ECO EMERGING

3rd quarter 2020

EDITORIAL

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ECONOMIC RESEARCH

BNP PARIBAS

The bank for a changing world

A PREMATURE RALLY

Since mid-April, calm has been restored in the financial markets of emerging economies. In most countries, exchange rates have begun to appreciate again, while money market rates and bond yields have eased thanks to 1) the general easing of policy rates and greater use of quantitative easing by national central banks, 2) external financial support, and 3) the return of portfolio investment. As is often the case, the equity markets have exuberantly – and prematurely – welcomed this return to normal. Indeed, the economic recovery seems to be taking shape, but it remains very fragile.

Since mid-April, financial tensions have been easing in the emerging countries. Bolstered by the very gradual return of portfolio investment, exchange rates have stabilised. Since mid-May, cumulative net inflows of non-resident portfolio investment into bond and equity markets amounted to USD 22 bn (according to data from the Institute for International Finance (IIF) for a selection of 20 emerging countries), compared to cumulative net outflows of USD 100 bn from the end of February to mid-May. As a result, the emerging market currencies have regained some of the ground lost in the first 3 to 4 months of the year (+1.6% on average since mid-March, vs. -6% in Q1). Equity prices, in contrast, have erased most of their losses (+17% on average since the end of March, vs. -20% in Q1). Is this normalisation process, which is very advanced in the equity markets, truly justified?

SIGNS OF A RECOVERY MUST BE EXAMINED CAREFULLY

Economic activity is effectively picking up again, with China leading the way with the easing of lockdown restrictions (technical recovery) and the acceleration of public investment projects since March. Excluding China, there have also been very clear signs of a recovery since April-May. For the vast majority of the main emerging countries, the Markit PMI diffusion indexes based on business survey data have regained between 10 and 20 points from April's lows. Only a few countries continue to slide into recession, notably those in which governments have defaulted and the economy is paralysed by currency restrictions or tighter currency controls (Argentina, Lebanon). According to the PMI sub-indices, the economic recovery is primarily driven by foreign trade. Although the sample is still small, exports from some countries have rebounded – or at least contracted less sharply – in May or June compared to the year-earlier period.

Yet interpreting diffusion indexes can be misleading during this very exceptional period. For the vast majority of countries, the indexes are still holding below the 50 threshold that separates expansion from contraction. This means that even though activity has rebounded strongly, it has yet to return completely to normal. Granted, we can reach a more positive interpretation if we use the same month of the previous year as our reference period for the purchasing managers and business leaders surveyed on sales trends, order books, stocks and employment (although the Markit survey refers to trends with respect to the previous month). It is sometimes "natural" to refer to the year-earlier period for this type of survey, and there is a better correlation between diffusion indices and the year-on-year change in the variables under review than with quarterly variations. An index that is near 50 would indicate that things have almost returned to normal compared to spring 2019. In other words, the gap has been virtually closed. Yet this seems hardly possible over such a short period of time.

STAY ALERT

In any case, cyclical indicators suggest a recovery in H2 2020. Yet the size and diffusion of the recovery remains highly uncertain. For this reason, the rebound in local equity markets seems a bit excessive and even premature.

In Brazil, India and Mexico, the pandemic is not under control, and some governments have even imposed new, selective lockdowns.

Despite the surge in fiscal deficits, for the moment we have not observed any difficulties in refinancing public debt. Bond yields have been held down through conventional monetary easing (via policy rate cuts, which have been widespread throughout the emerging countries) and/or through quantitative easing (by expanding the ways in which central banks can refinance banks and indirectly companies, or through the monetary financing of fiscal deficits). Yet if the pandemic persists, this financial support will not prevent an upsurge in delinquencies and non-performing loans.

Lastly, higher risk premiums on sovereign debt in the local currency increase the attractiveness of carry trades and the inflow of volatile capital at a time when the emerging countries need financial stability even more than usual. For of a selection of 17 emerging countries, the median yield spread between the sovereign bond and a bond with an equivalent maturity in the financing currency (USD, EUR or JPY) remained stable at about 450 basis points (bp) between end-December 2019 and end-June 2020. But this spread must be looked at in terms of foreign exchange volatility to evaluate the profitability of the carry trade. After taking into account the policy rate differential, and thus the possibility of short-term foreign exchange coverage of positions (via the futures market or currency swaps), the median yield spread has nearly tripled, from 80bp to 200bp. For investors ready to take the risk of rolling over very short-term forex hedges, the spread is very attractive.

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BEYOND THE REAL GDP REBOUND

The economy has been recovering gradually since March, and the rebound in real GDP was strong enough in Q2 2020 to enable it to recover rapidly the ground lost in Q1. Yet the shock triggered by the pandemic and the ensuing lockdown measures has severely weakened some sectors (such as export-oriented industries), some corporates (notably micro-enterprises and SMEs) and some households (especially low-income earners). The central bank has cautiously eased credit conditions and the government has introduced a stimulus plan estimated at about 5 points of GDP for 2020. Public investment in infrastructure projects remains the instrument of choice, but direct support to corporates and households is also expected to boost private demand.

After plummeting during the period of the strictest lockdown in February, economic activity has gradually turned around since March. The contraction in real GDP was unprecedented in Q1 2020, down 9.8% on a quarterly basis (and -6.8% year-on-year) but the rebound in Q2 (+11.5% q/q and +3.2% y/y) was strong enough to completely regain the ground that was lost. On this point, China stands apart from most of the other big economies.

The turnaround observed over the past four months was mainly driven by a V-shaped rebound in industrial production and investment in public infrastructure and real estate. Even so, the economy has been hit be a severe shock that has left numerous scars. Certain sectors, notably those dependent on tourism and international demand, are still a long way from returning to normal. Although only temporary, the loss of corporate sales, jobs and household revenue will continue to strain domestic demand. Meanwhile, export prospects are darkened by the uncertain economic recovery in the developed countries and renewed tensions between China and the United States. Lastly, the risk of new outbreaks of the epidemic is hampering consumer behaviour[1].

Consequently, our short-term growth forecasts face downside risks. Inversely, they are firmly supported by the authorities' stimulus policies. Although the initial support package was relatively moderate, it has been gradually expanded and should keep pace with the economic recovery, even after the first rebound.

A DIFFERENTIATED REBOUND

All economic indicators point to a gradual recovery over the past four months, with industrial production and public investment rebounding more vigorously than private demand and services (chart 1).

On a year-on-year basis, industrial production swung back into positive growth as of April (+3.9% in volume, then +4.4% in May and +4.8% in June). In the first six months of 2020, industrial production was just 1.3% lower than it was in the same period in 2019. The production decline in value terms has been accentuated by producer price deflation (-1.9% y/y on average since the beginning of the year), which has aggravated the deterioration in profits of industrial enterprises (19% lower in January-May 2020 compared to the same period in 2019).

On the demand side, the recovery since March has been bolstered by the rebound in investment, especially in public infrastructure, construction and the real estate sector, which were supported by the authorities' stimulus measures. Investment in the manufacturing sector picked up much more slowly, constrained by the difficult financial situation of enterprises, notably SMEs. Export companies remain being especially cautious.

FORECASTS

	2018	2019	2020e	2021e
Real GDP growth (%)	6.7	6.1	2.5	8.1
Inflation (CPI, year average, %)	2.1	2.9	2.5	2.3
Official budget balance / GDP (%)	-2.6	-2.8	-3.6	-3.0
Central government debt / GDP (%)	16.3	17.0	19.6	20.7
Current account balance / GDP (%)	0.2	1.0	0.3	0.2

TABLE 1

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

SUPPLY-DRIVEN REBOUND, RETAIL SALES LAGGING BEHIND

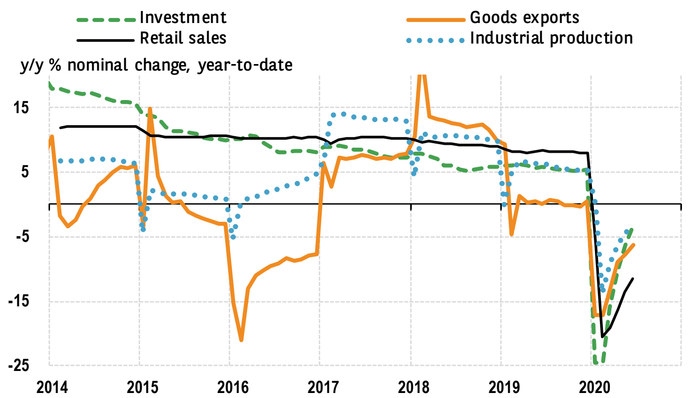

CHART 1

SOURCE: NBS, CUSTOMS

Even though foreign trade data show only a mild decline in merchandise exports over the period March-June (-1.6% y/y on average in USD), after the major disruption in February (-40%), export prospects remain bleak in the short term.

Private consumption has also struggled to recover, undermined by the downturn in the labour market and household revenues. The unemployment rate has held close to 6% since February (vs. 5.2% in 2019) and per capita disposable income declined by nearly 4% y/y in

1 In early June, the outbreak of new Covid-19 cases in Beijing led the authorities to reintroduce lockdown measures in certain districts. Fears have since eased, and official health reports show that the epidemic is currently under control, with a relatively flat curve for new infections over the past two months, and only 58 confirmed cases per 1 million inhabitants (some counties in China have been completely spared).

real terms in Q1 2020. In June, retail sales volumes continued to contract in year-in-year terms (down 2.9%), despite a big rebound in automobile sales (+11.8%). Online sales of goods and services were naturally more dynamic (+16%). The factors that have been straining the recovery in household consumption and exports are expected to persist in the short term, and the authorities are counting primarily on investment-related support measures to stimulate the economy.

FISCAL STIMULUS

The central bank has intervened right from the beginning of the Covid-19 crisis to address the liquidity needs of the financial sector. It has also eased monetary and lending conditions, and then encouraged banks to cover the cash flow needs of their clients and to refinance existing loans to prevent defaults and bankruptcies. Micro-enterprises and small businesses seem to be the main focus of the authorities' concerns. Growth in total social financing accelerated from 10.7% y/y at the end of February to 12.7% at the end of June 2020 and should reach 13% to 14% by year-end 2020. The easing in credit conditions should remain relatively moderate in the end, as the central bank's leeway is much constrained by the excessive debt of the economy.

Stimulating economic growth will depend more on fiscal policy. Measures introduced and/or announced since February aim to help the sectors and companies hit hardest by the epidemic, to boost household revenue (notably by supporting employment), and to stimulate domestic demand. Public investment in infrastructure projects, which is still the government's instrument of choice, has rebounded strongly over the past two months. Direct measures to support corporates, employment and private consumption are expected to be implemented more gradually.

Following the annual session of the National People's Congress in late May, the government released its 2020 budget plan and announced a deficit target of 3.6% of GDP this year, up from 2.8% in 2019. Although this deficit target is historically high, it nonetheless suggests that the recovery plan will be moderate. However, the government's "official" budget largely underestimates the real amplitude of the stimulus, and Chinese fiscal policy in general. Fiscal policy is comprised of several segments, some of which are reported in the official budget, while others can be found in various off-budget accounts, such as the social security fund, funds financed by "special" central government bond issues, the special funds of local governments and the accounts of their financing vehicles. State-owned companies can also participate in stimulus measures. Lastly, transfers can be made between these various accounts over the course of the fiscal year.

In addition to the official deficit target, which is financed through so-called "general" bond issues (about 70% of which are issued by the central government and 30% by local governments), the authorities have announced the amount of "special" bond issues in 2020 to finance the supplemental budget allocated to post-Covid recovery measures. The central government will issue special bonds amounting to a total of CNY 1000 bn (1% of estimated 2020 GDP)[2], and the quota for special bond issues by local governments was increased by CNY 1600 bn to a total of CNY 3750 bn (3.6% of estimated 2020 GDP). Public debt is almost entirely denominated in RMB and issued in the local markets. Central government debt is still moderate and is projected at no more than 20% of GDP in 2020. In contrast, the debt of local government (including their financing vehicles) is high, estimated at about 50% of GDP.

