agricultural output, on the other hand, expanded slightly over Q1. On the demand side, only net exports made a positive contribution to growth.

The economic recovery initiated in May has strengthened but is very unevenly spread across sectors. The grains[1] and mining sectors have performed well, benefiting from the weakness of the BRL, rising prices and the economic recovery in China. The partial suspension of poultry imports by China, following coronavirus outbreaks in a number of slaughter houses, have not yet significantly affected the performance of the cattle industry. Overall, strong commodity and livestock exports have contributed, amongst others, to the reduction of the current account deficit by nearly USD 30 bn over the period from January through August (12 months cumulative sum).

On the other hand, services, which account for around 70% of GDP and 47% of formal employment, are still struggling to forcefully recover (up 2.6% m/m in July, after falling by around 20% between February and May). The performance across the sector is however highly heterogeneous with the aggregate picture overshadowing some bright spots. Transportation services, the event industry, tourism and personal services are still facing substantial difficulties. By contrast, information and communication technology services have experienced more dynamic growth. Meanwhile, activity levels in industry are returning to pre-crisis levels (February). The bounce back has been generalized to all the subcomponents of industrial production (capital goods, intermediate goods, durable and non-durable consumer goods).

| FORECASTS | 2018 | 2019 | 2020e | 2021e |
|---|---|---|---|---|
| Real GDP growth (%) | 1.3 | 1.1 | -5.0 | 3.0 |
| Inflation (CPI, year average, %) | 3.7 | 3.7 | 1.5 | 3.0 |
| Fiscal balance / GDP (%) | -7.1 | -5.9 | -17.3 | -7.1 |
| Gross public debt / GDP (%) | 77 | 77 | 96 | 98 |
| Current account balance / GDP (%) | -2.3 | -2.9 | -0.7 | -0.8 |
| External debt / GDP (%) | 36 | 37 | 47 | 41 |
| Forex reserves (USD bn) | 374 | 357 | 360 | 350 |
| Forex reserves, in months of imports | 18 | 17 | 21 | 19 |
| Exchange rate USDBRL (year end) | 3.9 | 4.0 | 4.8 | 4.0 |

TABLE 1

e: ESTIMATES AND FORECAST
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

PORTFOLIO INVESTMENTS BY NON-RESIDENTS

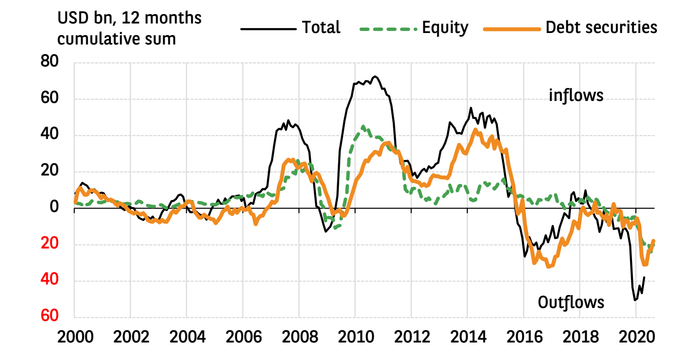


CHART 1

SOURCE: BCB

On the expenditure side, the government's emergency aid package has helped underpin strong retail spending especially on construction materials, household furniture and appliances. This has enabled broad

1 The national statistics agency, IBGE, estimates that 250.5 million tons of grains will be produced this year, a new record and a 3.8% increase compared to 2019. Rice, soy beans and maize crops are expected to account for more than 90% of the total yield.

retail sales to experience a V-shaped recovery with July's sales only 2% below those of February.

For the time being, the improvement in economic activity has yet to feed through to the labour market. The unemployment rate (13.8% in July) and the underemployment rate are still at peak levels, whilst the contingent of discouraged workers remains high at an estimated 5.5 million. In services, job losses have been reported in the last 6 PMI surveys. Some improvements are however to be noted: employment figures in manufacturing and construction have started to recover, new unemployment insurance claims fell by nearly 20% in August, while the labour market in July saw more formal jobs being created than being lost, a first since February.

## END OF THE EASING CYCLE. FORWARD GUIDANCE MAKES ITS DEBUT

After proceeding to 9 consecutive cuts of its key policy rate, the BCB interrupted its easing cycle in September, holding the SELIC at 2% (from 6.5% in mid-2019). The monetary policy committee (Copom) also indicated its intention not to raise rates until its central inflation scenario converges towards its targets for 2021 (target of 3.8%) and 2022 (3.5%). This novel and more active communication stance on behalf of the BCB shows that it has embraced forward guidance as an additional monetary policy tool. The policy is intended to better guide market expectations at a time when the slope of the yield curve is facing upward pressure due to increased uncertainties surrounding the government's fiscal position.

Since July, the policy rate in real terms has been in negative territory following the slight rise in inflation. Indeed, the higher food and fuel prices, the stronger recovery of consumption supported by disbursements of government aid and the emergence of bottlenecks on the supply side due to insufficient inventories and logistical difficulties have jointly contributed to an increase in the consumer price index from 1.9% in May to 2.4% in August. At the same time, prices of inputs in industry have risen rapidly, as a result of shortages faced by suppliers and the enduring weakness of the BRL.

For the time being, the BCB does not seem to be too concerned about inflation risk as core inflation (excluding energy and food) has remained broadly stable and inflation expectations have remained well below the target. Nor does it seem to be concerned about the weakness of the currency (the BRL has been down 30% against the USD since January). On the other hand, the BRL's volatility continues to be a real challenge for the authorities (the BCB has intervened in the FX market some twenty times this year). Since June, there has been a measured return of portfolio inflows from non-residents. However, the weakening trend of the BRL, its volatility, as well as the structural fall in interest rates are all factors that contribute to keeping investors away from local markets. Between January and August, net portfolio outflows have amounted to USD 25 bn.

## A RECORD HIGH BUDGET DEFICIT. DIFFICULT CHOICES LOOMING

The central government's budget deficit has more than doubled over the course of this year (11.9% of GDP in July, from 5.5% in January on a 12 months rolling basis). This increase reflects a sharp deterioration of the primary deficit (7.9% of GDP, from 1.1%) – as the interest burden has continued to fall over the period, dropping to 4% from 4.5% of GDP in January (*pro memoria*, the interest burden stood at 7.2% of GDP in January 2016). According to the IPEA's calculations, 70% of the increase in the central government's primary deficit relates to the increase in primary expenditure – the remainder being the result of a fall in revenues estimated at BRL 150 bn between January and July, representing some 2% of GDP. The budget deficit is likely to end the year at just over 17% of GDP, due in large part to the partial extension of the emergency aid programme through the end of the year[2]. The programme has helped President Bolsonaro witness a resurgence in popularity. This uptick could end up benefitting his government in the run-up to the municipal elections scheduled to take place later this year in November.

**RECORD-BREAKING FISCAL DEFICITS**

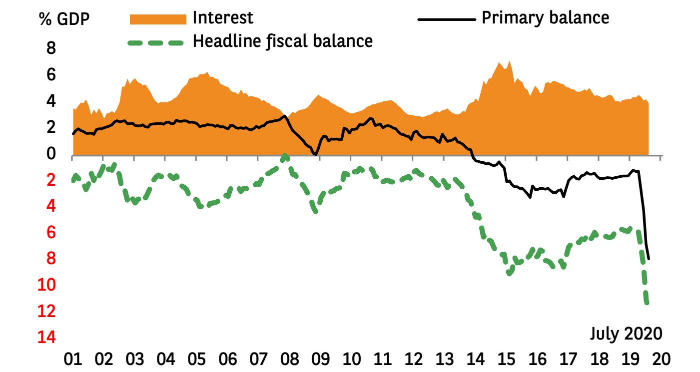


CHART 2

SOURCE: NATIONAL TREASURY, IBGE, BNP PARIBAS

The negotiations over the 2021 budget (presented at the end of the summer) are likely to crystallise tensions between the executive and Congress over compliance of the constitutional spending cap[3]. Some parliamentarians are pushing for the abandonment or flexibilization of the fiscal rule. Adherence to the spending cap has also been a bone of contention within the executive, between supporters of fiscal discipline and those in favour of an increase in social spending[4] and public investment.

With a projected primary deficit of 3% of GDP, the proposed 2021 budget – in its current configuration – is in compliance with the spending cap but leaves practically no room for the government to support the economy through stimulus spending. In the coming months, the credibility of fiscal policy is likely to remain a hotly debated issue especially in light of the strong pressures exerted on the political class to maintain or further expand social safety nets.

On the reform front, the government has proposed to unify two federal consumption taxes (PIS and Cofins) into a single federal valued added tax. The executive has also presented its administrative reform, aimed at restructuring careers in the civil service and adjusting salary plans for civil servants. According to Minister of the Economy, Paulo Guedes, these reforms could generate savings of nearly BRL 300 bn over 10 years. However, the impact on public finances will only become visible over the medium term.

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2 The aid of BRL600 per person has been halved to BRL300; some 5 million Brazilians will also no longer qualify for the programme. Thus far, some 65 million people are estimated to have benefited from the programme, with an estimated cost of BRL45 bn or so. By way of comparison, the Bolsa Familia programme cost BRL33 bn in 2019.
3 According to the cap, primary spending cannot increase faster than inflation. The fiscal rule, which was first introduced in 2016, was exceptionally suspended in 2020 as a result of the pandemic.
4 The President, for instance, wanted to introduce a new social programme, Renda Brasil, which was to take over from the emergency aid program at the end of 2020.

# ARGENTINA



## STILL UNDER EMERGENCY MEASURES

**The health crisis has slammed an economy that was already suffering from more than two years of recession. GDP will probably contract by more than 10% in 2020. With the technical rebound that began in late Q2 and the signing of a public debt restructuring agreement, the country should manage to pull out of recession in the second half. Yet financial instability persists with the erosion of foreign reserves, the stark disconnection between official and parallel exchange rates and expectations of surging inflation. The authorities have tightened forex controls again. IMF support is essential for financial stability but might not suffice for a sustainable recovery.**

### DEBT RESTRUCTURING: LOOSENING THE NOOSE

In early August, the Argentine government finally reached a swap agreement in principle on its USD 66 bn in international bonds with the major bondholder committees, agreement which has been validated in early September by virtually all of its private creditors (the swap participation rate was 93.5%). Of the 12 tranches of eligible bonds, bondholders accepted a steep haircut on the coupon rate (which was cut from 7% to 3% on average) while extending the repayment schedule. In exchange, the State had to accept a marginal reduction in the face value of its debt (debt principal repayments are practically unchanged[1]). The same conditions were applied to USD domestic bonds, which are essentially held by local creditors. For the repayment schedule as a whole (through 2050 for the most part), the debt burden was reduced by USD 37.7 bn compared to the initial schedule. This gives the country a vital breath of fresh air given the deterioration in the economic and social situation.