OFFICIAL AND AUGMENTED FISCAL DEFICITS

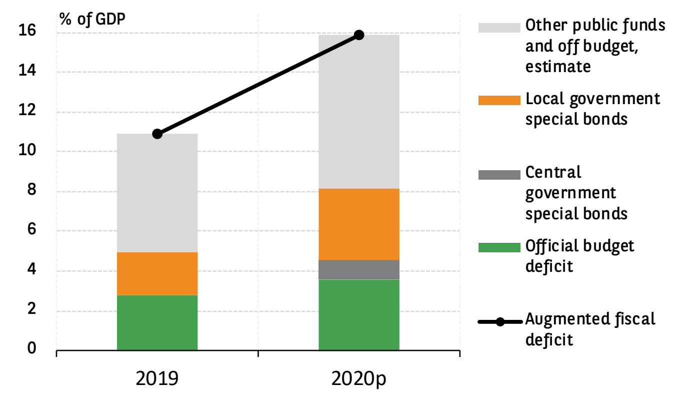

CHART 2
SOURCE: CHINESE GOVERNMENT, BNP PARIBAS

Adding together the official deficit, the funds generated through special bond issues and the estimated amount of off-budget accounts, the "augmented" fiscal deficit comes to 10.9% of GDP in 2019 and is expected to reach 15.9% of GDP in 2020 (chart 2). This increase of about 5 points of GDP gives a more realistic picture of the size of the fiscal stimulus planned by the authorities. They have not specified which amounts will be allocated to the various support measures. We can nonetheless highlight two main kinds of measures: additional investment in infrastructure projects is estimated at about 2% of GDP, and direct support measures for corporates and households are estimated at about 3% of GDP. They notably include social security and tax exemptions and reductions, and an extension in the unemployment insurance system to accelerate benefit payments and cover more migrant workers.

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2 The central government issued this type of bonds only twice in the past, in 1998 and in 2007.

INDIA

DISILLUSION

India should report an unprecedented contraction in real GDP this year. The big question is how strong will it rebound thereafter? The rating agencies have begun to doubt whether India will return to its potential growth rate in the years ahead because its economic slowdown began much earlier than the Covid-19 crisis. India's slowdown dates back at least to 2018, and could even be an extension of the 2009 financial crisis. Since 2014, real GDP growth seems to have been driven solely by positive external shocks, creating the illusion of robust growth. Yet the banking sector is still much too fragile to restore GDP to the growth rates of the past.

FRAGILE GROWTH SINCE 2018, OR MAYBE EVEN 2009

In fiscal year 2019/20, ended 31 March 2020 (FY2020), India reported real GDP growth of only 4.2%, its weakest performance since the global financial crisis of 2009, and far below its potential growth rate, estimated at 7.3%. In Q4 2019/20 (January to March 2020), real GDP rose only 3.1% compared to the year-earlier period. All components of growth slowed sharply or contracted. This sharp slowdown only partially reflects the impact of the coronavirus pandemic on economic activity.

The current slowdown began well before the coronavirus crisis. It can be traced back to September 2018 and the bankruptcy of two subsidiaries of the non-banking financial company Infrastructure Leasing & Financial Services (IL&FS). Since then, economic activity has gradually slowed, corporate profits have fallen and the unemployment rate has risen.

The IL&FS bankruptcy triggered a sharp drop in lending by non-banking financial companies (NBFC) and housing finance companies (HFC), whose weight in financing the economy had increased sharply since 2014 (especially for households, real estate companies and SME). The NBFC and HFC had stepped in for the ailing state-owned banks. Starting in 2018, mutual funds, the main source of financing for the NBFC, sharply reduced their exposure to the most vulnerable ones, generating a sharp increase in their financing costs and a liquidity squeeze.

The decline in non-banking lending since September 2018 has been a major handicap for a whole section of the economy, notably the construction and real estate sectors. The number of residential real-estate projects declined by 85% in the year 2019-20, and sales prices for residential assets contracted by 2.7% y/y in Q4 2019. Micro, small and medium enterprises (MSME), which play an essential economic role (29% of GDP and 48% of exports), were granted only a third of the loans they requested in full-year 2019.

The economic slowdown has intensified since September 2019. Household consumption slowed with the increase in the unemployment rate, and corporate investment contracted (-2.8% in full-year 2019/2020) as earnings declined and financing became more difficult. Lastly, like in the rest of Asia, exports also contracted, reflecting trade tensions between China and the United States.

According to certain economists[1], the economic slowdown observed since 2018 is actually an extension of the financial crisis of 2009. The fragile financial situation of banks and companies can be traced back to 2009, and has hampered investment, competitiveness and India's exports. A series of positive external shocks since 2014-15 has helped boost growth (especially the sharp drop in commodity prices and the increase in non-banking lending since 2014), creating the illusion of robust growth.

1 Arvind Subramanian and Josh Felman (2019)

FORECASTS

	2018	2019	2020e	2021e
Real GDP growth(1) (%)	6.1	4.2	-4.7	8.3
Inflation (1) (CPI, year average, %)	3.4	4.7	3.5	4.4
General Gov. Balance(1) / GDP (%)	-6.3	-7.3	-11.5	-8.5
General Gov. Debt(1)/ GDP (%)	69.9	72.2	84.9	83.7
Current account balance(1) / GDP (%)	-2.1	-0.8	-0.1	-1.0

TABLE 1

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

INDUSTRIAL PRODUCTION

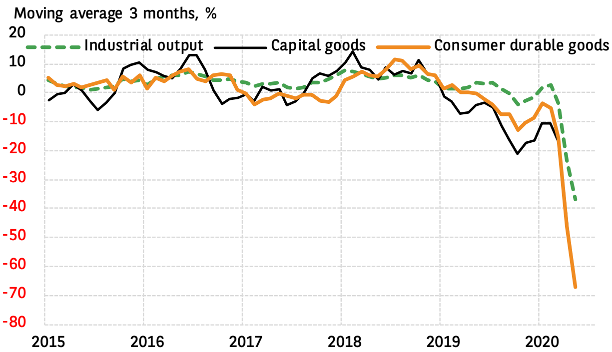

CHART 1

SOURCE: RBI

The Covid-19 crisis, in contrast, has directly impacted an economy whose economic fundamentals were already weakened, with little fiscal and monetary policy leeway to deal with the crisis. For the first time since fiscal year 1979-80, India will not be spared recession, which was not anticipated at the beginning of the pandemic.

AN UNPRECEDENTED CONTRACTION IN ECONOMIC ACTIVITY

In June, the IMF revised downwards its growth outlook for India. It now expects real GDP to contract by 4.5% in fiscal year 2020-21 (whereas in April it was forecasting a sharp slowdown to +1.9%), before rebounding by only 6% in 2021/22. The 10-week lockdown of the population has had an unprecedented impact on economic growth. Moreover, even though general lockdown restrictions have been lifted since 1 June, several states were forced to maintain shelter-in-place measures in certain cities and districts due to the spread of the virus. At the end of June, the number of new coronavirus cases was still rising by 4% a day.

The lockdown triggered an unprecedented contraction in economic activity. In April-May, industrial output plunged by 46% on average compared to the same period last year (after contracting more than 18% y/y in March), with an especially sharp drop in capital goods production. Survey results of business leaders in industry and services alike confirm that economic activity contracted sharply for the third consecutive month at the end of June.

Since the general lockdown ended on 1 June, economic activity has rebounded slightly. The industrial business confidence index rebounded to 47.2 in June, but this is still well below the 50 threshold that separates contraction from expansion. The unemployment rate fell back by more than 15 percentage points to 8% in mid-July after a high in April-May. Lastly, after plummeting in April, electrical power consumption has begun rising again. Looking beyond the Covid-19 pandemic, meteorological services are also forecasting a good monsoon this year, which should boost the revenues of rural households.

A BIG SHOCK FOR A FRAGILE BANKING SECTOR

India's banking sector is fragile, especially the state-owned banks, although the March 2020 rescue of Yes Bank by the government and the central bank is a good reminder that some private banks are vulnerable, too.

The quality of bank assets has generally improved since 2018, but the banks are still fragile with insufficient provisions. According to the IMF, the ratio of non-performing loans net of provisions to capital was 41% at year-end 2019. At the end of September 2019, the non-performing loan ratio for the banking sector as a whole was 9.2%, although it was 12.7% for state-owned banks (vs 3.9% for private banks). Despite the Insolvency and Bankruptcy Code adopted in 2016, debt restructuring periods are still long (394 days on average), even though they have been shortened considerably.

At the end of March 2020, equity capital was generally sufficient to meet capital adequacy requirements thanks to the government's massive capital injections over the past two years[2] (the capital adequacy ratio was 15.3%). Yet the situation still differs widely between state-owned banks, and some may need further capital injections in the months ahead.

Liquidity is also insufficient: liquid assets covered only 22.9% of short-term commitments at year-end 2019. Corporate profitability is also extremely low, with ROA and ROE of only 0.2% and 2.7%, respectively, in 2019.

The economic crisis triggered by the Covid-19 pandemic will drive up credit risk by 220 basis points (bp) according to S&P estimates last May, but it could rise much higher given the expected economic contraction. Moreover, companies were already seeing their financial situation begin to deteriorate in 2019. At the end of the year, the central bank estimated that the most fragile economic sectors in terms of credit risk were construction, metalworking, infrastructure and mining.

Excluding companies and workers in the transport, construction, tourism, food services and retail sectors, the economic agents with the highest exposure to the lockdown were households and small businesses (which account for 27% and 5% of banking lending, respectively), including micro-enterprises and SME. The 3-month suspension of loan payments only partially alleviated the pressure on these borrowers. Moreover, even though banks are the main lenders to mid-sized companies, it is the NBFC who have the highest exposure to the most fragile borrowers.

PURCHASING MANAGERS INDEX (PMI)

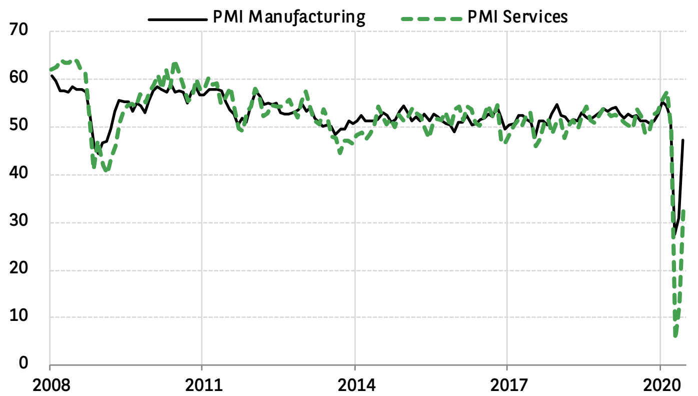

CHART 2

SOURCE: MARKIT

The banks and the NBFC will have to deal with rising credit risks at a time when they are already fragile. Although lending institutions will continue to benefit from government support, they will become more selective in granting loans, which is bound to place a damper on the recovery.

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2 Over the past two fiscal years, the government has injected INR 2826 bn (the equivalent of 1.4% of GDP) to recapitalise the most fragile state-owned banks.

BRAZIL

HIT HARD

While the Covid-19 epidemic continues to spread, restrictions have started to ease in parts of the country. A severe contraction of economic activity is anticipated in Q2 with the latest data indicating that a low point was reached in April. A rapid recovery of economic activity will be constrained by the economy's weak growth engines, especially investment. Fiscal and monetary policy measures have continued to be deployed or extended to help cushion the impact of the crisis. While the currency continues to exhibit weakness and fiscal balances keep deteriorating, continued monetary easing has helped boost the stock market.

A CONTROVERSIAL MANAGEMENT OF THE HEALTH CRISIS

Against a backdrop of escalating political tensions[1], the management of the health crisis on the part of the federal authorities has been highly controversial: temporary suspension in the publication of Covid-19 statistics, successive dismissal of two health ministers, lack of a clear health strategy at the national level, clashes between different levels of government over the easing of restrictions, presidential veto to water down parts of a law requiring to wear face masks in public spaces.

This context has accentuated the difficulties of controlling the progression of the epidemic which continues to wreak havoc. At the beginning of July, Brazil ranked second after the United States amongst the countries hardest hit by the Covid-19 pandemic. Over a month, its death toll doubled to nearly 65,000 and the number of confirmed cases tripled to more than 1.6 million – with the virus infecting the President himself. The cumulative number of deaths per million inhabitants at 313, has remained below that of neighbouring countries such as Chile and Peru, but also France (460), Sweden (540), Italy (577) and Belgium (844). Yet with the world's highest number of deaths per day (more than 1000 on a 7 day rolling average), Brazil will likely make its way to the top of this ranking.

At the national level, it will likely take several months to reverse the epidemic curve due to the virus' late progression in certain regions (notably in the centre-west and southern parts of the country). However, in the regions initially most affected, including the states of Sao Paulo and Rio de Janeiro — the country's two main economic engines (accounting for nearly 50% of GDP) — the spread of the virus has levelled off, and in some cases slowed down. As a result, state governors and mayors — who are responsible for deciding when to reopen their economies according to a ruling by the Supreme Court — have begun to ease restrictions and allow businesses to gradually reopen. Looking forward, the lifting of restrictions across states will likely remain very heterogeneous.

FORECASTS

	2018	2019	2020e	2021e
Real GDP growth (%)	1,3	1,1	-7,0	4,0
Inflation (CPI, year average, %)	3,7	3,7	2,6	3,0
Budget balance / GDP (%)	-7,1	-5,9	-16,3	-6,7
Public debt / GDP (%)	77,2	78,2	98,0	94,2
Current account balance / GDP (%)	-2,3	-2,9	-0,8	-0,8

TABLE 1

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

CONSUMER AND BUSINESS CONFIDENCE INDEXES

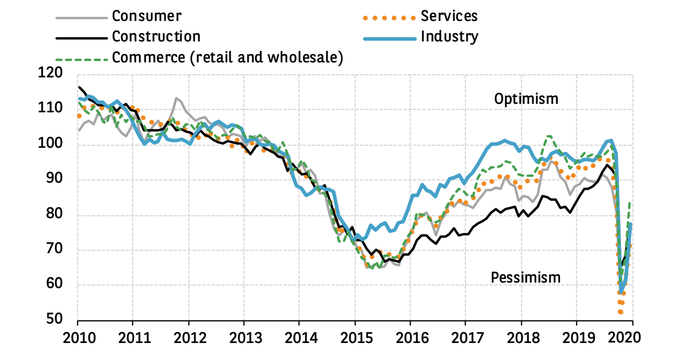

CHART 1

SOURCE: FGV

SUBSTANTIAL LOSSES IN TERMS OF ECONOMIC ACTIVITY

GDP results for the first quarter released at the end of May highlighted the first effects of the pandemic on the economy. GDP contracted by 6% q/q at an annualized rate (-0.2% y/y), and was marked by a decline in industrial activity and services also down 5% to 6% on an annualized basis. The correction was limited by the resilience of the agricultural and livestock sectors — which remain comparatively less affected by the crisis.

The magnitude of the recessionary shock in Q2 is expected to be substantial at around -35% q/q on an annualized basis, but could end up being less severe than expected. In April, during the first full month of containment measures, the Central Bank's leading GDP indicator (IBC-R) plummeted (-9.7% m/m; -15.1% y/y) reflecting the sharp fall in industrial production (-18.8% m/m; -27.2% y/y) and a record drop in activity in the services sector (-11.7% m/m; -17.2% y/y). Survey data show that activity and employment in services have continued to deteriorate throughout the quarter (the services PMI stood at 35.9 in June). The rebound in consumer and business confidence since May has so far failed to offset the historic plunge observed in April.

That said, the investment indicator produced by the IPEA for May shows a faster than expected recovery in investment (+28.2% m/m), driven most notably by higher spending in the civil construction sector.

1 Resignation of Sergio Moro, the very popular Minister of Justice who accused President Bolsonaro of meddling in a federal police investigation implicating members of his family and close collaborators for embezzlement; "Fake news" probe : investigation by the Supreme Court into an alleged disinformation and intimidation campaign orchestrated by a group of parliamentarians and other members of the President's inner circle, including his two sons, during the presidential elections; and fireworks attack on a Supreme Court building by a pro-Bolsonaro group and multiplication of threats against judges.

Also, the shorter-than expected interruption in the production of capital goods, intermediate goods and durable and non-durable consumer goods led to a rebound in industrial production in May (+7% m/m, 21.9% y/y) with 20 out of 26 sectors recording positive growth. At the same time, the flow of heavy vehicles on toll roads increased by nearly 10% in May and June, while broad retail sales (including vehicles and building materials) also strengthened (+19.6% m/m) ending a two-month decline. Thanks to liquidity support measures by authorities, corporate lending has also markedly increased swinging back into positive territory in real terms for the first time since 2014 (+8.5% y/y in May, vs. -1.6% y/y in February).

After four months of contraction, the manufacturing PMI also returned to expansion territory in June (51.6), driven in particular by an upturn in the new orders component. Lastly, the trade balance has performed well in recent months thanks to the recovery of Chinese demand while the prices of iron ore and certain agricultural commodities held up their ground (e.g. soybeans, orange, sugar, and beef). The solid performance in terms of export volumes coupled with the sharp slowdown in imports suggests that net exports should make a positive contribution to growth.

RULING OUT A V SHAPED RECOVERY

The strength of the recovery should be constrained by the absence of vigorous engines of growth. Stimulus through public investment will be limited by the fragility of fiscal accounts. At the same time, firms are likely to postpone investment decisions due to 1/ large excess capacity[2] 2/ weak demand and 3/ the need to honour financial obligations temporarily suspended during the crisis. Penalized by the weakness of the currency and an increase in debt, some companies, according to survey data, are already working towards reducing their costs (lower imported inputs and job cuts) and scaling back their planned investments. The suspension of a large number of auctions associated to the government's concessions and privatizations (USD 36 bn initially planned in 2020) programme should also contribute to the decline in foreign direct investment (representing 25.5% of gross fixed capital formation according to UNCTAD). Increased precautionary savings, prolonged social distancing practices and the deterioration of labour market conditions are also likely to strain the growth of private consumption. The hitherto limited rise in unemployment (12.6% at the end of May compared to 11.9% at the end of December) is actually distorted by the concurrent decline in the active population reflecting the sharp increase in the number of "discouraged" workers.

By keeping the labor force participation rate at the level observed at the end of 2019, the unemployment rate would reach almost 21% according to calculations by GSP. In view of these considerations, GDP is unlikely to return to pre-crisis levels before 2022 at the earliest[3].

ONGOING SUPPORT FROM ECONOMIC POLICY

In June, the Central Bank of Brazil (BCB) unveiled a new support program for micro-enterprises and SMEs which could extend credit up to USD 40 bn. In order to further increase corporate liquidity, the BCB will also purchase private debt securities on the secondary market. Meanwhile, the BCB has been authorized by Congress to intervene in the primary sovereign debt market. However, it does not intend to use this prerogative to flatten the yield curve (which has markedly steepened in recent months) but instead broadens its toolkit to intervene in the event of market dysfunctionalities. With inflation well below target, the BCB has made three cut to its key policy rate since March (by a cumulative total of 200 basis points with a SELIC at 2.25%). Monetary easing has helped fuel a rebound in the Brazilian equity market, which erased some of the losses suffered in March (-45% at the height of the crisis, vs -13% in early July compared to the start of the year). Despite a rebound in May and early June, the USD/BRL exchange rate is still down 25% year to date and remains since February the most volatile currency across emerging markets. Meanwhile, non-resident investors have still to forcefully return to local markets following massive net outflows of USD 32 bn over period March to May.

SOVEREIGN RISK PREMIA (BASIS POINTS)

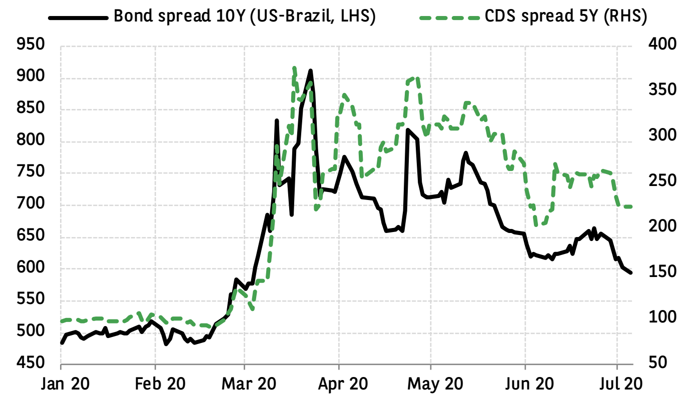

CHART 2

SOURCE: MACROBOND, DATASTREAM

The government has extended numerous measures to help support the most vulnerable populations, states and municipalities as well as businesses. The total fiscal impact of these measures is expected to however around 9 percentage points of GDP. This should bring the primary deficit to at least 11.5% of GDP and the public debt ratio close to 100% of GDP according to the latest estimates by the Ministry of the Economy. The deterioration of Brazil's fiscal balances has not yet translated into a lasting rise in sovereign risk premiums. After widening significantly in March, the spread on 10 year bonds between Brazil and the US as well as the 5 year CDS spread have both narrowed. They remain however around 100 and 150 basis points respectively above their pre-crisis level and the risk of witnessing a renewed widening remains high.

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2 The production capacity utilisation rate in industry was 60% in May and 66.6% in June, still well below its historical average of 80%. Inventories of semi-durable, non-durable and capital goods are high and will likely dampen output growth.
3 The level of uncertainty around projections remains high, as evidenced by the high dispersion of growth forecasts across official organizations: Brazil's Central Bank is forecasting -6.4% in 2020; the World Bank, -8% (+2.2% in 2021); and the IMF and OECD, -9.1% (based on the assumption—in the latter case—that there will be a 2nd wave of the pandemic in Q4). The IMF expects GDP to grow by +3.6% in 2021, while the OECD is forecasting a +2.4% rise.

RUSSIA

BETTER ARMED TO HANDLE THE SHOCK

The Russian economy is more solid today than it was five years ago. After the 2014-15 crisis, the government managed to rebuild its sovereign wealth fund, which is now enabling it to offset the loss of oil revenue. Public finances are less dependent on oil revenues, thanks to the VAT increase in 2019, and the government should have no trouble meeting its short-term commitments. Yet lockdown restrictions and the collapse of commodity prices will have a big impact on both growth and the banking sector, which is still fragile, although it is less vulnerable to a forex shock.

THE ECONOMY IS EXPECTED TO CONTRACT SHARPLY IN Q2, BUT THE FIRST SIGNS OF A REBOUND APPEARED IN JUNE

Russia was hit by a double supply and demand shock in 2020, triggered by the lockdown of the population between 30 March and 11 May (and extended to mid-June in some districts), the collapse of Urals crude oil prices (-40% y/y in the first six months of the year), and the 20% decline in oil production since 1 May, in compliance with the OPEC+ agreement.

Real GDP growth was still 1.6% year-on-year (y/y) in Q1 2020, before plummeting by an average of 11% y/y in April-May according to the preliminary estimates of the Ministry of Economic Development. The downturn in industrial output accelerated in April and May, to -6.6% and -9.6%, respectively. All components of demand fell sharply. Retail sales were down 21% on average in April-May. The unemployment rate hit 6.2% in June, the highest level since the 2009 financial crisis, and real wages slumped (-2% in May). Similarly, in the first four months of the year, corporate profits plunged 54.4% y/y.

In June, economic activity should rebound slightly with the lifting of lockdown restrictions, as suggested by the latest survey results. In industry, the business confidence index rebounded to 49.4 in June after dropping to a low of 31.3 in April. Although the composite index is still below the 50 threshold that marks the beginning of expansion territory, industrial leaders expect activity to accelerate based on the increase in order books. Even so, for the full Q2, the Ministry of Economic Development is still forecasting a contraction in GDP of about 9.7% y/y.

In H2, economic activity should continue to strengthen, but the recovery will be slow and gradual. Several factors will boost the recovery, including an accommodating monetary policy (the Russian central bank has cut its key rate by 175bp since January), financial support for low-income households, a slight increase in public spending and mild inflationary pressures.

Consumer price inflation is expected to remain mild through the end of the year, holding below the central bank's target of 4% y/y. In June, inflation was 3.2% even though most of the rouble's depreciation last spring had probably carried over already to prices. This means the central bank has some manoeuvring room to cut its key rate below 4.5%, although any rate cuts are unlikely to exceed 50bp. At its June monetary policy committee meeting, the central bank made it clear that it did not want to see real interest rates drop into negative territory. Yet even with an especially accommodating monetary policy (key rates have never been so low before), it is hard to imagine a rebound in investment before 2021.

According to the central bank, GDP will contract between 4% and 6% in 2020, while the IMF foresees a decline of 6.6% followed by a big rebound in 2021.