### DOUBTS ABOUT ARGENTINA'S CAPACITY TO REBOUND

As the entire country was under lockdown restrictions starting in late March, the economy contracted violently by 16.5% q/q in Q2 (-21% y/y). As in most countries, the economy then rebounded after bottoming out in April. In June, however, the INDEC monthly index of activity was still 15% below the January-February level, and industrial output continued to lag by 7% in July. The construction activity index was the only indicator that returned to pre-lockdown levels, although it is still 13% below the 2019 average (see chart 1).

The recent and very relative rebound in activity indexes was counterbalanced by a very sharp downturn in consumer confidence. This reflects persistently high inflationary pressures (1.9% a month on average in May-July) fuelled by the peso's depreciation, which has fallen 2.5% a month on average since March. In the formal sector, real wages continued to contract (-4.6% year-on-year in the private sector and -8.5% in the public sector in H1 2020). Since 2017, the purchasing power of private sector wages has fallen by 22% and public sector wages by 26%. GDP will probably contract by more than 10% over the full year despite the automatic rebound in activity after the economy reopens in H2, the increase in central government primary spending by about 5% of GDP since the end of 2019 and monetary easing (see below).

In 2021, there are reasons to doubt the economy's capacity to rebound despite the relief provided by the debt restructuring agreement, even assuming the country manages to reschedule its debt repayments with the IMF, which are normally due starting from 2021. External conditions will remain depressed, especially agricultural commodity prices, which will limit an export-driven recovery. Looking beyond the international situation, Argentina's economy is still mired in a vicious circle, caught between currency depreciation and inflation, which the previous

**FORECASTS**

| | 2018 | 2019 | 2020e | 2021e |
|---|---|---|---|---|
| Real GDP growth (%) | -2.5 | -2.1 | -11.0 | 8.5 |
| Inflation (CPI, year average, %) | 33.8 | 53.5 | 44.0 | 50.0 |
| Gen. Gov. balance / GDP (%) | -5.0 | -3.8 | -9.2 | -5.7 |
| Gen. Gov. debt / GDP (%) | 86.1 | 89.6 | 93.0 | 85.0 |
| Current account balance / GDP (%) | -5.3 | -0.8 | 2.3 | 1.0 |
| External debt / GDP (%) | 53.5 | 62.2 | 68.0 | 60.0 |
| Forex reserves (USD bn) | 64.0 | 45.0 | 41.0 | 47.0 |
| Forex reserves, in months of imports | 8.9 | 7.8 | 9.0 | 9.2 |
| Exchange rate USDARS (year end) | 38 | 60 | 80 | 120 |

TABLE 1 e: ESTIMATES AND FORECAST
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

**PARTIAL CATCHING UP**

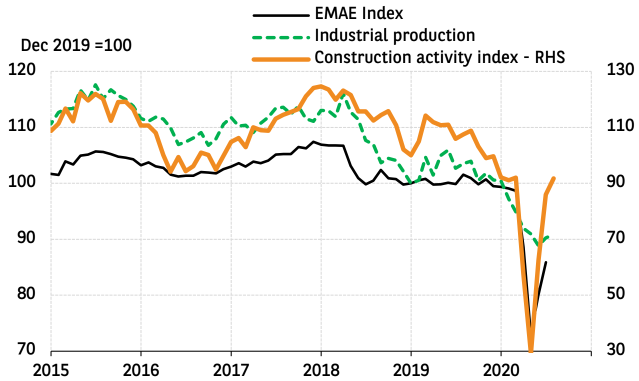


CHART 1 SOURCE: INDEC, ISAC, DATASTREAM

1 In net present value (NPV), and compared with the initial debt repayment schedule, the State has obviously benefited from a debt reduction thanks to lower coupon rates, a rescheduling of repayments and a discount rate significantly higher than the coupon rates because of the increased in the risk premium. All these parameters are the terms of the bargaining between The State and bondholders. The result is a NPV value of the debt that satisfies the two parties. The resulting NPV rate is about 55% i.e. a haircut rate (in NPV terms) of 45%.

government failed to halt despite its policy of eliminating forex controls, lowering export taxes and deregulating water and energy utility rates. This vicious circle has stretched public finances, both directly (due to the need to regularly raise social welfare benefits) and indirectly (through the high cost of sterilising capital inflows for the central bank). It also prevented monetary policy's countercyclical leverage from functioning properly, precisely because inflation expectations were anchored to the evolution of the nominal exchange rate.

Granted, over the past 12 months BCRA has managed to drastically reduce its key rates, from 85% to 32% (over the same period the inflation rate only fell from 53% to 42%). Yet monetary easing occurred in an emergency situation characterised not only by the country's default on its debt and tighter forex controls, but also by the de facto abandon of exchange rate stability. Still negligible in August 2019, the gap between the official USD exchange rate and the parallel rate (the blue chip swap rate) rose to nearly 80% just a year later (see chart 2).

Normally, for a country that benefited from controlled inflation and financial stability prior to the health crisis, the 2021 rebound should be as strong as the 2020 shock was abrupt. For Argentina, however, nothing could be less certain, even with IMF support.

LACK OF FINANCIAL STABILISATION

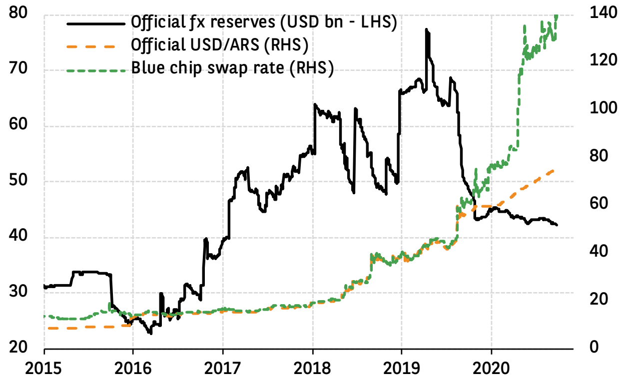


CHART 2

SOURCE: BCRA, DATASTREAM

## INFLATION IS EXPECTED TO SURGE AGAIN

First, despite the size of the recession over the past two and a half years, inflation is not under control. According to BCRA surveys, in August, year-on-year consumer price inflation from a 12-month horizon was expected to rise to 51.2%, compared to 40.7% for the most recently known month (August). The main cause is still the vicious circle between wages and the exchange rate, and these dynamics are all the stronger given the large gap between the official and parallel exchange rates[2].

Yet many local analysts also point out the excessive growth of the monetary base, which rose 35% in Jan-Aug. 2020 vs 30% in full-year 2019. This is due to monetary financing of the primary deficit, which amounted to 4.7% of GDP cumulated over 12 months in July, vs 0.5% in December 2019. As a result, BCRA transfers to the Treasury (direct advances and book profits drawn from the revaluation of foreign reserves) have amounted to nearly 6% of GDP since the beginning of the year.

So far, the exceptional situation created by the Covid-19 pandemic justifies exceptional financing at no cost for the State[3]. But this can only be a temporary solution.

In 2021, the government wants to limit its fiscal effort by reducing the primary deficit to 4.5% of GDP (excluding exceptional spending linked to the Covid-19 crisis, primary spending should increase by 7.6% in real terms).

Yet it seems unlikely that the IMF would authorise the continuation of direct financing by the central bank. Inflation originating from money supply growth could ease with the resumption of classic financing via borrowing. In the meantime, however, there is reason to fear that the current surge in money supply growth will have persistent effects at least through the beginning of 2021.

## A PERSISTENT SQUEEZE ON EXTERNAL LIQUIDITY

Persistent pressure on external liquidity is the second negative factor for the recovery. The current account deficit has narrowed sharply to only USD 0.9 bn in Q1 (cumulative over 4 quarters), and should give way to a surplus (the trade surplus was nearly USD 20 bn in July, cumulative over 12 months). Yet the central bank's foreign reserves have continued to erode, to USD 42.6 bn in early September, down from USD 45 bn at year-end 2019. Resident purchases of USD had declined sharply with the implementation of forex controls, but they have picked up again since March. In mid-September, the central bank had to introduce new forex control measures[4], including temporary restrictions on the repayment of USD debt by domestic companies[5].

An agreement with the IMF is thus vital to bolster external liquidity and to provide guarantees concerning improvements in the country's solvency, which will remain very fragile since the state was unable to obtain a reduction in its debt. Yet IMF financial support will not suffice to fuel a sustainable recovery from the crisis. The Argentine government and the IMF must strike the right balance between fiscal consolidation and monetary and exchange rate policy goals, one that reassures private creditors without stifling hopes for a recovery.

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2 Econometric estimations show that the pass-through between the exchange rate and inflation is 0.2 when the gap is lower than 40% but 0.4 when it is above 40%.
3 Central bank's advances (Adelantos transitorios) do not bear interests.
4 All debit and credit card expenditures are included in the USD 200 monthly limit on USD transactions. New 35% income tax advance on any fx purchases (on top of the existing 30% mandatory PAIS tax introduced in Dec. 2019). Prohibition on USD purchases by individuals receiving state benefits and grants. Non-residents are prohibited from selling securities with settlement in USD in the local market unless the position is held for at least one year.
5 Companies with over USD 1 mn of USD-denominated debt monthly maturities between October 15, 2020 and March 31, 2021 will be allowed to settle only the equivalent of 40% of their debt service and will have to send a repayment plan for the remaining 60% by October 1.