FORECASTS

	2018	2019	2020e	2021e
Real GDP growth (%)	2.5	1.3	-4.2	3.5
Inflation (CPI, year average, %)	2.9	4.5	3.7	3.7
Central Gov. balance / GDP (%)	2.9	1.9	-4.8	-3.0
Public debt / GDP (%)	14.5	15.3	20.3	21.1
Current account balance / GDP (%)	6.8	3.8	0.1	1.2

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

INDUSTRIAL PRODUCTION

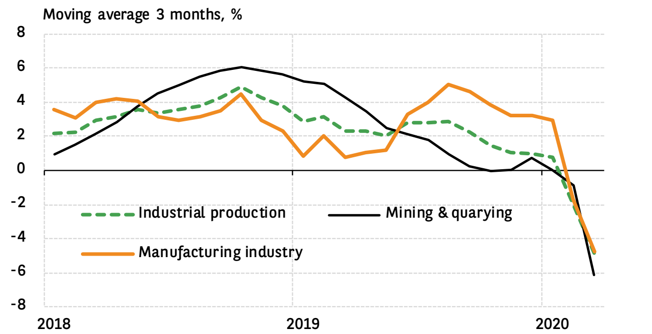

CHART 1 SOURCE: ROSSTAT

THE SOVEREIGN FUND OFFSETS THE DECLINE IN REVENUE

Since the 2015 crisis, the government and the central bank have worked to reduce the country's oil dependency. This mission has now been accomplished. In 2019, the equilibrium oil price was only USD 42 a barrel, down from USD 113 five years earlier. Moreover, in H1-2020, despite the collapse of oil and natural gas revenues (-35.4%), government revenues contracted by only 4.8%. In compliance with the fiscal rule in effect since 2017, the government used part of the national wealth fund's assets (USD 12.5 bn) to offset the loss of oil revenues, which fell below USD 42 a barrel between 11 March and 30

June 2020. At 1 June, the fund totalled USD 171 bn, or 10.7% of 2019 GDP. As a result, the government was able to maintain its spending commitments as part of the 2020 budget while accommodating the very sharp increase in healthcare spending arising from the coronavirus pandemic. In the first six months of the year, all spending increased by around 26%, generating an annualised deficit equivalent to 1.9% of 2019 GDP.

To counter the Covid-19 pandemic and the economic consequences of lockdown measures (notably for households and SME), the government announced three fiscal stimulus plans, which the World Bank estimated at a total cost of 2.8% of GDP. Moreover, on 2 June the Ministry of Finance announced a "recovery support package" valued at RUB 5000 bn (4.1% of GDP) to be implemented between Q3 2020 and Q4 2021. Yet this recovery plan includes the vast majority of previously announced support measures (notably the central bank's monetary measures to help SME). Additional spending is actually estimated at only RUB 430 bn (0.4% of GDP), about a third of which will be paid out in H2 2020, and the remainder as part of the 2021 budget.

In full-year 2020, the fiscal deficit is expected to near 5% of GDP, and public debt could slightly exceed 20% of GDP. Refinancing risk is extremely low for Russian debt, although some pressures have emerged in the bond market since June, after the Ministry of Finance announced bigger-than-expected domestic bond issues. Residents hold 67% of these bonds, and payments in 2020 and 2021 are estimated at USD 17 bn and USD 23 bn, respectively, of which only USD 4 bn is denominated in US dollars.

SOLID EXTERNAL ACCOUNTS

At 1 July, foreign reserves amounted to USD 438 bn, USD 5 bn less than at the beginning of the year. The rouble has lost only 9.1% in value against the US dollar since year-end 2019, even though Urals crude oil prices have fallen by more than 38% on average. The rouble's relatively strong showing can be attributed to the application of the fiscal rule of 2017: the national wealth fund sold off assets to offset fiscal losses, which helped boost the Russian currency. In the first six months of the year, the current account surplus shrank by 38% compared to the year-earlier period (to only USD 22.3 bn), even though the balance of services deficit narrowed after Russia closed its borders. The trade balance continues to show a surplus, even though it has fallen by more than 46% due to the downturn in oil exports.

In H2 2020, the easing of international travel restrictions, the expected rebound in merchandise imports, and a rebound in domestic demand will strain the current account, at a time when exports are likely to remain sluggish. In full-year 2020, the current account surplus is expected to narrow to about zero.

Increased portfolio investment should offset the downside pressures on the current account balance. Since May, non-resident investors have begun showing interest in Russian debt again, and issues are expected to reach RUB 5 tn (4.5% of GDP) over the full year. At 1 June, foreign investors held 31.8% of domestic debt (vs. 32.2% at the beginning of the year).

A MORE SOLID BANKING SECTOR THAN IN 2014

The banking sector is not as fragile as it was in 2014 and is in a better position to handle the upcoming crisis. Liquidity has increased, the banks have reduced debt (notably USD-denominated debt), and the sector has strengthened its external position. Although asset quality is

NATIONAL WEALTH FUND AND FOREIGN EXCHANGE RESERVES

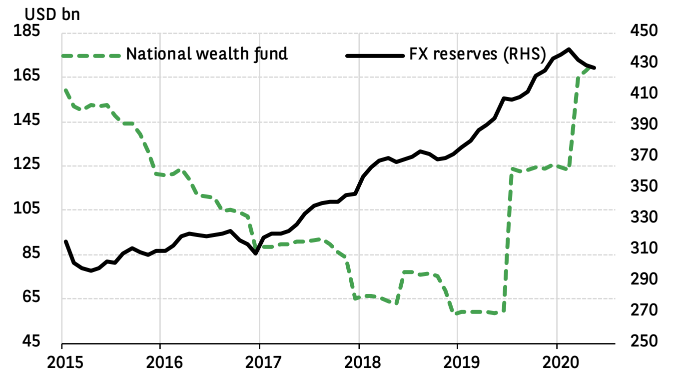

CHART 2 SOURCE: CBR

still fragile, it has improved since 2018, and the degree of dollarization has been sharply reduced. In May 2020, doubtful loans still accounted for about 10.9% of loans outstanding, but debt restructuring (and any provisions) due to the Covid-19 crisis will not take effect until 30 September.

In the oil and metals sectors, companies seem to be in a sufficiently solid financial situation to absorb the decline in prices and demand. In contrast, the lockdown will have much bigger repercussions on companies in the transport, real estate, construction and tourism sectors.

The central bank expects to see a sharp increase in doubtful debt through early 2021. Default rates in these sectors could increase 2 to 3 fold, reaching 11-13% in hotel services, 9-10% in the production of non-essential goods, and 6-7% in real estate. Between 20 March and 6 May 2020, the banks restructured the equivalent of 3.7% of lending to large corporations and 6.9% of small business loans. Even so, the Russian banking sector should be able to handle the increase in credit risk. In April, the capital adequacy ratio was 12.7%. Moreover, the sector will continue to benefit from government support, although it could become more selective.

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POLAND

RUNNING TEMPORARILY OUT OF STEAM

The Polish economy has to smooth the impact of the Covid-19 pandemic, which hit not only through the decline in foreign demand but also through the lockdown's impact on domestic consumption. Yet the country has enough policy leeway to do so, thanks notably to a reasonable level of public debt before the slowdown began. GDP is unlikely to return to pre-crisis levels before mid-2021, which is bound to curb investment. Thereafter, Poland is expected to return to its robust growth trajectory since its strengths remain intact (competitiveness, labour supply, low wage costs and productivity gains), which have transformed the country into the European Union's 5th biggest industrial sector.

SHARP RECESSION IN Q2

Poland is one of the EU member countries whose GDP contracted the least in Q1, a sign of the vitality of Polish growth, which has not faltered for nearly the past 15 years. Poland accounted for 4.5% of Europe's manufacturing industry in 2019, up from 2.2% in 2004. Yet Poland will not avoid its first full-year contraction in GDP since 1991, with a 3% decline in 2020.

The country managed to keep a lower level of Covid-19 cases, with only 900 cases per 1 million inhabitants. Yet this was achieved through a lockdown that began in mid-March and was tightened in the weeks that followed. Beginning in early May, most of these restrictions were gradually lifted.

Manufacturing output in Poland contracted by 27% year on year (y/y) in April 2020, which is close to the EU average, but not as bad as in the other Central European countries, where openness to foreign trade is higher. In May, the easing of lockdown restrictions has helped output to recover, but still 17% below pre-crisis level. A further recovery is expected in June, but again not to full capacity.

Poland was hit by a double shock in Q2: the 30% decline in Polish exports in April (y/y) was coupled with a contraction in domestic demand. However, the latter recovered quite quickly, since after a -10% decline in April (y/y), it was back to the pre-crisis level in May. Although the decline in demand was significant, it was not as severe as in the rest of Central Europe.

The Polish economy began to show signs of recovering in Q3, with expectations in the surveys of a rebound in industrial output and a slight upturn in household confidence as fears of inflation gradually ease. Yet the crisis is expected to have a more lasting impact on investment prospects.

The severe economic shock has not called into question the convergence of Poland's standard of living with the European average: It reached 76% of the EU average at year-end 2019, up from 61% ten years earlier.

Other virtuous circles are also expected to facilitate the recovery from recession. The current account surplus is expected to rise to 2.2% of GDP (from 0.5% in 2019) due to the decline in oil prices, which fell to an average of USD 38 a barrel in 2020 year-to-date from USD 64 in 2019. The resulting decline in inflation is expected to persist, with an average inflation rate below 2% in Q4 2020, after peaking at 4.6% in Q1. This should bolster household purchasing power.

Poland's relative stability and a rather advantageous yield spread (compared to the Eurozone) should continue to attract capital inflows. This should nurture a moderate appreciation of the Polish zloty to PLN 3.35 per EUR, despite current monetary easing measures.

FORECASTS

	2018	2019	2020e	2021e
Real GDP growth (%)	5.2	4.1	-3.0	3.5
Inflation (CPI, year average, %)	1.8	2.2	3.0	2.6
Gen. Gov. balance / GDP (%)	-0.2	-0.7	-7.0	-5.0
Gen. Gov. debt / GDP (%)	48.8	46.4	56.0	57.5
Current account balance / GDP (%)	-1.0	0.5	2.2	1.5

TABLE 1

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

MANUFACTURING PRODUCTION AND PRODUCTION EXPECTATIONS

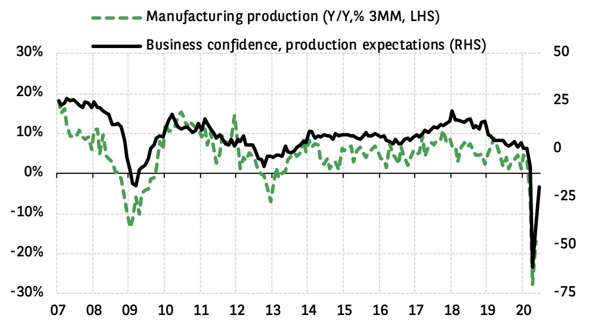

CHART 1

SOURCE: CEIC, DG ECFIN

STRONG SUPPORT FROM THE POLICY MIX

Poland had the advantage of entering the Covid-19 crisis with some leeway in terms of both fiscal and monetary policies. Public debt has fallen constantly since 2016, to 46% of GDP in 2019.

The government rapidly launched fiscal measures for about 4.5% of GDP, mainly through direct subsidies, tax holidays for companies and wage subsidies. Government-backed loans were also granted for a total of nearly 3 points of GDP through the BGK (public bank), with a capped amount of 4.5% of GDP. Lastly, Polish development funds will finance this support for up to 4.5% of GDP through bond issuance with a public guarantee.

Public finances will likely have to support the economy for longer, since activity is not expected to be back to full capacity before mid-2021. As a result, the fiscal deficit should remain significant at 5% of GDP in 2021, after 7% in 2020.

Public debt is expected to rise sharply, by 11 percentage points by year-end 2021. Yet monetary stimulus measures have helped erase fears about the market's capacity to absorb new debt issuances. The Central Bank launched a securities purchasing programme and purchased nearly PLN 100 bn in securities between mid-March and the end of May (15% of the Central Bank's total assets).

This covers a little over half of government bond issues. Ongoing securities purchases, which are not limited in size, have sharply reduced the government's residual needs. At the same time, the Central Bank lowered its key policy rates, which are now near the zero lower bound (0.1%).

As a result, fiscal stimulus measures implemented to cope with the Covid-19 crisis did not prevent 10-year government bond yields from declining to 1.35% at the end of June, from more than 2% at the end of February. The prospects of 'lower for longer inflation' is an anchor for low long-term rates in the medium-run.

At the same time, several measures involved the banks, including the conditional 3-month deferral of loan payments for households and companies requesting relief. Prior to the outbreak of Covid-19, the banks were relatively flush with capital, with a CET1 ratio of 16.3% at Q3 2019. It allowed a number of bank regulations to be repealed (including the 3-point systemic risk buffer) and the range of eligible collateral was expanded.

THE GROWTH POTENTIAL REMAINS SOLID

Looking beyond the underutilisation of production capacity, which is expected to extend through mid-2021, Poland has numerous strengths that will help it get back on the growth path. The job market is structurally vibrant, with strong productivity gains and job creations. It helped to fix a structural unemployment problem, since the unemployment rate went below 10% only in 2015, for the first time since 2008.

The competitive advantage of the manufacturing sector (25% of the economy) has increased during the last years, fuelled by productivity gains larger than European average (30% compared to 9%) between 2019 and a stable real effective exchange rate over the same period.

There has also been an upmarket shift in production. Poland has risen in export complexity rankings (the greater the complexity, the fewer the foreign competitors), and now trails right behind Slovakia, which had a considerable advance just a few years ago. In the automotive sector, nearly 60% of the value of exports are created in Poland, which is the highest proportion among the Visegrad group (which also comprises Hungary, Slovakia and the Czech Republic).

Looking beyond these factors, at some point Poland's ongoing industrial development could be hampered by a labour shortage. Yet agriculture still accounts for a relatively high share of employment. With expected productivity gains, it is estimated that just over a million jobs could be freed up once farm employment reaches the same proportions seen in the other countries that have already completed this transition.

The energy transition is another milestone that Poland will have to make to maintain its industrial future. The country must face two challenges: the weight of industry (especially the metal industries) and the weight of coal in energy consumption (70%). Unlike the other Central European countries, Polish consumers represent the major part of industrial outlets.

CENTRAL BANK DOMESTIC ASSETS (PLN BN)

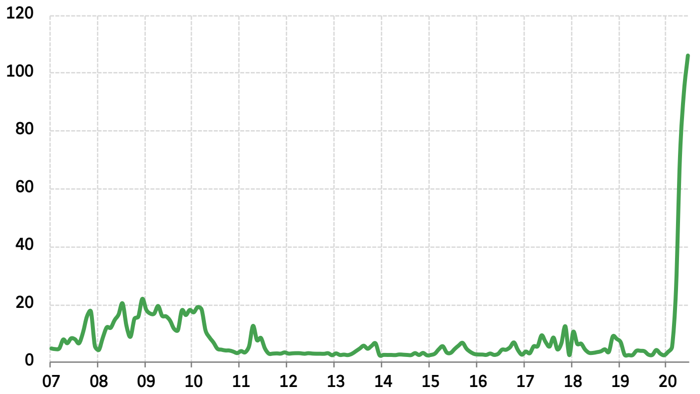

CHART 2

SOURCE: NBP, BNP PARIBAS

The transformation of Poland's industrial sector will have to be mirrored by a change in consumer behaviour. The electromobility and alternative fuel law passed in 2018 helped trigger a catch-up movement, and local carmakers are beginning to produce electric vehicles. A plan to promote renewal energy sources is targeting a 65% increase in production capacity by 2024.

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UKRAINE

YOU REAP WHAT YOU SOW

Ukraine is usually quite prone to boom bust cycles. Yet high volatility has not allowed to stabilize growth towards a higher level, and fickle capital inflows have reinforced the importance of funding from foreign institutions, notably from the IMF and the European Union. Such official financing, coupled with the structural progress it has made in recent years, seem to have helped the country to cope with the Covid-19 crisis, at least for the moment, with fewer negative financial consequences than initially feared. Strong foreign demand for Ukraine's grain, lower oil prices and the foreign financing are all favourable factors that have helped the country weather the crisis, and raise hopes for a rapid economic recovery once the Covid-19 crisis is over.

WEATHERING THE COVID-19 SHOCK

In early 2020, Ukraine benefitted from lower risks than during previous recessions. Better policy management has limited the size of twin deficits (public and current account deficits) and helped to initiate (public and external) debt consolidation. Moreover, the disinflation process has reduced depreciation pressures on the UAH, despite recurrent political uncertainty.

Against this background, Ukraine was not hit by the Covid-19 pandemic as hard as its neighbours, with nearly 1000 cases per 1 million inhabitants, compared to nearly 4500 for Russia. Even so, the government imposed a strict lockdown from mid-March and gradually began to ease restrictions in mid-May. The drop of manufacturing output eased partially in May (-15.6% y/y), after -20.3% in April.

The authorities managed to avoid the sudden stop of capital flows faced in 2008 and 2014, so domestic demand did not contract as suddenly and sharply as before. The government secured financial packages from international institutions, as it was able to comply with necessary preconditions:

i/ a banking law allowing safeguarding the clean-up of the banking system, including notably the consolidation of doubtful loans

ii/ the end of a ban on farmland sales.

The Covid-19 pandemic caused a shift in household demand around the world, with a focus on essential goods. Ukraine's customers sought to secure the provision of commodities more than usual, which was a boost for Ukrainian grain exports. As a result, the decline of total exports was much lower in Ukraine compared to regional peers (-6% in April, compared to -30% in Poland).

In the meanwhile, Ukraine entered into recession during the 1st quarter (-1.3% year-on-year) and it should intensify in Q2. However, the GDP contraction should be less severe in 2020 as a whole (-4.2%) compared to regional peers.

Monetary policy is another explanation of the not so negative performance of Ukraine. The Central Bank was able to ease its policy rate by 750 basis points since the beginning of 2020, using the leeway created by the disinflationary process. Lower oil prices even magnified it, since inflation declined to 1.7% (y/y) in May 2020.

Moreover, Ukraine should be able to post a current account surplus of 1.5% of GDP in 2020 for the first time since 2005. This phenomenon and foreign capital inflows have helped to stabilize the exchange rate after some pressure in March and April. It should re-appreciate moderately as a result towards UAH 26 per USD by year-end (compared to UAH 24 in early 2020), buoyed by high yields on Ukrainian bonds (the yield on 3-year UAH government bonds is 10.75%).

FORECASTS

	2018	2019	2020e	2021e
Real GDP growth (%)	3.3	3.4	-4.2	2.8
Inflation (CPI, year average, %)	11.0	7.9	1.7	3.7
Gen. Gov. balance / GDP (%)	-2.2	-2.3	-7.0	-5.0
Gen. Gov. debt / GDP (%)	60.2	55.0	63.0	65.0
Current account balance / GDP (%)	-3.3	-0.9	1.5	-1.0

TABLE 1

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

EXPORTS CHANGE IN APRIL 2020 (Y/Y)

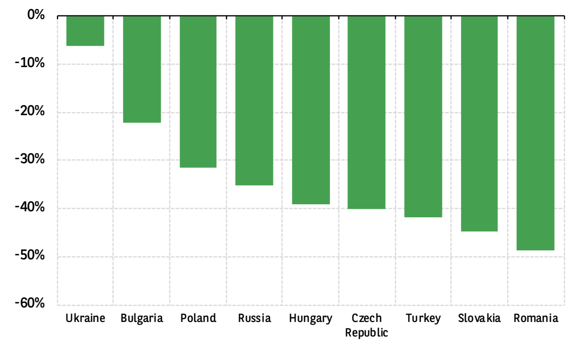

CHART 1

SOURCE: CEIC, BNP PARIBAS

POLICY SUPPORT: THIS TIME IS DIFFERENT

Ukraine had the leeway to ease its policy-mix this time, a situation that was not allowed by systemic crises in 2008 and 2014.

Fiscal policy support is strong, including through a moratorium on social security payments to the end of May, higher pensions and a financial package for the medical professions. A programme of subsidised and state-guaranteed loans was also expanded. Unemployment benefits were raised and a temporary unemployment benefit was created for quarantined jobs purposes.

As a result, the public deficit is expected to swell to 7% of GDP in 2020, and then to remain significant at 5% of GDP in 2021. This implies another increase in public debt. The sharp reduction in the public debt ratio in recent years (to 55% of GDP in 2019) is a key strength. The increase in debt should be financed by disbursements from the IMF (USD 2 bn paid out in June, out of a total allocation of USD 5 bn by year-end 2021) and other international institutions, mainly the European Commission and EBRD. It is also expected to support foreign currency reserves to USD 27 bn at end-2020 (compared to USD 25 bn at end-2019).

The Central Bank also eased reserve requirements for banks, thus freeing up liquidity in hryvnia. Liquidity supply was increased through new instruments and by expanding the range of eligible collateral in order to include municipal bonds and state-guaranteed corporate loans. The introduction of various capital additional buffers (notably for systemic risk and capital conservation) was postponed at least until October 2020. Moreover, loan defaults during the Covid-19 crisis and debt restructuring before September 2020 will not be considered as non-performing loans.

The law simplifying the restructuring and recapitalisation procedures for Ukrainian banks was also postponed until August 2024. This is an important decision because the banking system has still a very high volume of non-performing loans on its balance sheet, inherited from the late resolution of the 2014 crisis. Although part has already been forgiven, non-performing loans still accounted for 49% of total loans outstanding in Q3 2019 (even though this is lower than the Q2 2017 peak of 58%).

REDUCE GROWTH VOLATILITY AND INCREASE THE POTENTIAL

At a time when the coronavirus continues to cause new victims in numerous countries, it is still too early to imagine the return to a stable growth trajectory without the risk of new setbacks. Yet Ukraine has weathered the Covid-19 crisis without severe financial instability, which could make another attractive investment argument for international investors.

However, there are risks to this kind of situation such as:

i/ capital flows triggering an exchange rate appreciation thereby weighing on growth rather than supporting it,

ii/ an increased vulnerability through a high share of short-term and foreign currency inflows.

Financial reforms are needed mainly to fix the financial dollarization of the economy. There is still a high share of public debt in foreign currencies (60%). Household deposits in foreign currencies account for 42.8% of bank liabilities, and net open foreign currency positions account for 47.4% of the capital of banks, a currency mismatch that exposes them to significant balance sheet risk in case of a sharp depreciation of the exchange rate.

Monetary policy effectiveness is limited by the low liquidity on long-term maturities. This incomplete yield curve also exposes borrowers to either borrow in local currency and short-term maturity (maturity mismatch) or in foreign currency (currency mismatch). In parallel, the government needs to stick with a long-term strategy to reduce its debt ratios, since there is still a USD 3 bn bond with Russia (4 bn in net present value) that matured in 2015 and was not repaid.

INFLATION AND POLICY RATE

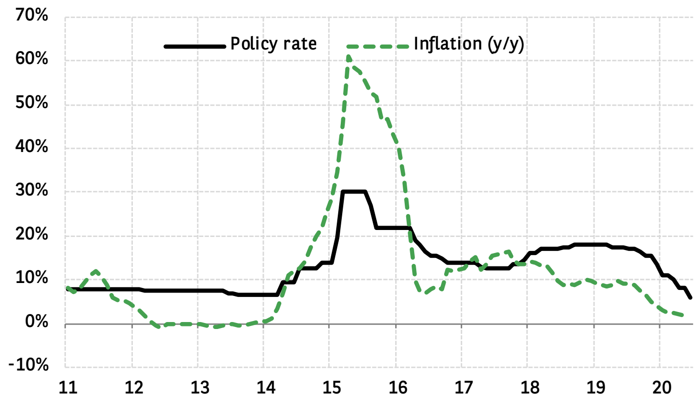

CHART 2

SOURCE: CEIC, BNP PARIBAS

Finally, Ukraine should improve its debt resolution procedures. Resolving insolvency is still long and costly, and the recovery rate is low. The country ranks 146th in this index of the World Bank's Ease of Doing Business report.

Looking beyond financial reforms, Ukraine also needs to avoid a Dutch disease: the risk to see a specialization on commodities (grains and industrial metals in Ukraine), thus triggering early deindustrialization. Human capital is key but, in our view, the problem is more the attractiveness of the local labour market than the skills of the Ukrainian labour force, since Ukrainian migrants are currently working in neighbouring economies, such as the Polish industrial sector.

Ukraine needs to improve its attractiveness towards investors in order to develop its industrial base. Economic stability (lower country risk, insolvency resolution) is a necessary precondition, but is not enough. There were already some reforms implemented during recent years that went in the right direction. As a result, it became easier to get credit, to deal with construction permits and to register property.

However, Ukraine needs more stability in order to nurture an investment cycle. Its physical infrastructure is ageing and in volume terms is lower than before: the overall capital stock has eroded by more than 20% in volume since the country's independence, according to the Penn World Tables.

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SLOVENIA

STRONG CAPACITY TO REBOUND

Slovenia's economy is in a relatively favourable position to face the Covid-19 crisis. The past three years were marked by robust growth, fiscal surpluses and the gradual clean-up of bank balance sheets. Yet as a small, open economy closely tied to the European Union, Slovenia could be significantly impacted by the crisis. European fiscal and monetary support as well as healthy public finances should soften the impact of the crisis on public finances and growth prospects.

ECONOMIC ACTIVITY PLUMMETS

Like in the other Eurozone member countries, the economic consequences of the Covid-19 pandemic are bound to trigger a severe recession in Slovenia in 2020. So far, the pandemic's health impact has been relatively mild compared to the rest of the region, with 54 deaths per 1 million inhabitants (vs. a Eurozone average of more than 360 deaths), but the spread of the pandemic is still uncertain. A second, smaller wave of the virus has emerged since mid-June.