# THE IMPORTANCE OF BEING EARNEST

**The Hungarian economy was hit particularly hard by the effects of the Covid-19 pandemic in the 2nd quarter of 2020, due to the weight of exports in its GDP. The shock seems to have been absorbed relatively well, with the government and central bank focusing on supporting the labour market and introducing the necessary moratoriums on interest payments and loan repayments. The stimulus measures introduced have been constrained in particular by the need to avoid an excessive depreciation of the forint. The reduction in government debt, interrupted this year, is likely to get back on track quickly, within the framework of an unchanged strategy: maintaining a moderate corporate tax in order to continue to attract foreign investment in the manufacturing sector.**

## A BRUTAL SHOCK, RELATIVELY WELL ABSORBED

As a country focused on exports, Hungary suffered a bigger than average hit from the Covid-19 pandemic (compared to Emerging Markets' peers), with a GDP drop by 14.5% q/q in Q2 2020.

The economy has bounced back in recent months, but short-term indicators have confirmed that exports lag domestic demand, notably consumer spending which made a substantial contribution to the recovery after the end of lockdown. By contrast, exports in June and July merely returned to pre-crisis levels.

This asymmetry in demand (coupled with a fall in investment) can be seen in trends in manufacturing production, which remains below its pre-crisis level, held back primarily by export sectors, particularly automotive production, down by 15%, and metals (-20%). The lag in manufacturing exports and the fall in tourism receipts are likely to result in a widening of the current account deficit, but not beyond 2% of GDP, a level which remains easily sustainable.

The comeback of private consumption explains the speed with which inflationary pressures have reappeared, after a period when lockdown and lower oil prices had driven them down. Excluding energy prices, inflation was even higher in July (about 4%) than it was at the beginning of the year. Meanwhile, it would seem that the situation in the labour market is relatively little changed. Granted, unemployment increased from 3.5% of the active population at the end of February to 4.7% in July. However, wage growth continued over the first half, a sign of continued market tension: wages were up 6.3% year-on-year in real terms.

The renewed inflation pressures have created a constraint on monetary policy, the easing of which, at the end of the lockdown, has again been interrupted. The gap between Hungarian inflation and the European average limits the Central Bank's leeway to ease. Given that capital is allowed to move freely within the European Union, stabilising the exchange rate assumes that monetary policy will be constrained (as a result of the 'impossible trinity'): higher inflation than in the euro zone implies a higher interest rate.

In April, this constraint led the bank to raise the upper end policy rate of its interest rate corridor to 1.85%, giving it the de facto ability to limit liquidity when the forint comes under excessive pressure, as the bank believes that too low interest rates can weaken the forint. Under these conditions the forint should be stable over the next few months at around the current rate of 360 forints per euro, and this stability will be supported by increasing foreign currency reserves.

Overall, the conclusion that the economic fundamentals have not been lastingly changed by the Covid shock continues to hold sway. Although GDP is not expected to return to pre-crisis levels until Q1 2022, the convergence of Hungary's average per capita income towards the European average looks set to continue.

**FORECASTS**

| | 2018 | 2019 | 2020e | 2021e |
|---|---|---|---|---|
| Real GDP growth (%) | 5.1 | 4.9 | -5.8 | 5.5 |
| Inflation (CPI, year average, %) | 2.8 | 3.0 | 3.5 | 3.3 |
| Gen. Gov. balance / GDP (%) | -2.1 | -2.0 | -6.0 | -4.0 |
| Gen. Gov. debt / GDP (%) | 70.2 | 66.3 | 74.0 | 73.4 |
| Current account balance / GDP (%) | 0.0 | -0.8 | -2.0 | -1.3 |
| External debt / GDP (%) | 77.0 | 78.0 | 82.0 | 76.8 |
| Forex reserves (EUR bn) | 27.4 | 28.4 | 30.0 | 31.0 |
| Forex reserves, in months of imports | 3.1 | 3.0 | 3.7 | 3.4 |
| Exchange rate EURHUF (year end) | 321.0 | 330.0 | 360.0 | 365.0 |

TABLE 1

e: ESTIMATES AND FORECAST
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

**MANUFACTURING PRODUCTION (LEVEL)**

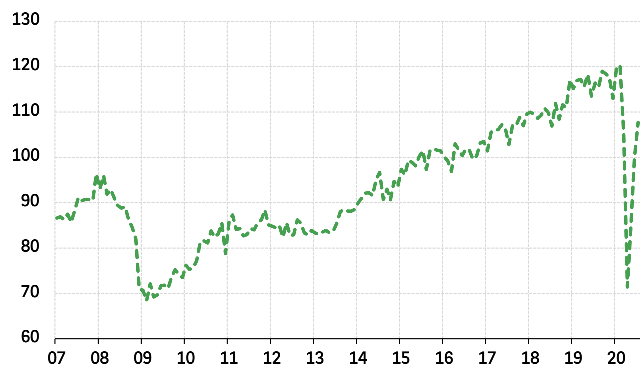


CHART 1

SOURCE: CEIC, BNP PARIBAS

## POLICY MIX: SUPPORTIVE, BUT CONSTRAINED

In front of the Covid-19 crisis, the Hungarian government has adopted an interventionist policy, most notably through the granting of greater powers to the Prime Minister. However, this has not resulted in any significant disruption to economic policy.

Constrained in the use of its policy rates, the central bank has focused on supporting liquidity in the economy through a moratorium on debt payments for households and companies who met the criteria and wanted to take up this option. The modest level of household indebtedness, 32% of income, was not a challenge.

However, domestic credit to non-financial corporates required closer attention, particularly as 42% of it is denominated in foreign currencies. Business lending increased as a result of the issue of government-guaranteed loans, together with a programme of lending to SMEs at subsidised rates, but remained modest at around 20% of GDP in 2020, from 30% in 2010.

Meanwhile, the Central Bank began to purchase government debt, albeit fairly late in the day (since May): pressure on Hungarian long-term rates has remained under control (as has the risk premium against the German Bund), benefiting from recent years' reductions in debt ratios. Ten-year rates are therefore likely to stay close to their current level of 2.4% through to the year-end, which is below the implicit average interest rate of 3.5% on Hungary's sovereign debt. The sensitivity of the sovereign risk premium to capital flows has fallen in line with the share of government debt held by foreign investors (from 60% a few years ago to around 30% now).

The support to the economy from fiscal policy has been significant and has come mainly in the form of tax and social security payments holidays and wage subsidies, including for new hires. These latter measures help explain the limited damage to the labour market and the noticeable recovery in consumption. The government has also provided additional funding to priority sectors (including tourism, healthcare, transport and logistics) as well as subsidised and/or guaranteed loans to companies and for the financing of exports. Ultimately, the government deficit is likely to climb to 6% of GDP in 2020, a relatively good performance compared to neighbouring countries.

The adherence to a fiscal rule since 2016 (which will remain in force until government debt is below 50% of GDP) has been a key factor in reducing government debt to GDP ratio. The government is already planning a fiscal consolidation in 2021, bringing the deficit down to 2.9% of GDP, and thus taking it back below the 3% threshold. Although this looks like an optimistic outcome, the scenario of a fiscal consolidation from 2021 is plausible.

The priority is to maintain fiscal targets that are consistent with a relatively low-tax approach, particularly for businesses, in order to continue to benefit from strong levels of foreign direct investment. This investment is a significant source of stability for a country whose currency reserves are stable at a relatively low level, as it creates sustainable financing of the current account deficit that re-emerged from 2019.

## ATTRACTIVENESS RELATIVELY UNCHANGED

The automotive value chain has a substantial weight in the Hungarian economy, involving both carmakers and car suppliers (notably metals companies and component makers). The impact on this sector from falling demand throughout Europe in the 2nd quarter of 2020 represented an additional drag on its recovery, coming on top of the effects of local lockdowns that resulted in factories being shut down.

As a result, miscellaneous evidence showed announcements of a limited postponement of investment in the sector and the total volume of gross foreign direct investment fell by 14% in the first half of 2020 relative to the same period in 2019. That said, investment is still likely to represent nearly 9.5% of GDP in 2020 and will remain important for the future of the country's industry: the value added locally represented only 45% of Hungary's automotive exports value in 2017, one of the lowest share in Central Europe.

FOREIGN DIRECT INVESTMENT (EUR BN), BY SEMESTER

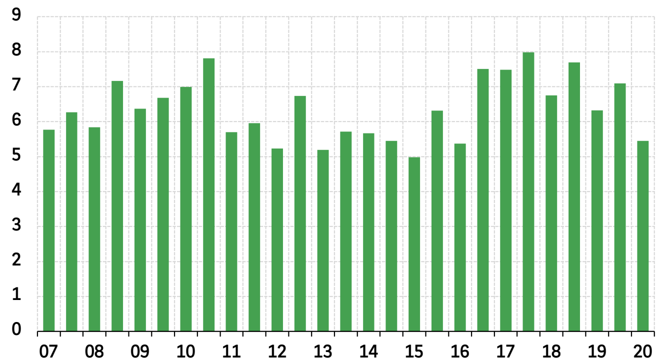


CHART 2 SOURCE: CEIC, BNP PARIBAS

The flexibilization of the labour market that has taken place over the last decade, coupled with the lowest corporate tax rate in Europe (9%), have been significant factors in the development of export-led businesses. Against this background, cost competitiveness remains essential and has been maintained despite shortages of workers in the labour market. The gradual depreciation of the forint has even allowed a slight fall in real effective terms over the last decade.

Over the medium term, further progress will be needed in terms of labour productivity, the incorporation of digital solutions and the automation of industry in order to maintain Hungary's lead over its competitors. A ranking of the complexity of exports puts the country 2nd in Central Europe, behind the Czech Republic, in terms of market positioning, but its lead over other countries has narrowed, particularly when it comes to those, such as Romania and Poland, where labour costs remain lower.

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# TURKEY



## LEANING AGAINST THE WIND

**Since late spring, Turkey has enjoyed a rapid, buoyant recovery. This is rather typical for an economy regularly hit by external shocks that are magnified by capital outflows. Turkey has managed to bounce back yet again thanks to strong economic policy support. The bad news is that it is accumulating several imbalances, including another significant current account deficit and a sharp increase in credit growth, which is accelerating faster than during previous recovery phases. These two factors, which put downside pressure on the lira while driving up inflation, signal a deterioration in the quality of growth and imply higher debt ratios.**

### A COMBINATION OF GROWTH AND IMBALANCES

Turkey continues to report a growth over-performance compared to peers. Like most of the other emerging countries, GDP contracted markedly in the second quarter (-11% q/q). Yet leading indicators point to a rapid, ample turnaround, with a manufacturing output largely back to pre-crisis levels.