The pandemic is having severe economic consequences due to strict lockdown measures and Slovenia's high economic integration within the European Union (EU). Our 2020 outlook calls for real GDP to contract by 9% in the Eurozone and by 7% in Slovenia. GDP contracted 4.5% q/q in Q1 2020 (vs. -3.6% in the Eurozone) due to the downturn in household consumption (-16%) and investment (-10%). Slovenian exports to the EU have plummeted by 30% since March, especially automotive and capital goods exports to Italy, France and Germany. The industrial output index seems to have bottomed out in April before picking up slightly in May, but that was an automatic effect linked to the lifting of certain lockdown measures. All in all, the Q2 downturn in GDP will be more pronounced due to tighter lockdown measures in Slovenia and in the EU as a whole.

Economic growth has averaged 3.3% since 2015. Over the past two years, the economy was buoyed in particular by consumption (53% of GDP) and investment (20% of GDP), which gradually replaced exports as the main growth engine. The unemployment rate hit a low of 3.8% at the end of 2019. For the moment, the rise in unemployment is still under control (4.8% in May according to Eurostat), thanks notably to government support measures. The domestic components of growth should pick up a little earlier than in the rest of the Eurozone because Slovenia was the first country in the region to declare the end of the pandemic (15 May), even though some restrictions are still in place. For the moment, the loss of purchasing power has been buffered by wage compensation schemes that allow employees without work to maintain part of their income. Yet job statistics could deteriorate in H2 with the ending of government support measures.

SIGNIFICANT SUPPORT MEASURES SHOULD BOLSTER THE RECOVERY FROM 2021

In 2021, the economic recovery will depend notably on government support measures and the European recovery. The European Union absorbs 74% of Slovenia's exports. The automobile and capital goods sectors are major export sectors, accounting for 38% of total exports. Fiscal support measures come from the Slovenian government as well as the EU budget. A series of measures were launched to help households and companies, with direct support measures totalling the equivalent of 4.2% of GDP in 2020. In 2021, we expect GDP to rebound by 6%.

FORECASTS

	2018	2019	2020e	2021e
Real GDP growth (%)	4.1	2.4	-7.0	6.0
Inflation (HICP, year average, %)	1.9	1.7	0.5	1.2
Gen. Gov. balance / GDP (%)	0.7	0.5	-7.2	-2.1
Gen. Gov. debt / GDP (%)	70.0	66.0	84.0	80.0
Current account balance / GDP (%)	6.3	6.8	4.0	6.0

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

INDUSTRIAL PRODUCTION INDEX, 2015=100

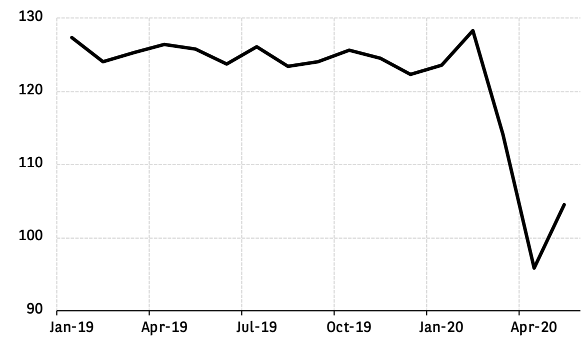

CHART 1
SOURCE: EUROSTAT

Thereafter, the European Union has set up the EU Next Generation recovery plan to support public finances, the private sector and priority sectors for member countries during the period 2021-2027. Slovenia's share of the programme could be equivalent to about EUR 5 bn, or 10% of 2019 GDP. Moreover, further liquidity injections by the ECB should enable Slovenian banks to respond to corporate needs.

LARGE EXPECTED FISCAL DEFICITS

Slovenia has reported fiscal surpluses since 2017 (+0.4% of GDP on average) thanks notably to buoyant economic growth. In 2020, the expected decline in fiscal revenues (-9.2% y/y in the first 5 months of the year) coupled with economic stimulus measures (spending was increased by 11.4% over the same period) should widen the fiscal deficit, which could exceed 7% of GDP. The deficit is then expected to fall back to more moderate levels in 2021 (2.1% of GDP).

In the medium term, there is no particular risk associated with Slovenia's fiscal situation. Yet demographic trends at work over the past decade are not favourable and could have a negative impact on economic prospects and public finances. The active population is shrinking by about 10,000 people a year, and problems addressing the shortage of skilled labour could reduce the potential growth rate. Currently, more than 35% of companies in the manufacturing sector and 45% of construction companies are experiencing shortages of skilled labour. The pension system is also a potential long-term source of fiscal imbalance given the rapid increase in spending on pensions (the highest in Europe). Pension system reform has been underway since 2013, but progress is slow.

RISING BUT SUSTAINABLE PUBLIC DEBT

Government debt has declined since 2015, to 66% of GDP in 2019. With the drop-off in activity and a record fiscal deficit, public debt should swell to 84% of GDP in 2020, before narrowing to 80% of GDP in 2021. Despite this big increase, debt dynamics should still be favourable in the medium term. Debt servicing as a percentage of total fiscal revenues has declined regularly since 2014 to 3.8% in 2019, from 7.1% in 2014. In recent years, the apparent interest rate on public debt has fallen to 2.6% in 2019 from 4.4% in 2014, while the average maturity has increased to 8.9 years in 2019 (from 5.7 years in 2014). About 95% of total debt is denominated in euros. The government's buyback operations have significantly reduced the share of debt denominated in USD. Not only has the debt profile improved, the government has also accumulated significant liquid assets, primarily from the proceeds of privatisation. This liquidity allocated to reducing the debt stock is equivalent to about 8% of GDP.

A HEALTHIER BANKING SECTOR TO FACE THE CRISIS

Slovenia's banking sector was hard hit by the financial crisis and required massive government support, but it has come through stronger since 2015. Asset quality and profitability have improved and the sector is less dependent on market financing (which accounted for 12% of funding in 2019, down from 33% in 2013) and more so on customer deposits.

The non-performing exposure ratio (using the European Banking Authority's definition) dropped to 2.2% in March 2020, from 3.6% the previous year, according to the central bank. Although this favourable trend will probably be reversed in 2020, Slovenian banks are likely to be resilient due to their high level of capitalisation and comfortable liquidity reserves.

Since mid-2019, the growth of domestic credit has slowed (1% y/y in May 2020 vs. 3.1% the previous year) due to the slowdown in household lending. After years of debt reduction, corporate lending has begun to rise again for the past year (+2.5% in May 2020). The debt to assets ratio has declined at less than 90%, from 137% in 2012. After a period of buoyant growth (consumer lending rose at an average annual rate of more than 10% between 2017 and 2019), household lending has slowed since year-end 2019 under the new standards imposed by the central bank to limit household debt. In May 2020, consumer lending was still trending slightly downwards (-0.1% y/y), while household lending continued to rise at a rate of 2.5%. So far, household debt as a percentage of disposable income has remained relatively stable at less than 16%, but it could rise in 2020 due to the economic contraction.

DOMESTIC CREDIT

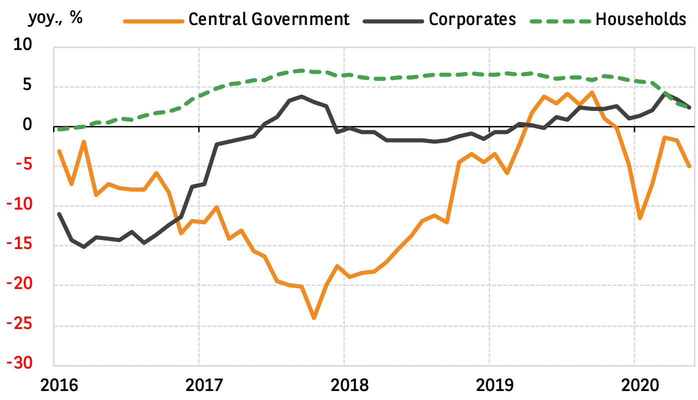

CHART 2

SOURCE: BANK OF SLOVENIA

The banks' exposure to the household segment rose from 30% of total domestic lending in 2012 to 53% in May 2020.

Real estate loans are fairly resilient and have continued to increase since the beginning of the year (+4.7% y/y in May 2020). The strong rise in real estate prices observed in 2017 and 2018 (up 10% and 9.1%, respectively) slowed to 5.2% in 2019, in keeping with the slowdown in growth. According to the central bank, higher real estate prices reflect the convergence towards European standards, and residential real estate prices have not yet reached levels signalling overvaluation

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MEXICO

ON THE DEFENSIVE

Growth prospects are deteriorating constantly in Mexico. In the short term, several factors are weakening the economy, including the impact of lockdown restrictions on domestic demand, the decline in oil prices, the disruption of supply chains and sluggish external demand. Without a fiscal stimulus package, the support measures announced by the central bank will not suffice to offset the enormous shock. In the medium term, the economy's capacity to rebound is limited. The downturn in the business climate and other pre-crisis factors that contributed to the slowdown, coupled with the government's contradictory signals, will continue to weigh on investment.

HEALTH CRISIS

The Covid-19 pandemic is still not under control in Mexico. The state of emergency to combat the health crisis declared at the end of March, along with most of the restrictions and support measures, were still in place in early July.

Yet the government's apparently contradictory decisions have maintained some confusion within the population. Despite the state of emergency, lockdown measures were set up later than in the other countries in the region, and they were never strictly enforced. The number of tests was also limited. On 14 May, the government began to gradually lift the lockdown measures, and each state was allowed to reopen based on a 4-colour coding system (green, yellow, orange and red, based on the virus' spread and hospital occupancy rates). On 9 July, 14 states (including Mexico City) were still coded red and the 18 others were orange. Red states should have maximum lockdown restrictions, but in some states, including Mexico City, certain activities have reopened since mid-June, including public transport, factories and retail stores. The government also extended the list of "essential businesses" to allow key sectors such as construction and automobiles to reopen again.

All in all, the country reported more than 4000 new cases a day during the month of June, and this pace has accelerated since the beginning of July. The total number of cases per million inhabitants is about 2400, and Mexico ranks 59th among the hard hit countries.

SEVERE RECESSION IN 2020

Economic prospects have deteriorated continuously since the beginning of the year. Mexico is expected to be hit by a very severe recession in 2020, with real GDP contracting by more than 8%. A combination of factors is placing a heavy strain on economic activity, notably the impact of lockdown measures on domestic demand, the drop-off in oil prices, supply chain disruptions, the desynchronization of global value chains and the decline in external demand (mainly from the United States, which accounted for more than 80% of total exports in 2019). After contracting 1.4% q/q in Q1 2020 (-2.2% y/y), GDP plummeted in April (-19.9% y/y, according to the central bank's economic indicator) and industrial output fell by nearly 30% (-35% for manufacturing production alone).

The central bank's economic support measures will not be enough to absorb the shock. Since the beginning of the year, the key rate has been cut by a total of 225 basis points to 5%. Several measures were introduced to support liquidity as well as the most vulnerable households and companies, for the equivalent of 3.3% of GDP. Other measures could be announced before the end of the year (several more key rate cuts are expected).

FORECASTS

	2018	2019	2020e	2021e
Real GDP growth (%)	2.0	-0.3	-8.0	2.5
Inflation (CPI, year average, %)	4.9	3.7	3.1	3.2
Gen. Gov. balance / GDP (%)	-2.1	-2.3	-6.5	-3.5
Gen. Gov. debt / GDP (%)	53.8	47.8	50.3	53.5
Current account balance / GDP (%)	-1.8	-0.4	-1.1	-1.2

TABLE 1

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

DROP IN INVESTMENT

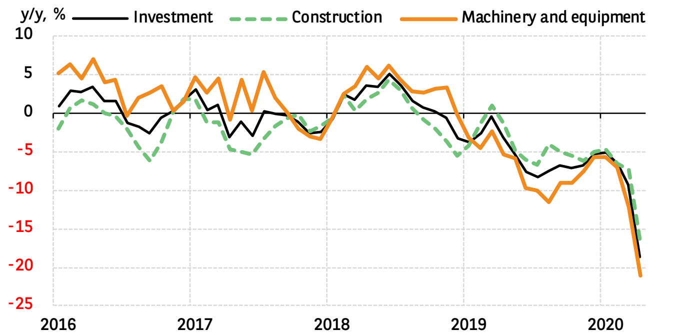

CHART 1

SOURCE: NATIONAL ACCOUNTS

From a fiscal perspective, in contrast, the government has yet to announce a massive economic stimulus plan, unlike the region's other countries. The government had sufficient fiscal policy leeway at the beginning of the crisis: over the past five years, the public deficit has averaged 2% (2.3% in 2019) and public debt has held below 55% of GDP since 2017. The decision not to stimulate the economy reflects the electoral promise of President Andres Manuel Lopes Obrador (AMLO), who pledged to maintain fiscal austerity. Even if a recovery plan were to be launched in the months ahead, it is bound to be limited in size (less than 1% of GDP).

LIMITED CAPACITY FOR A REBOUND

Growth prospects have diminished considerably for 2021 and beyond. Without a government stimulus package, domestic demand will falter. Moreover, the Mexican economy has already been slowing since year-end 2018 (GDP contracted 0.3% in 2019) and the factors behind the slowdown will continue to strain growth. Since taking power, the new government's messages have been contradictory, making it difficult to interpret economic policy. Uncertainty over the participation of private players in the energy sector reform and in the vast infrastructure plan presented in early 2020 has helped erode the business climate. As a result, investment has declined constantly since November 2018. This decline accelerated from -5% in 2019 to -7% in Q1 2020 (-9.4% y/y in March). Net inflows of foreign direct investment (FDI) have also dwindled since mid-2018 (to an average of 2% of GDP since Q2 2018, from an average of 2.3% between 2014 and early 2018).

According to the IMF, the benefits of reopening supply chains and the start-up of the new trade agreement with the United States and Canada (effective 20 July) will not offset the negative impact of declining investment and uncertainty over economy policy decisions for the next two years. In its revised forecast released on 24 June, the IMF lowered its growth outlook for Mexico to -10.5% in 2020 and +3.3% in 2021, from -6.6% and 3%, respectively, in its previous forecast published in April.

FDI INFLOWS SLOWDOWN

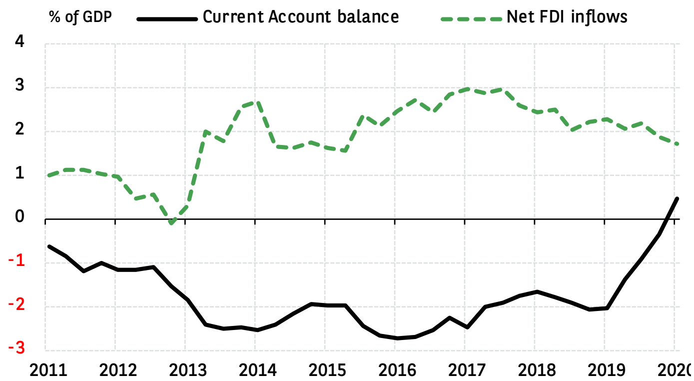

CHART 2 SOURCE: BANK OF MEXICO

ALARMING PUBLIC FINANCES

Similarly, public finance trends are alarming in the short to medium term. The slowdown in economic activity and the drop-off in oil prices should drive up the public deficit to more than 5% of GDP in 2020 (from 2.3% in 2019). Moreover, it could prove to be very difficult to consolidate public finances once the crisis is over.

On taking power, the new government set several policy goals, including investing massively in Pemex, the state-owned oil giant; developing social welfare programmes; and increasing social welfare spending and public investment, while at the same time maintaining fiscal austerity. These objectives, which seemed hard to reconcile and accomplish before the crisis, now seem almost impossible.

Meanwhile, the financial and operational situation of the oil giant Pemex continues to deteriorate[1]. Plummeting oil prices only aggravated the group's liquidity needs, and the government will have to step in repeatedly to provide substantial financial support in the months ahead, putting an additional squeeze on public finances in 2020 and 2021. According to Moody's estimates at the end of April 2020 (based on the assumption that oil prices would average USD 50 a barrel in 2021 and USD 37 a barrel in 2022), the financial support that Pemex would need simply to cover its liquidity needs and the refinancing of debt reaching maturity (excluding investments initially provided for in the July 2019 development plan) should account for between 0.5% and 1.8% of GDP each year between 2020 and 2022. After integrating part of the planned investment, the necessary financial support would range between 1.5% and 2.8% of GDP.

In 2020, the government should be able to avoid borrowing further on the financial markets by drawing on its sovereign fund. Yet there will not be enough funds left over to renew the operation in 2021. Even if a presidential decree authorises the government to draw on other funds for the equivalent of 3% of GDP, the public debt ratio is likely to swell to more than 50% of GDP in 2020. Mexican debt is also exposed to changes in investor sentiment, since more than 30% of domestic debt (denominated in the local currency) is held by non-resident investors.

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1 In November 2019, even assuming that production stabilises and the government actually makes all the investments it has announced, the IMF was already estimating that Pemex would continue to report a deficit for the next five years

THAILAND

TOWARDS A GRADUAL RECOVERY

The economic rebound expected in H2 2020 has been slow in the making. For the moment, the pandemic seems to be under control, and there have already been several phases of reopening, but domestic demand remains sluggish. Exports also fell sharply again in May. Above all, it is the absence of international tourists that is straining growth prospects, at least in the short term, because fiscal and monetary support measures – though massive – will not suffice to totally absorb the shock. As a result, the recovery is likely to be more restrained than in the other Asian countries.

A GRADUAL REOPENING

The Covid-19 state of emergency is still in effect in Thailand. Introduced in late March, emergency powers have been extended until the end of July. Yet there have been fewer than 10 new cases reported daily since the end of April (only 5 cases on 9 July) and the country has begun to reopen for business through a series of phases beginning in early May. Fewer than 3,500 cases have been reported since the pandemic began (46 cases for 1 million inhabitants), and the total number of deaths has held at 58 since 2 June.

For the moment, Thailand's borders are still almost completely closed. Entry is authorised only for a very restricted number of cases (Thai citizens and their family members as well as foreign residents), and limited to 500 people a day. A period of self-isolation is also imposed systematically. The number of visas should gradually increase by the end of July, depending on the amount of room capacity to accommodate the quarantine period.

TOURISM COMES TO A STANDSTILL

For the moment, it is uncertain when the borders will reopen for tourists. In June, the government announced plans to create a "travel bubble" i.e. to partially open its borders to tourists from a restricted number of countries (like Japan, China and South Korea, where the epidemic has not spread much). Due to the resurgence in new cases in these partner countries, plans to start up the "travel bubble" -- initially scheduled for early August – have been postponed to an unspecified date.

Consequently, the tourism sector should make a very small contribution to growth in the quarters ahead, straining GDP in H2 2020 and full-year 2021.

In late May, the government announced a support package for the tourism sector to encourage Thai residents to travel domestically, through subsidies for domestic travel and by "offering" several extra days of vacation to replace bank holidays that occurred during the lockdown period. Yet the revenues generated by this domestic travel plan would not offset the loss of revenues arising from the absence of foreign tourists.

According to Ministry of Tourism data, "domestic" tourism revenue accounted for nearly USD 10 bn in 2018, or 2% of GDP (2019 data was not available yet), while international tourists generated more than USD 58 bn in revenue, or nearly six times more (nearly 12% of GDP), with four times as many visitors (3.3 million visitors per month on average in 2019, and nearly 4 million on average in January-February 2020, before the first lockdown restrictions).

The sector's economic weighting in the broad sense of the term (including the multiplier effects of tourism revenues) is estimated at more than 20% of GDP. The Tourism Ministry is expecting nearly a million job losses in the formal sector (out of a total of 4.5 million jobs). This would drive up the unemployment rate by at least two percentage points (according to the most recently available statistics, the unemployment rate was stable at 1% in March) and strain private consumption.

FORECASTS

	2018	2019	2020e	2021e
Real GDP growth (%)	4.2	2.4	-9.0	5.3
Inflation (CPI, year average, %)	1.1	0.8	-2.0	0.0
Gen. Gov. balance / GDP (%)	-0.8	-1.0	-6.0	-3.5
Gen. Gov. debt / GDP (%)	40.6	41.3	48.1	53.7
Current account balance / GDP (%)	5.6	6.9	2.5	5.1

TABLE 1

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

TOURISM SECTOR HIT HARD

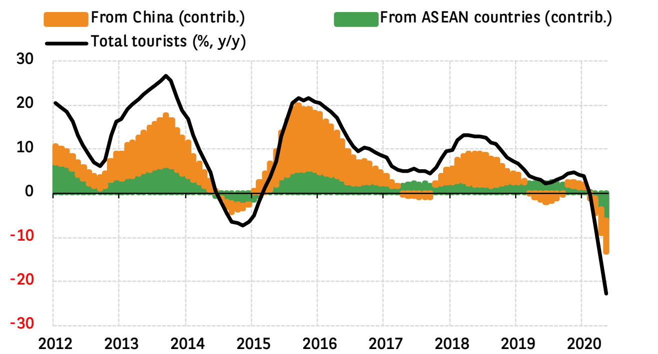

CHART 1

SOURCE: MINISTRY OF TOURISM

SUPPORT FROM THE POLICY MIX

From the beginning of the crisis, the authorities have expressed their determination to boost the economy. The government harnessed its fiscal policy leeway to support growth. A series of measures have been announced since March accounting for a total of nearly 10% of GDP. The first support measures mainly targeted the healthcare sector and the most vulnerable workers and companies (including workers without access to the social security system). The next measures were designed to provide broader support to households and companies. Lastly, a tourism support package was announced in May.

The public deficit is expected to swell significantly in 2020, but will still account for "only" 6% of GDP (up from 1% of GDP in 2019), since the government intends to finance part of the stimulus package through public organisations and enterprises, whose accounts do not appear in the budget. The government plans to borrow THB 1 bn (about 6% of GDP) in the form of bond issues, most of which will be in domestic bonds spread out through September 2021. All in all, public debt is expected to increase to 48% of GDP in 2020 (from 41% in 2019), but will remain under the 60% threshold set by the country's fiscal rule.

Even so, public finances are not expected to become significantly more vulnerable, at least not in the short term. The temporary nature of some measures combined with an economic recovery should foster a gradual reduction in the public deficit as of 2021. The debt profile is also favourable, since less than 2% is denominated in foreign currency, and only a small share, estimated at less than 15%, of government bonds is held by non-resident investors.

As to the central bank, it has cut its key rate by 75 basis points (bp) since the beginning of the year, to 0.5%. It has also implemented several measures to support financial sector stability and facilitate access to lending for the most vulnerable companies. In its latest press release, the central bank warned that the recovery of domestic demand would be less robust than initially expected, and that additional support measures would probably be needed for the most vulnerable households and SME (which account for nearly 9% of employment). This, plus the recent strengthening of the baht (which regained pre-crisis levels after depreciating by 8% against the USD between January and April) and the revision of inflation forecasts (-2% in 2020 and 0% in 2021), justify the ongoing easing of monetary policy, as well as the announcement of new unconventional monetary measures by the end of the year.

A LESS ROBUST REBOUND

Fiscal and monetary support measures have raised high hopes that economic growth will rebound in Q3 2020, but the size of the recovery will probably be hampered. In addition to the absence of international tourists, maintaining the coronavirus state of emergency and social distancing will continue to curb growth. Although the reopening process is well underway, monthly indicators of private consumption and investment have deteriorated sharply (-12.5% each on average in April-May, year-on-year). At the same time, supply chain disruptions, the desynchronization of global value chains and the decline in external demand are heavily straining exports. After April's rebound, exports contracted sharply again in May (-22% year-on-year).

All in all, GDP is expected to contract by nearly 9% in 2020 (vs. average growth of 3.5% over the past five years), before rebounding to more than 5% in 2021.

Looking beyond 2021, it is highly likely that the pandemic will cause lasting changes in household and corporate behaviour, notably in terms of consumption and investment, curbing the growth of global trade. Under this environment, the erosion of Thailand's economic competitiveness, an aging population and a chronically fragile political situation could tarnish the country's attractiveness in the eyes of investors (both foreign and local) and lower its potential growth rate.

INFLATION AND POLICY RATE

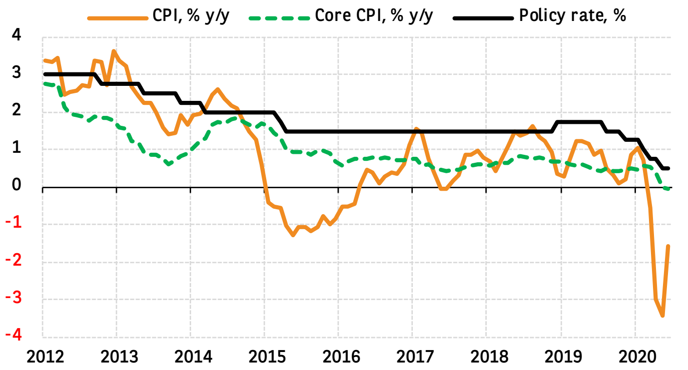

CHART 2

SOURCE: BANK OF THAILAND

The vast infrastructure investment plan presented by the government in early 2020, which was designed to improve the country's infrastructure and competitiveness, could make a difference. The big question is whether it will be actually implemented.