This does not mean that all is going for the better. Turkey was hit by a drastic drop-off in tourism revenues (which are expected to decline by 80% in 2020), creating a shortfall of USD 24 bn. This is the main driver behind the sharp widening of the current account deficit, triggering an equivalent shortfall in foreign currency reserves.

Turkey's economic performance is a mix of stark contrasts, which have persisted for years. Excluding short periods of severe slowdowns, economic growth has been surprisingly robust, but with persistent imbalances. Growth fuels imports, which in turn erode the trade balance. This structural trade deficit fuels significant financing needs, which puts pressure on the exchange rate.

As a result, the lira came under renewed downward pressure this summer, after being squeezed in the midst of the crisis this spring. The central bank (CBRT) set up foreign currency swap lines with the commercial banks, and captured part of their USD liquidity. CBRT also increased its gold reserves, taking advantage of the increase in precious metal prices.

Even so, its foreign currency reserves diminished sharply, reflecting not only the current account deficit, but also the disaffection of both residents and non-residents. Residents increased their gold purchases (weighing on the current account balance) while, non-residents sold Turkish assets, notably public debt securities. These holdings dwindled to 3% in August 2020, down from nearly 12% a year ago, contributing to capital outflows.

Turkey should be among the first countries to be back to pre-Covid GDP levels (before year-end 2021), but it will face two persistent macroeconomic imbalances, larger than in peer economies. The vicious circle between foreign currency outflows and the depreciation of the lira continues to fuel double-digit inflation. The prospects for a gradual growth recovery around the world in 2021 and still constrained cross-border tourism activities raise fears of only a partial rebound in tourism. This situation would maintain the current account deficit at significantly high levels.

FORECASTS

| | 2018 | 2019 | 2020e | 2021e |
|---|---|---|---|---|
| Real GDP growth (%) | 2.9 | 0.9 | -2.0 | 4.5 |
| Inflation (CPI, year average, %) | 16.2 | 15.5 | 12.1 | 11.9 |
| Budget balance / GDP (%) | -1.4 | -3.5 | -7.5 | -4.5 |
| Public debt / GDP (%) | 29.9 | 32.6 | 45.1 | 46.7 |
| Current account balance / GDP (%) | -2.6 | 1.2 | -3.7 | -3.0 |
| External debt / GDP (%) | 56.5 | 55.7 | 64.7 | 68.6 |
| Forex reserves (USD bn) | 73.0 | 79.0 | 48.0 | 38.0 |
| Forex reserves, in months of imports | 3.5 | 4.2 | 2.7 | 2.0 |
| Exchange rate USDTRY (year end) | 5.3 | 6.0 | 8.0 | 8.7 |

TABLE 1

e: ESTIMATES AND FORECAST
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

MANUFACTURING PRODUCTION (LEVEL)

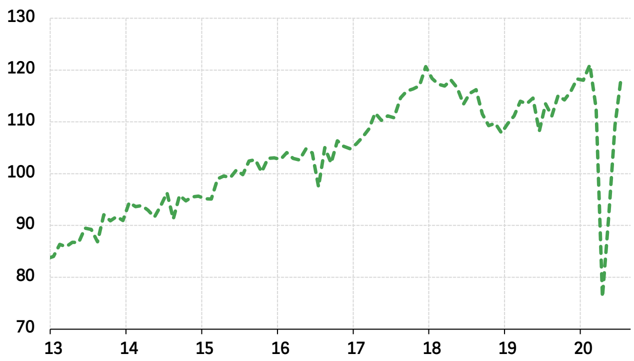


CHART 1

SOURCE: CEIC, BNP PARIBAS

### A TEXTBOOK CREDIT BOOM

In recent years, economic policy was systematically growth supportive, and the recent period was no exception. Conventional monetary policy (involving one or more key rate adjustments) has remained accommodative. The main key rate was lowered from 12% at year-end 2019 to 8.25% in May, even though inflation has remained relatively stable at about 12%. This gap triggered a need for a sudden reversal of the monetary policy strategy. From July, the effective policy rate was tightened (the Central Bank can implement discretionary switches to other instrument in order to fine-tune liquidity at higher rates, without any monetary policy committee decisions). In September, a formal increase of all policy rates was decided, by 200 bps, in order to limit TRY depreciation risks, but real policy rates remain negative.

One of the major consequences of the accommodating bias of monetary policy is the acceleration of domestic credit since March 2020. In Turkey, credit growth to the non-financial private sector is structurally strong in nominal terms (as is inflation), but it goes hand-in-hand with strong nominal GDP growth. Since the beginning of the year, however, credit growth in the non-financial private sector has risen to a pace of about 40%, but nominal GDP growth has been much slower. Although this mismatch might be only temporary, it raises fears of a headlong rush into debt.

Following the 2018 recession, the banking system began accumulating non-performing loans (5.4% of loans outstanding at year-end 2019). This increase halted with the credit support measures implemented after the outbreak of the Covid-19 pandemic. Moratoriums on debt payments and ample corporate credit lines even triggered a slight decline in the nominal amount of non-performing loans. Above all, strong credit growth simply led to their dilution, to 4.2% of loans outstanding in July 2020.

More importantly, the increased debt burden is also a potential source of higher credit risk in the future. Regarding major non-financial corporates, domestic loans have partially replaced their external debt, which has fallen by as much. Yet this substitution effect was only partial, and total corporate debt increased.

Aware of the impact that rapid credit growth has on the lira's depreciation, the central bank recently reversed its credit stance with a 300 basis point increase in the required reserve ratio on foreign currency deposits.

## RATHER UNORTHODOX BUDGET FINANCING

The fiscal stimulus is expected to widen the fiscal deficit to about 7.5% of GDP in 2020, while the debt ratio is expected to rise to 45% of GDP from 32.6% in 2019. CBRT has accumulated the equivalent of 10% of its assets in public debt securities, which is the target it indicated when announcing its securities purchasing programme in March. The Central Bank was able to cover part of the State's financing needs as well as to alleviate the impact of reduced public securities holdings by non-residents, while limiting its purchases in order to maintain credibility.

So far, the increase in 10-year rates has been fairly mild although it was not completely eliminated (13.8% on 21 September, from 12% in mid-March). Higher interest rates coupled with the increase in debt should lead to an increase in the debt service. The interest expenditure burden has already been rising constantly since 2018, and should reach 3 points of GDP in 2021. At the same time, the average maturity on public debt has diminished from 4.2 years in 2017 to 2.9 years in 2020. As a result, market volatility has a higher impact on public finance than it did in the past.

Public debt financing was not a problem before the health crisis, but it now risks becoming a source of fragility for the country. Holdings of public debt securities by Turkish banks increased by 70% between year-end 2019 and the end of August 2020. Most of these holdings were with state-owned banks (public debt accounts for 12% of their assets vs. 9% at year-end 2019). This has increased the sovereign-bank nexus, the interdependence between sovereign risk and banking risk.

NOMINAL GDP GROWTH VS. NOMINAL CREDIT GROWTH (%)

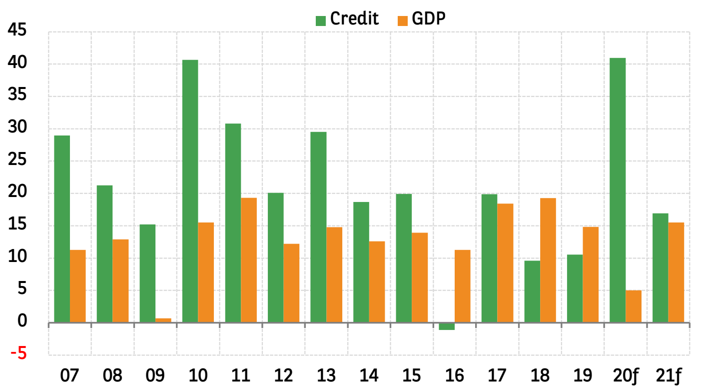


CHART 2 SOURCE: CEIC, BNP PARIBAS

## THE PATHS TO REBALANCING

Turkey's external refinancing needs (and possibly in the future, its public debt refinancing needs) are structurally high, which accentuates the shocks to Turkish growth: given the high volatility of portfolio investment, these high refinancing needs strain foreign currency liquidity and the exchange rate, drive up risk premiums, and end up encouraging saving and borrowing in foreign currencies.

The first solution would be to limit imports. In Turkey's case, imports are high for three reasons: energy, gold and the import content of merchandise exports. It is difficult to imagine reducing imports generated by exports (excluding gold) without altering the nature of Turkey's production facilities for some of its foreign investors. Gold imports increase during periods when the lira depreciates sharply, and limiting them would not solve their cause, which is entailed by foreign currency shortages. In contrast, reducing the energy deficit, the primary cause of the trade deficit, seems to be the most favoured approach by the Turkish authorities. Various projects to exploit natural resources in the Black Sea and the Eastern Mediterranean should be analysed against this background.

A second solution would be to act on the causes of the current account imbalance, namely the shortfall in savings compared to investment. This imbalance largely reflected the shortfall in savings with regard to private sector investment, although this is less true today after the decline in net investment. The steady swelling of the fiscal deficit (excluding appropriate adjustments during crisis periods) has modified the current account deficit's financing problem. Against a background of fickle capital flows, it can lead to a crowding-out effect of the private sector through a rise in long-term bond yields (in order to attract foreign inflows and finance the current account deficit). This clearly shows the importance of fiscal consolidation once the Covid crisis is over.

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# EGYPT



## LOOKING FOR A BALANCED MONETARY POLICY

**The Egyptian economy has performed pretty well in the face of the pandemic. Activity has been bolstered by major public investment projects, whilst inflation has fallen well below the central bank's target. The fiscal and current account deficits are likely to increase, but international support and access to capital markets at favourable conditions have contributed to a macroeconomic stabilisation. The continuation of a high policy rate at the central bank has helped keep the Egyptian market attractive to international investors. Thanks to injections of liquidity, lending remains strong, although this increases the exposure of banks to sovereign debt and credit risk in an increasingly uncertain environment.**

### ACTIVITY BOLSTERED BY PUBLIC SECTOR INVESTMENT

Economic activity remained strong during the 2020 fiscal year, despite lockdown measures. GDP grew by 3.5% in real terms. This was significantly slower than the 5.6% posted in 2019, but ahead of most analysts' estimates. In reality only the final quarter of the fiscal year (Q2 2020) was affected by public health restrictions. Over the first three quarters GDP grew by an average of 5% year-on-year. Construction activity was only marginally affected by restrictions on travel, and public infrastructure projects (transport, new cities) continued pretty much as normal. Lastly, strong demographic growth (at more than 2% per year) is a significant base for economic growth.

The outlook for 2021 is relatively positive and growth could increase slightly (3.8% estimated). On the health front, the Covid-19 epidemic is currently fairly well controlled according to official figures. As a result, most restrictions have been relaxed (only those relating to places of worship remain in force), allowing a recovery in the market services sector. In addition, the government introduced measures to support household purchasing power. However, against a background of rising rate of unemployment (9.6% in Q2 2020, the highest level for two years) and falling disposable income for a large part of the population, it seems unlikely that household consumption will grow significantly this year. Instead it will be public spending, particularly on mega-projects, which will continue to drive GDP growth.

### A SIGNIFICANT FALL IN INFLATION

Consumer price inflation has been falling steadily since the beginning of the year, due mainly to lower food prices, which makes up 40% of the index. Food prices fell month-on-month for the third consecutive month in August and are down by an average of 0.4% over the past twelve months. It is far from certain that these lower food prices will last and thus allow Egypt to reduce inflation significantly over the coming years. In part, the fall in consumer prices has been the result of the slowing of economic growth. In addition, government intervention has given it higher control over food product trade and prices. It is not certain that this policy will be sustainable over the medium term.

We estimate that annual inflation is likely to hit a yearly average of 4.6% in December 2020, well below the Central Bank of Egypt's target of 9% +/-3%, and then drop to 4.0% on average for the fiscal year 2021.

### THE POLICY RATE IS STILL AT A HIGH LEVEL

Under circumstances that would seem to favour monetary easing, the CBE has a gradual approach and prefers to maintain its policy rate at a high level (8.75%) for the time being. There are three arguments for this policy. First, after the 300 basis point cut in March, further cuts would have limited effects on economic activity. Although most of the health restrictions that limited economic activity have been lifted, the prospects for recovery remain uncertain, which is not encouraging corporates to invest.

**FORECASTS**

| | 2018 | 2019 | 2020e | 2021e |
|---|---|---|---|---|
| Real GDP growth (%) | 5.3 | 5.6 | 3.5 | 3.8 |
| Inflation (CPI, year average, %) | 21.5 | 13.4 | 5.6 | 4.0 |
| Central. Gov. balance / GDP (%) | -9.5 | -8.0 | -8.7 | -9.2 |
| Central. Gov. debt / GDP (%) | 93 | 89 | 86 | 89 |
| Current account balance / GDP (%) | -2.4 | -3.6 | -3.8 | -4.1 |
| External debt / GDP (%) | 37 | 34 | 33 | 35 |
| Forex reserves (USD bn) | 44 | 44 | 38 | 38 |
| Forex reserves, in months of imports | 7.2 | 6.9 | 6.2 | 6.2 |
| Exchange rate USDEGP (year end) | 17.9 | 16.7 | 16.1 | 16.0 |

TABLE 1

(1): Fiscal year from July 1st of year n to June 30th of year n+1
e: ESTIMATES AND FORECAST
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

**CONSUMER PRICE INFLATION (%)**

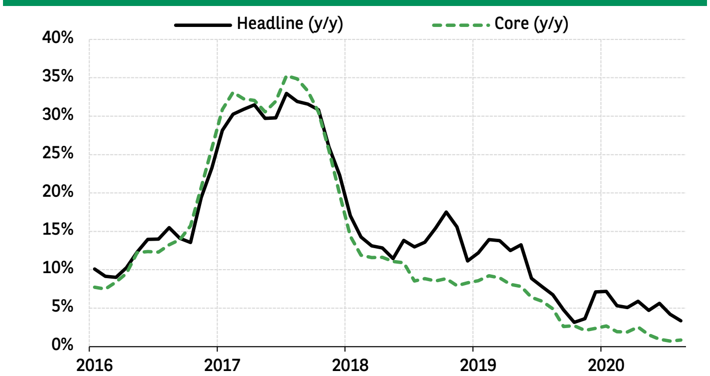


CHART 1

SOURCE: GENERAL AUTHORITY FOR STATISTICS, BNP PARIBAS

Secondly, the spectacular fall in inflation is still fragile. The fall in food prices is linked to factors that are likely to change, whilst the ending of regulated energy prices makes these much more sensitive than before to market prices. Thirdly, the financial shock in 2020 and the global recession that has followed have confirmed the continuing vulnerability of the country's external accounts, and the need to maintain an interest rate policy that will attract foreign investors who are active in the local currency debt market.

With tourism collapsing and expectations of a worsening of the current account deficit, foreign investors fled the Egyptian markets in March. The value of TBills held by non-residents fell by USD 12.7 billion to USD 7 billion over the three months to May. International liquidity has been restored thanks to the financial support of the IMF for a total of USD 8 billion and the issue of USD5 billion in sovereign debt on the international markets. In July foreign portfolio inflows recovered and TBills held by non-residents reached more than USD 10 billion. The current level of interest rates gives the Egyptian market a significant advantage in terms of the risk-reward balance, and contributes to the stability, or even slight strengthening of the currency, providing further incentive for carry trade positions.

CONTRIBUTIONS TO MONEY SUPPLY GROWTH (%)

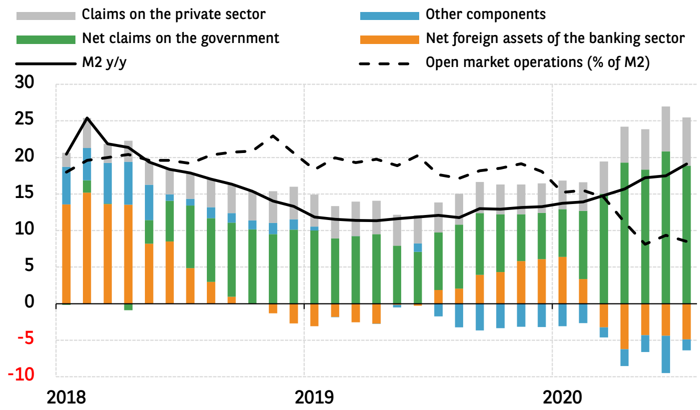


CHART 2

SOURCE: CBE, BNP PARIBAS

## INJECTION OF ADDITIONAL LIQUIDITY INTO THE ECONOMY

In parallel with high interest rates, the CBE has injected liquidity into the economy through open market operations. These operations have been used on a massive scale since the end of 2016 in order to limit the expansion of money supply and its possible inflationary consequences. Since the beginning of this year, the value of open market operations has reduced significantly, dropping from an average of 20% of M2 in 2018 and 2019 to 8.5% in July 2020. This additional liquidity has mainly been used to finance government debt, which has contributed on average a 19% increase in M2 since April 2020 (against 5.8% for the private sector). This increase in liquidity has not had inflationary consequences due to the slowing of economic growth and the attractiveness of certificates of deposit offered by public banks (50% of bank assets) in order to discourage the dollarisation of deposits.

## EXPANSION OF LENDING TO HOUSEHOLDS AND GROWING BANK EXPOSURE TO SOVEREIGN DEBT

The changes seen in money supply are mirrored in the exposure of banks to sovereign debt. Claims on the government represented 42% of total claims in May 2020 (from 32% a year earlier). Banks' exposure to sovereign debt has returned to its level at the end of 2016, when foreign investors were absent from the government local debt market. However, maintaining interest rates at a sufficiently attractive level for foreign investors could contribute to freeing up liquidity for the private sector.

The acceleration of claims on the private sector is noteworthy (up 20% y/y in June 2020), although it remains slower than growth in claims on the government (49%). In the first half of 2020, the increase in lending to companies mainly concerned short-term loans and was boosted by the policy of loans at subsidised rates introduced by the CBE in 2019, the rate on which was cut from 10% to 8%. Although lending to companies has grown since the beginning of the year (18% y/y to May 2020), it has been lending to households (30% of private sector credit) that has seen the most significant growth (up 30%). Egyptian banks are known for their cautious lending policies, and household borrowing is conditional on a regular source of income.

This said, the growth in lending to households will need to be watched closely given the deterioration of the economic situation. Against a background of rising poverty recorded by the World Bank since 2016, the gradual withdrawal of the subsidy policy has resulted in a reduction in purchasing power for a large section of the middle class. The current economic slowdown and negative outlook for tourism does not suggest an improvement in the short term.

For the time being, the quality of bank assets in the private sector has remained stable. According to the bank results published for the first half, the non-performing loan rate was 3.8% in Q2 2020, from 3.9% in Q1 2019 (4.5% in September 2019 for the banking system as a whole according to the IMF). At the same time, banks have made sizeable increases in provisions to take account of tougher economic conditions. However, the moratorium on interest payments on bank loans to all borrowers has made a significant contribution to stabilising the quality of banks' asset portfolio. The ending of the moratorium in September 2020 will reveal borrowers' real financial positions and could affect the quality of bank loan books.

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# LEBANON



## AN ECONOMY ON THE BRINK OF COLLAPSE

**Lebanese GDP could fall by a quarter in 2020 under the combined effect of the deep economic crisis that has taken place since 2019 and the Beirut port explosion. In the short term, hopes of a recovery are limited. The economic system that closely links the public finances, commercial banks and the central bank appears to be on its last legs. The system of multiple exchange rates will not prevent the exhaustion of foreign currency reserves in the near future. Meanwhile, the government, which is in default on its foreign currency debt, has been forced to monetize its fiscal deficit. Commercial banks have built up record exposure to sovereign debt and substantial external liabilities.**

### A COLLAPSE OF ECONOMIC ACTIVITY

The chemicals explosion in the port of Beirut on 4 August, was the latest chapter of an economic collapse that has been happening over many years. Since 2015, economic growth has fallen back significantly (down by 1.1% per year on average since 2015), and the recession in 2019 could be as much as 6.5% according to the IMF. The Lebanese economy depends on market services (around 50% of GDP) and geographically on its immediate neighbourhood (tourism, investment). As a result, it has suffered the consequences of the economic depression in the Gulf which has followed the lasting fall in oil prices and regional political tensions. After two consecutive years of recession, the contraction of economic activity in 2020 is likely to be very severe. Since the beginning of the year, the balance of payments crisis has resulted in significant restrictions on imports and pushed inflation to record levels (110% y/y in July). Against this background, domestic demand has plummeted as the government was not in a position to support the economy. On top of this, although the country was initially unaffected by the Covid-19 pandemic, the number of new cases has risen sharply since the summer. For the moment, constraints on economic activity have moderated, having eased somewhat in early September.

The World Bank estimates that the damage from the chemical explosion in August can be put at between USD3.8 billion and USD 4.6 billion for physical damage and between USD2.9 billion and USD 3.5 billion for lost production. Thus the total cost of the explosion could be equivalent to 15% of 2019 GDP. The cost of rebuilding is estimated at around USD 2 billion over 2020 and 2021.

In the absence of up-to-date national accounts, a number of indicators highlight the scale of the economic crisis. For instance, arrivals at Beirut Airport collapsed by 98% in Q2 2020 (y/y), cement deliveries and area covered by construction permits were both down around 50% in H1 2020 (y/y), whilst new documentary letters of credit for imports virtually dried up altogether (-90% in H1 2020 y/y). In all, we estimate that GDP will contract by at least 25% in 2020. In the short term, any economic recovery is conditional on a rebuilding of foreign currency liquidity.

### FOREIGN CURRENCY LIQUIDITY DRIES UP

By restricting access to foreign currencies, the balance of payments crisis has had a significant effect on economic activity. The Lebanese economy is very highly dependent on imports. Imports of goods and services represent roughly 70% of GDP, compared to 23% in Egypt for example. The widening of the balance of payments deficit since 2018, and the desire to maintain the pound's peg to the dollar, put increasing pressure on currency reserves at the Banque du Liban (BdL). This led to the introduction of non-official capital controls and limited access to foreign currencies by preventing depositors from accessing foreign currency deposit accounts (around 80% of total deposits). The direct consequence of this was the development of a parallel currency market, and the difference between official and unofficial exchange rates exceeded 85%. In 2020, an official multiple exchange

**FORECASTS**

| | 2018 | 2019 | 2020e | 2021e |
|---|---|---|---|---|
| Real GDP growth (%) | -1.9 | -6.5 | -25.0 | 4.0 |
| Inflation (CPI, year average, %) | 6.1 | 3.1 | 85.0 | 50.0 |
| Central. Gov. balance / GDP (%) | -11.0 | -13.3 | -10.0 | -8.0 |
| Central. Gov. debt / GDP (%) | 151 | 169 | 257 | 256 |
| Current account balance / GDP (%) | -27.0 | -21.0 | -10.0 | -12.0 |
| External debt / GDP (%) | 119 | 116 | 255 | 290 |
| Forex reserves (USD bn) | 32 | 30 | - | - |
| Forex reserves, in months of imports | 12.0 | 11.0 | - | - |
| Exchange rate USDLBP (year end) | 1507 | 1507 | - | - |

TABLE 1

e: ESTIMATES AND FORECAST
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

**A WIDENING EXTERNAL DEFICIT**

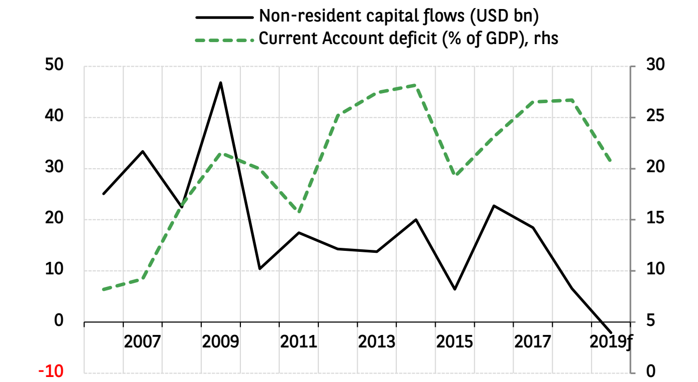


CHART 1

SOURCE: BDL, BNP PARIBAS

rate system was introduced, with an official base rate (LBP1,507/USD) for imports of essential goods and an official parallel rate (LBP3,900/USD) for other transactions. The unofficial parallel market rate has slightly appreciated since July, with the discount currently running at 80%, putting it at LBP7,700/USD. Given the current situation in foreign currency liquidity, this system is not sustainable as it threatens to strangle the economy step by step.

In practice, the currency reserves that are usable to the central bank are shrinking fast. Gross reserves currently stand at around USD 42 billion. The status of the gold held by the BdL is ambiguous. Its lower liquidity suggests that it should not be included in available reserves. However, it accounts for more than 40% of total gross reserves. Using a strict definition that excludes gold stocks and commercial banks' required reserves, the foreign currency reserves that are truly available were less than USD2 billion on 15 September. On the basis of the BdL's parallel exchange rate for non-essential imports (3,900), these reserves covered less than 6 months of goods imports. This figure remains theoretical, as it does not take account of the other lines of current payments and assumes that the government will remain in default on its foreign currency debt. Since the beginning of 2020, the government defaulted on three repayments of foreign currency bonds, totalling USD 2.5 billion. In 2021, repayments of principal alone totalling USD 2.1 billion will fall due.

## THE BANKING SECTOR IN A STALEMATE

The specificity of the breakdown in the foreign currency financing circuit for the Lebanese economy has made the balance of payments position unsustainable over the short term. Given the very high structural current account deficit (around 24% of GDP on average since 2010), the flows of foreign currency deposits from non-residents, which allowed the BdL to underpin the peg to the dollar and the government to meet its international obligations, have dried up since September 2019. With the economic crisis worsening and in view of the risks relating to exchange rate controls, non-resident deposits fell by 24% y/y in July 2020, with total deposits down by 18%. The decline in bank assets has been on a similar scale, and has affected all counterparties, both private and public. It is no longer possible for banks to finance a portion of the fiscal deficit. Moreover, the net external position of banks continues to be a sizeable deficit (USD30 billion, or 15% of bank assets). This deficit has narrowed a little since March, but this has been primarily due to increasingly limited access to external financing for Lebanese banks.

Lebanon's banks have significant exposure to sovereign debt. Although direct loans to the government are limited and stable (at around 12% of assets), exposure to the BdL is more than 57% of assets. Since the introduction of "financial engineering" mechanisms by the BdL, the central bank has played a key role as an intermediary in the financing of the budget deficit; in total, therefore, commercial banks' exposure to sovereign debt (including via the BdL) is equal to around 70% of their total assets. This financing system has done little more than shift part of the deficit to the central bank (which is still awaiting audit) and to commercial banks, whose net external liabilities have increased.

## POLITICAL DEADLOCK

The main source of imbalance in the Lebanese economy remains the public finances, and the recurrent and substantial deficit. The primary balance has been in deficit since 2018 (3.1% of GDP in 2019) and debt interest payments account for nearly 50% of total government revenues.

COMMERCIAL BANKS: SIMPLIFIED BALANCE SHEET (Y/Y %)

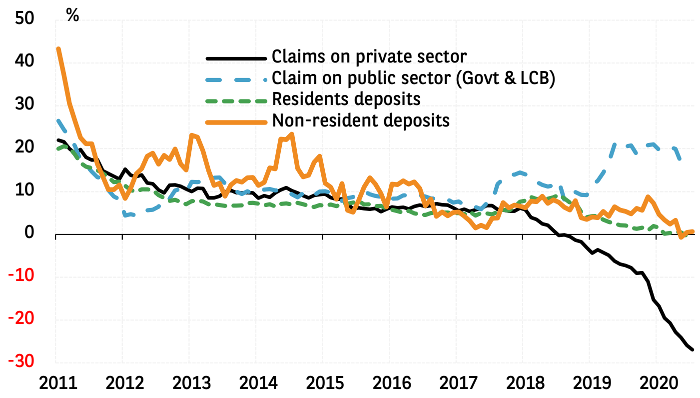


CHART 2

SOURCE: BDL, BNP PARIBAS

The government deficit has averaged 9.8% of GDP since 2015. Government debt was around 160% of GDP in 2019. With external debt representing 35% of total debt, the depreciation of the currency and the collapse of GDP will push this debt to GDP ratio up to 257% of GDP in 2020, despite the very high level of inflation.

For the time being, the political deadlock and the lack of a local consensus on the reforms needed have prevented the development of any programme of international financial support. Rescuing the Lebanese economy will require more than just restructuring government debt, reforming the public finances and making the exchange rate regime more flexible. It will also require the upgrading of basic infrastructure (notably in the energy sector), as the first stage of improving the productive base, and restoring the attractiveness of the Lebanese economy. Foreign direct investment (FDI) into Lebanon was equivalent to 4.7% of GDP in 2018. This seemingly favourable figure masks the fact that nearly 80% of FDI has come in the real estate sector, with greenfield FDIs accounting for only 5.6% of the total. In the absence of reforms that will increase potential growth, any improvement in macroeconomic balances thanks to international support will only be a short-lived solution.

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# MOROCCO



## A DELICATE BALANCING ACT

**Despite rapid support measures, the economy will not escape a severe recession this year. With the abrupt halting of tourism activity, the drop-off in exports to Europe and the collapse of domestic demand in Q2, GDP will contract by about 6%. Although there are high hopes that a good agricultural harvest will fuel a rebound in 2021, the recovery of non-agricultural activities will take time. In contrast, Morocco's macroeconomic stability does not seem to be threatened. But growing pressure on public finances leaves the authorities very little manoeuvring room.**

As the spread of the virus has intensified again in recent weeks, the Moroccan authorities are still trying to strike the right balance between the health emergency and the economic crisis. The stimulus plan announced during King Mohammed VI's speech illustrates this strategy. The announced stimulus is massive at MAD 120 bn (11% of GDP), but the way in which it will be implemented should help limit the impact on public finances. More than 60% of the plan consists of state-backed loans. Like for the Covid fund, private and institutional investors will cover two-thirds of the new investment fund (MAD 45 bn). Monetary policy support consists of the rapid mobilisation of conventional tools, but the central bank refuses to intervene directly to finance the Treasury. In an unstable environment, this determination to preserve macroeconomic stability is reassuring. Even so, the prospects of a growth rebound after the 2020 shock are still uncertain.

### A MARKED SLUMP IN ACTIVITY

Already undermined by a 5% contraction in agricultural added value due to unfavourable weather conditions in Q1 2020, the Moroccan economy was then hit by a spectacular drop-off in Q2 GDP. According to the High Commission for Planning, GDP contracted 14.9% year-on-year (see chart 1). With the early introduction of lockdown measures, domestic demand collapsed: investment plummeted 17.4% y/y and household consumption declined 21.2%, despite extremely low inflation (which averaged 0.5% in the first seven months of the year). Furthermore, being dependent on the European market and having a large tourism sector, Morocco had to cope with a powerful external shock. Excluding oil refining, the manufacturing output index contracted 21.4% y/y in Q2, which can be largely attributed to the difficulties of export supply chains, and automobiles in particular (-57%). Value added in the "hotel and restaurants" sector plummeted 90%, slashing growth by 2.3 percentage points. Despite the good performance of financial services, the tertiary sector (50% of GDP) felt by 14.9% in Q2.

Although the second half is expected to see an improvement thanks to the lifting of lockdown measures since June, the full-year recession is bound to be severe at 5.8%. Moreover, the risks are on the downside, as illustrated by the lockdown measures that were recently reintroduced in Casablanca.

Yet the downturn could have been much worse without the authorities' rapid intervention. The central bank lowered its key rate from 1.5% from 2.25% prior to the crisis, and commercial banks are no longer required to make deposits as part of mandatory reserves. By implementing state-backed loans combined with the easing of provisioning rules in exchange for loan restructuring and extended loan payments, the banks continue to support the economy. At the end of July, bank lending was up 5.8% year-on-year, and this momentum was largely fuelled by greater needs for corporate cash flow. Nearly 60% of the increase in loans outstanding since March were for liquidity loans. Despite greater pressure on bank liquidity, corporate borrowing conditions have improved (the average lending rate fell by 33 basis points to 4.58% in the first six months of the year) and there has not been a surge in

FORECASTS

| | 2018 | 2019 | 2020e | 2021e |
|---|---|---|---|---|
| Real GDP growth (%) | 3.1 | 2.5 | -5.8 | 4.6 |
| Inflation (CPI, year average, %) | 1.8 | 0.2 | 0.8 | 1.2 |
| Central. Gov. balance / GDP (%) | -3.8 | -3.8 | -7.5 | -5.6 |
| Central. Gov. debt / GDP (%) | 65.2 | 65.0 | 76.1 | 78.0 |
| Current account balance / GDP (%) | -5.5 | -4.1 | -6.8 | -5.9 |
| External debt / GDP (%) | 44.3 | 45.6 | 53.8 | 52.6 |
| Forex reserves (USD bn) | 22.6 | 25.3 | 27.0 | 25.4 |
| Forex reserves, in months of imports | 4.9 | 5.3 | 6.9 | 6.0 |
| Exchange rate USDMAD (year end) | 9.6 | 9.6 | 9.5 | 9.3 |

TABLE 1

e: ESTIMATES AND FORECAST
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

ECONOMIC GROWTH

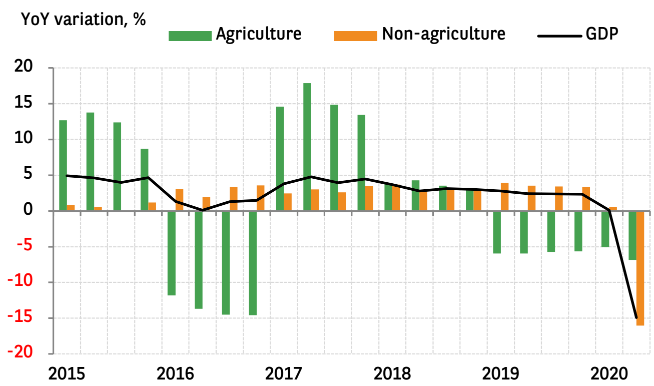


CHART 1

SOURCE: HCP

non-performing corporate loans (+12% y/y compared to +17% for non-performing household loans at the end of July).

### A SOLID EXTERNAL POSITION DESPITE TOURISM DEBACLE

The authorities also acted prudently by drawing on the IMF's entire USD 3 bn Precautionary and Liquidity Line (PLL) in early April. This operation swelled foreign reserves by 13% (see chart 2), which eased the pressures emerging on the dirham (MAD). In March, the currency fluctuation band was widened to +/- 5% around a basket of currencies comprising 60% of euro and 40% of US dollar. Although MAD immediately depreciated by 5-6% against the two benchmark currencies, it has stabilised since April within the fluctuation band without any central bank intervention. With foreign reserves now covering more than seven months of imports, Morocco's external position seems to be solid to face up to potential pressures.

The expected shock has not materialised yet. Although the main sources of foreign currency plummeted in the first seven months of the year, with exports down 17% and tourism revenues down 44%, imports also contracted 17% under the double impact of the downturn in domestic demand and oil prices. Even excluding energy, the trade deficit shrank by 10%. Nonetheless, the trade balance is bound to deteriorate as demand picks up, and the shortfall in tourism revenues is expected to reach 4% of GDP. Remittances by the Moroccan diaspora have also been resilient, declining only 3.2%, but caution is needed here, too. The current account deficit is expected to near 7% of GDP in 2020. With foreign direct investment in a slump, the authorities have decided to tap again the international financial markets to make up for the financing needs not covered by the massive aid from international donor funds. As expected, the Eurobond issuance of EUR 1 bn has got a warm welcome by international investors. Despite a greater mobilisation of external financing, the external debt remains under control (54% of GDP in 2020).

## PUBLIC FINANCES: SWELLING DEBT IS STILL MANAGEABLE

Public finances have come under significant pressure. In the first eight months of the year, fiscal and non-fiscal receipts contracted by 8% and 14%, respectively. Although spending was virtually flat thanks to cutbacks in energy subsidies and tighter control of investments, the budget deficit widened by 50% compared to August 2019, and an Amended Finance Bill had to be passed for the first time since 1990.

The deficit is now expected to reach 7.6% of GDP, up from an initial target of 3.8%, even though most of the stimulus plan was financed through the MAD 33.7 bn Covid fund, two thirds of which is comprised of grants. Government debt is expected to increase by more than 10 points to 76% of GDP. There are also fiscal risks contingent on the financial situation of state-owned companies that have also been hit by the crisis. State-backed external debt amounted to 15.5% of GDP in 2019, but this figure is not included in the scope of government debt.

Nonetheless, the deterioration in Moroccan public finances is still manageable since the government continues to benefit from favourable financing conditions. Despite significant issuance on domestic debt market since the beginning of the year, the yield on Treasury notes has never been so low, which should allow it to maintain the interest payment at less than 13% of government revenue. Moreover, the structure of the debt is not risky, with 78% denominated in MAD.

## HAS THE 2021 RECOVERY ALREADY BEEN JEOPARDISED?

It is hard to evaluate the rebound capacity of the Moroccan economy. Although there are hopes for a better agricultural harvest in 2021 after two difficult years, non-agricultural activities are expected to turn around only gradually at best. According to the central bank's latest estimates, tourism revenues could double in 2021 if the health crisis permits, but this would still be 60% below the 2019 level. It also seems very hypothetical that industrial activity could return to normal, although the upturn in automobile production at the new PSA plant

FOREX RESERVES

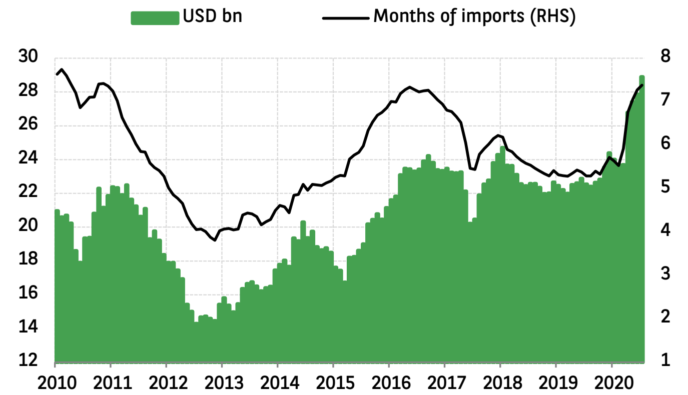


CHART 2 SOURCE: CENTRAL BANK, OFFICE DES CHANGES

should help boost exports. More importantly, there are numerous doubts about the health of Morocco's economic fabric.

Emergency measures have certainly helped buffer the shock, but they will not prevent an upturn in business failures as the various support measures wind down. The central bank recently conducted a stress test in which the non-performing loan ratio was expected to rise to 9.9% at end-2020 and 10.8% at end-2021, compared to 7.6% in 2019 (and 8.2% in July 2020). The financial system's stability is not in jeopardy, but the monetary authorities have warned that a new stress test will be conducted by the end of the year to take into account an evolving situation. In other words, we cannot rule out an even sharper increase in the non-performing loan ratio. Household behaviour is another unknown. Although the rise in unemployment was relatively mild in Q2 (+1.8 points to 12.3%), especially in urban areas (+0.5 points), the concomitant 10-point drop in the household confidence index to an all-time low seems to reflect a sharp deterioration in living conditions.

One last unknown is the scope of the recovery plan. Growth dynamics were already modest before the economic shock of the pandemic, despite a high investment rate from both public and private sectors. The effectiveness of public spending generally goes hand-in-hand with the implementation of structural reforms, but they can be postponed during times of hardship. In any case, the authorities will have very little manoeuvring room as government debt begins to reach high (but still manageable) levels. The government's determination to preserve the country's investment grade status is also likely to encourage moderation.

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# ANGOLA



## A WORRYING SITUATION

**With the country in recession for the fifth consecutive year (latest estimates put the contraction in 2020 at 4%), the current crisis is acting as a catalyst for existing weaknesses and further damaging the country's economic prospects. The combined effect of lower oil prices and production and the depreciation of the currency has increased pressure on the capacity for external financing and the sustainability of Angola's debt. The country has seen a significant decline in its currency reserves, which could become insufficient as the financing deficit increases. Currently under negotiation, the expected support of bilateral creditors (most notably China) is becoming crucial.**

### THE ANGOLAN ECONOMY IN DEPRESSION

The consequences of the current crisis are substantial and come at a time when Angola has suffered negative growth since the oil shock of 2014-16: on average the economy contracted by 1.4% each year from 2016 to 2019. Despite President Lourenço's programme of reforms, the current shock will accentuate the structural vulnerabilities of the economy, namely the lack of diversification and its financial dependence on China. The weight of the fossil fuel sector makes Angola particularly vulnerable to falls in oil prices and to a shortfall in investment in the sector, which has resulted in a steady decline in production since 2016 (from 1.72 million b/d to an estimated 1.38 million b/d in 2019, a fall of 20%).

Although the slowdown in Q1 2020 was limited, the impact of the crisis can be seen much more clearly in Q2 2020. Overall, economic activity shrank by 6.1% year-on-year (compared to a 1.8% contraction in Q1 2020). Although production levels have picked up slightly since the beginning of the year[1], the oil sector made a negative contribution to GDP growth. In value terms, the decline has been even greater, due to falling oil prices. This contraction of oil revenue has knock-on effects throughout the rest of the economy. In addition, the trade sector has been particularly hard hit by the state of emergency and global restrictions.

Advance indicators suggest that the economic contraction will continue. The business confidence index continues to fall (a moving average in Q2 2020 of -21 points, compared to -15 points in Q1 2020) reflecting both the operational constraints on the resumption of business (disruption to both domestic and international production chains) and concerns about demand suffering a lasting hit. The sharp falls in confidence in the manufacturing sector (-36 points) and the trade sector (-43 points) reflect these twin issues. Despite the easing of preventative health measures, the weakness of private sector consumption has combined with a hesitant recovery in external demand.

Meanwhile, the IMF has revised its forecasts, ruling out any hope of an economic recovery in 2020 and predicting an unprecedented 4% contraction for 2020 as a whole (from 1.3% previously projected). The IMF then expects a modest rebound in 2021 (3.2% on the same set of estimates, from 2.6% previously), although this will be partly explained by a base effect.

Domestic demand (nearly 50% of added-value) is also constrained by high levels of inflation. The economic contraction and collapse in the oil price have weakened the local currency, the kwanza (AOA), which has lost 20% against the USD since the end of 2019, thus increasing inflationary pressures. Inflation, which had already been pushed upwards by the unpegging of the currency[2] and the introduction of VAT in October 2019, hit 13.1% y/y in Q2 2020 and is likely to move some way out of the BNA's target range of 7% to 9% over the year as a whole

FORECASTS

| | 2018 | 2019 | 2020e | 2021e |
|---|---|---|---|---|
| Real GDP growth (%) | -1.2 | 0.9 | -4.0 | 3.2 |
| Inflation (CPI, year average, %) | 19.6 | 17.1 | 21.0 | 20.6 |
| Gen. Gov. balance / GDP (%) | 2.2 | 0.8 | -2.8 | -0.1 |
| Gen. Gov. debt / GDP (%) | 89.0 | 109.2 | 120.3 | 107.5 |
| Current account balance / GDP (%) | 6.9 | 5.7 | -1.3 | 0.1 |
| External debt / GDP (%) | 56.8 | 76.2 | 94.0 | 89.1 |
| Forex reserves (USD bn) | 15.4 | 17.3 | 15.5 | 16.9 |
| Forex reserves, in months of imports | 7.4 | 12.4 | 9.9 | 10.2 |
| Exchange rate USDAOA (year end) | 252.9 | 343.9 | 407.3 | 437.4 |

TABLE 1

e: ESTIMATES AND FORECAST
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

ANGOLAN GROWTH AT HALF MAST

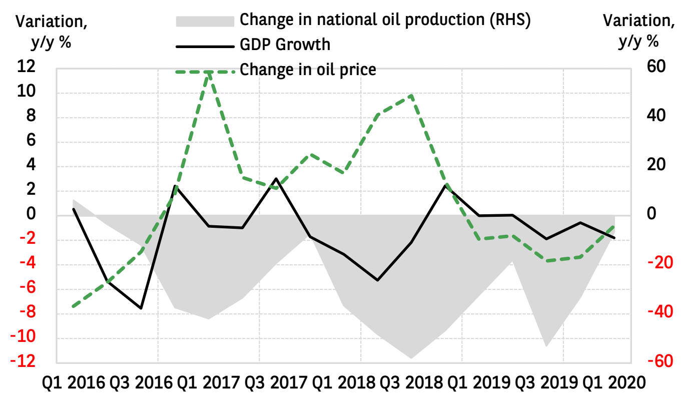


CHART 1

SOURCE: IMF, JODI, ANGOLAN NATIONAL AUTORITHIES

1 Angola having failed to respect OPEC's production quotas.
2 In October 2019, the National Bank of Angola (Banco Nacional de Angola or BNA) removed the +/-2% corridor on movements in the kwanza in order to deregulate the exchange rate and reduce the gap between official and parallel rates

– reaching 21% y/y on average over 2020 and then 20.6% in 2021[3] as a result of adjustments in regulated prices and the kwanza's rapid slide.

Quite apart from the increase in non-performing loans, the combined impact of inflation and the depreciation of the kwanza creates risks for the banking sector. The number of defaults is likely to surge, as 28% of lending is denominated in dollars. Moreover, the depreciation of the currency increases debt service costs and the country's external debt position and heightens the financing risk if this leads to growing pressure on currency reserves.

## INCREASED PRESSURE ON FINANCING CAPACITY

The current crisis has significantly weakened the country's financial prospects, which had already been damaged by the 2014-2016 shock. The IMF has revised its forecast of the public debt to GDP ratio for 2020 to 120.3% to take account of current conditions. This change is due largely to the kwanza's depreciation, as 70% of outstanding debt is denominated in foreign currency.

The country's ability to meet its external financing needs has been significantly reduced as a result. Following the 2014-2016 shock, Angola was only able to finance its current account deficit by drawing heavily against its foreign currency reserves, which fell from USD 32.2 billion in 2013 to USD 17.3 billion by the end of 2019. In addition, the country's external debt has more than doubled as a percentage of GDP, rising from 20.6% in 2013 to 76.2% at the end of 2019, notably as a result of increased non-concessional borrowing made possible by the low interest rate environment.

In the current climate, the deterioration of both liquidity and external solvency has resulted in an increase in the cost of external financing that will be hard to sustain. This is most notably visible in an increase in the sovereign yield spread on sovereign debt of more than 500 basis points (bp) since the beginning of 2020, taking it from 557 bp at end-December 2019 to 1,063 bp in August. This is primarily because reserve levels are historically low, and the external financing requirement depends heavily on oil exports, which account for 95% of the country's foreign currency income. The fall in such income as a result of lower oil prices is exacerbated by a structural decline in production. The estimated external financing needs for 2020 is USD 5 billion (more than 8% of GDP) and the country's ability to cover this is limited. As the government's fiscal receipts from oil revenue do not account for the totality of fiscal receipts, the kwanza's depreciation makes repayments increasingly costly. Angola's financing capacity depends in particular on bilateral loan agreements denominated in foreign currencies, particularly with China (which accounted for more than half of total debt in 2019).

In the very short term, the country should be able to avoid a default on its foreign debt, with debt servicing costs estimated at around 36% of 2020 revenues (including USD 3.3 billion in debt repayment and USD 1.2 billion in interest).

For the time being, the country has received temporary relief from the financial support of the IMF, which has recently disbursed the 4th tranche of its loan facility (USD 1 billion) and a payment under the Extended Fund Facility established in 2018 (USD 767 million). Angola has also agreed a moratorium on debt service payments with bilateral and official creditors under the DSSI (Debt Service Suspension Initiative) introduced by the G20 nations and the Paris Club. This will produce savings of around USD 30 million by the end of 2020. However, this does not cover borrowings from China, meaning that negotiations

**DETARIORATION OF THE EXTERNAL POSITION**

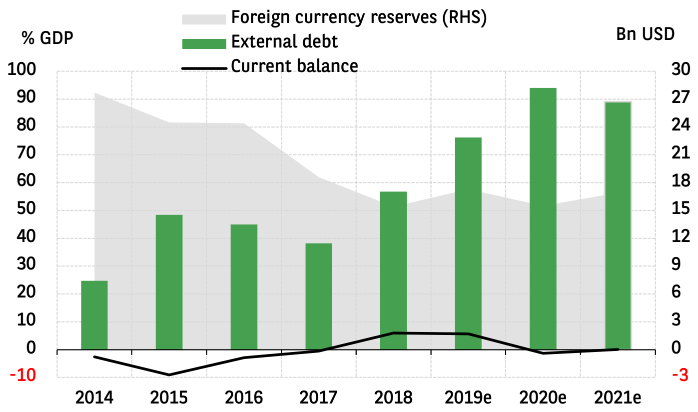


CHART 2 — SOURCE: IMF, BNP PARIBAS

with Beijing will be decisive (currently thought to get to positive outcomes). Nor do these measures cover debt to the private sector.

In the absence of an agreement, or if the sums involved remain insufficient, a rescheduling of the debt could be necessary to make it sustainable. Further ahead, the rebuilding of external financial buffers, which will depend on a significant increase in oil prices, and a genuine diversification of the economy will both be vital.

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3 According to the IMF, which has revised its pre-Covid estimates (October 2019). Its initial inflation forecast for 2020 was 15% (from more than 17% in 2019).

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