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GULF COOPERATION COUNCIL

THE CONSEQUENCES OF THE CRISIS FOR EXPATRIATE EMPLOYMENT

The massive use of expatriate workers, a key element in the Gulf states' economic models, has been called into question by the economic recession, widening budget deficits and employment nationalisation programmes, particularly in the public sector. The construction and services sectors, which also depend massively on foreign workers, are suffering as a result of cuts in public spending. However, it is far from certain that the expected reduction in expatriate employment in the short term will result in a significant and lasting increase in employment for Gulf nationals. The Gulf states are likely to have difficulties to go without foreign labour.

THE REFORM OF THE LABOUR MARKET IS UNDERWAY

The double economic shock of the Covid-19 pandemic and the oil price collapse has come at a specific time for the Gulf states. Many of them are in the process of reforming their economic models in order to diversify economies and reduce the role of the state. At the same time, one of the main drivers of these reforms is the creation of employment for nationals in the private sector. This two-faceted reform (encouraging the expansion of the private sector and 'nationalising' employment) is particularly necessary in Saudi Arabia, Bahrain and Oman, which are dealing with recurrent budget deficits and considerable pressure on labour markets.

These countries introduced programmes to encourage the employment of nationals several years ago. However, since 2016, with oil market conditions being unfavourable to the producers of the Gulf Cooperation Council (GCC), the process has accelerated significantly. The most significant case is that of Saudi Arabia, with the introduction of the Nitaqat programme and the goal of steadily 'nationalising employment' in certain professions. This has started to produce positive results, with an increase in the employment of Saudi nationals in the private sector.

That said, across the GCC as a whole, the split of private sector employment between nationals and expatriates has not really changed. The data available show that expatriates continue to make up a very high percentage of the total active population, at over 80%, a figure that has been more or less stable over the last five years. This is as true for those countries with little pressure on the labour market and acceptable fiscal positions (Kuwait, Qatar and the United Arab Emirates (UAE)) as it is in those which have struggled with the issue of increasing the employment of nationals in the private sector for several years (Bahrain, Saudi Arabia, Oman). For example, in Saudi Arabia, despite the proactive nature of the policies adopted, this rate was 77% in Q1 2020, the same as it was at the end of 2016.

SAUDI ARABIA FORECASTS

	2018	2019	2020e	2021e
Real GDP growth (%)	2.2	0.3	-6.3	3.8
Inflation (CPI, year average, %)	2.5	-1.2	3.6	1.1
Gov. balance / GDP (%)	-5.9	-4.5	-11.4	-7.9
Central government debt / GDP (%)	19.0	23.0	32.0	36.0
Current account balance / GDP (%)	9.0	4.7	-4.1	-0.1

TABLE 1

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

PMI INDEX NON-OIL PRIVATE SECTOR, EMPLOYMENT

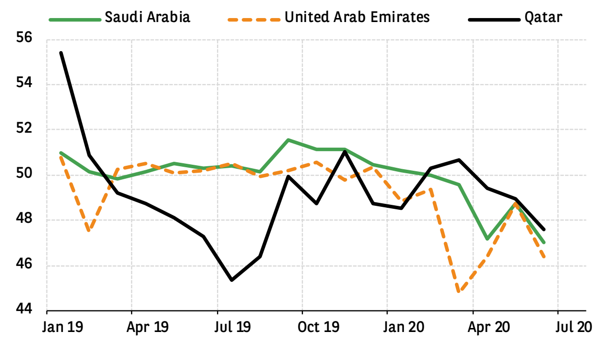

CHART 1

SOURCE: MARKIT

A DRAMATIC TIGHTENING OF FISCAL CONSTRAINTS

The current economic crisis is on an unprecedented scale, particularly as it follows several difficult years which saw a worsening of the main macroeconomic indicators in the Gulf. The aggregate budget balance for the region went from a surplus of 8.4% of GDP between 2010 and 2014, to a deficit of 6.5% of GDP from 2015 to 2019, a figure likely to rise to a record deficit of 12.7% of GDP in 2020. Fiscal receipts from hydrocarbons are likely to plummet by 42%, or around USD110 billion, this year under the combined effect of lower prices and the introduction of production quotas designed to limit the supply of hydrocarbons on the global market. The increases in budget deficits have deteriorated solvency indicators. Debt issuance has also set new records since the beginning of this year (USD26 billion on the Eurobonds market), whilst some governments have had to draw on their sovereign wealth funds to meet financing needs.

Given the very sharp increase in their borrowing, governments have little room to manoeuvre, meaning that they cannot simultaneously stimulate their economies and continue to reform their public finances. Stimulus measures in response to the effects of the Covid-19 pandemic have been relatively modest (between 2% and 5% of GDP) and have most noticeably been accompanied by fiscal restrictions, which have been significant in some cases. In Saudi Arabia, for example, the threefold increase in VAT was surprising for its scale and its apparently pro-cyclical nature, whilst reductions in spending could total as much as 4% of GDP. For some countries, such as Bahrain and Oman, where public finances have deteriorated substantially, the room for manoeuvre is even more limited.

TUMBLING INTO RECESSION

Despite the economic diversification policies introduced in recent years, economic activity remains highly dependent on oil revenues. As a result, the changes in the oil market since 2015 have had negative effects on non-oil economic activity due to the lasting reduction in the oil rent. On average, growth in non-oil economic activity across the region fell from 6.8% between 2010 and 2014 to 2.5% from 2015 to 2019. The outlook for 2020 is clearly negative (-3.4% on average). The expected recovery in 2021 will in any event be limited by the mixed prospects for the oil market.

Alongside the oil sector, the two areas most seriously affected will be construction (budget cuts) and tourism (travel restrictions). These two sectors also employ a large share of expatriate workers. In Saudi Arabia and the UAE, these sectors have a relatively more significant role in the economy than elsewhere in the region. Thus, the retail and hotel-restaurant sectors in these two countries account for more than 21% of non-oil GDP, a figure which is below 15% in other gulf states.

WHAT CONSEQUENCES FOR EXPATRIATE EMPLOYMENT?

The necessary clean-up of government budgets will result in a reduction in the number of expatriates employed in the public sector (in general they account for less than 10% of the total workforce in the public sector). Thus, currently in an electoral period, Kuwait has announced that it wants to halve the presence of expatriates within the national oil company and the civil service. In Qatar, where expatriates account for 95% of the active population, the government plans to reduce the total wage bill for expatriates in the public sector by 30% (notably in the state-owned airline and oil companies) through wage cuts and/or redundancies. Similarly in Oman, the government is seeking to nationalise employment in the public sector as far as possible. At a GCC level, these decisions probably do not represent a very significant number of departures, but are significant of the extent of the current crisis and its likely consequences for the public finances and employment.

At the same time, the sharp slowdown in non-oil sectors is likely to trigger a massive departure of expatriate workers. For example, more than 150,000 foreign workers have left Kuwait since mid-March, and it is estimated that more than a million could have left the country by the end of the year. Although advanced indicators of activity in non-oil sectors have recovered since May 2020 in Saudi Arabia, the UAE and Qatar (albeit remaining in contraction territory at below 50 in Qatar and Saudi Arabia, but moving above that mark in the UAE), their employment components are still on a downward trend.This pattern, of a gradual recovery in economic activity but a depressed labour market, is likely to continue until at least the end of this year. It is therefore estimated that the number of expatriate workers in Saudi Arabia and Dubai could be reduced by 10%, or some 1.5 million people, in 2020.

A NEGATIVE PICTURE IN THE SHORT TERM AND UNCERTAINTY THEREAFTER

These significant departures of workers will not affect just the least skilled jobs in construction or services, but also intermediate positions. In the short term, they will have a negative effect on domestic demand. Over the medium term, the economic crisis might help accelerate the process of nationalising employment, but this will remain a partial shift, as shown by recent trends in Saudi Arabia.

SAUDI ARABIA: CHANGE IN EMPLOYMENT BY NATIONALITY

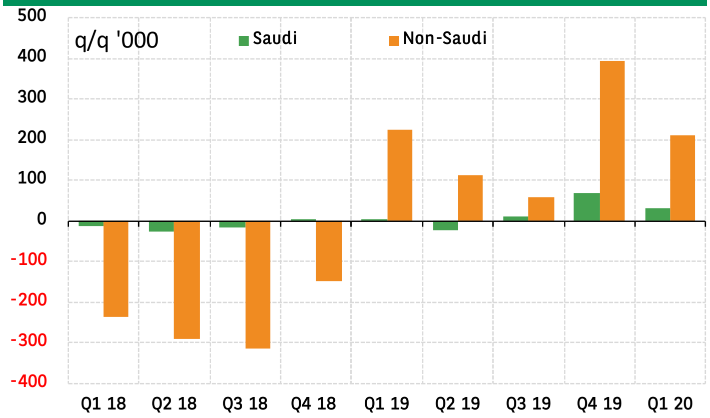

CHART 2

SOURCE: GASTAT

In this country, prior to the health crisis, government policies had had positive results for the creation of jobs for Saudi nationals. Thus despite the fact that the economic position was already pretty gloomy, job creation for nationals hit high levels in Q4 2019 and Q1 2020 (+100,000) after having been negative for a number of quarters (-74,000 between Q1 2018 and Q2 2019). However, expatriate employment grew even more strongly over the same period. Since S2 2018, total employment rose by 9%, with expatriate employment rising 11% and employment of Saudi nationals by just 3%. The inclusion of nationals in the labour market still suffers from rigidities (wage inertia, lack of qualifications). Looking at the GCC countries as a whole, it is still too early to determine whether or not the expected reduction in expatriate employment will have a significant and lasting effect on the employment of nationals.

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SOUTH AFRICA

GOING FROM BAD TO WORSE

The shock triggered by the Covid-19 epidemic has been violent and has hit an already very fragile economy. Over the past five years, economic growth has averaged only 0.8% and the country has slipped into recession since mid-2019. The economic contraction and the deterioration in public finances will be on an unprecedented scale in 2020. Real GDP may well not return to its pre-crisis level before 2025. The government has been adept in adjusting its financing strategy to cover its needs, which have increased steeply following the introduction of the fiscal stimulus plan. The support expected from multilateral lenders in the short term is reassuring, but trends in government debt will continue to be a concern over the medium term.

A VIOLENT ECONOMIC SHOCK WITH LONG-LASTING EFFECTS

A strict lockdown has been imposed on all South Africans since late March. It has been relaxed slightly since May 1st, but the path of the epidemic has led the authorities to re-tighten restrictions in recent days. As a matter of fact, the epidemic has started slowly but accelerated alarmingly in recent weeks. It had not reached its peak by July 15th, at which point South Africa already recorded 311,000 cases and 4,450 deaths, in a population of 59 million.

The economic consequences of the health crisis are severe, especially as they hit an already very fragile economy that has been in recession since mid-2019. Real GDP growth averaged only 0.8% per year between 2015 and 2019, held back by significant structural constraints and brought to a virtual standstill last year due to major power outages. In Q1 2020, before the direct effects of the lockdown started to be appear, real GDP contracted by an annualised 2% quarter-on-quarter (following contractions of 0.8% in Q3 2019 then 1.4% in Q4 2019). During the lockdown, economic activity collapsed across all sectors in April, and then saw a timid recovery. For instance, manufacturing production plunged by 44% month-on-month (m/m) in April and by 49% year-on-year (y/y). The Purchasing Managers Indexes (PMI) suggest that production picked up in June, but remained well below its pre-crisis levels (chart 1).

The economy is likely to face an unprecedented contraction in Q2 2020, before a difficult recovery in the second half of the year, assuming that the country has moved past the peak of the epidemic by then. After an expected recession of 8.5% in 2020, the economic recovery in 2021 is likely to be limited, constrained by South Africa's very low potential growth rate (estimated at 1.5% before the health crisis). Based on our current estimates, real GDP is unlikely to return to its pre-Covid-19 crisis levels until 2025.

The social context, with very high levels of poverty, income inequality and unemployment, will worsen still further. The official unemployment rate hit 29.1% at the end of 2019 (and 57.1% amongst those aged 15 to 24), and already climbed to 30.1% by Q1 2020. The social impact of the Covid-19 crisis could be mitigated by the government's support measures but, one the one hand, the fiscal room for manoeuvre is limited and, on the other hand, the impact of the measures will be limited by the large size of the informal economy (which represents around 30% of employment). Households will at least benefit from slower consumer price inflation. Prices increased 2% y/y in May 2020 (from 4% in December 2019), the lowest inflation rate of the past fifteen years. Inflation is likely to remain between 2% and 3% over the next few quarters, with deflationary pressures from falling demand and lower oil prices more than offsetting the opposing effects of a weaker rand. This trend in inflation widens the central bank's scope to ease monetary policy (the monetary authorities have an inflation target of

FORECASTS

	2018	2019	2020e	2021e
Real GDP growth (%)	0.8	0.2	-8.5	2.3
Inflation (CPI, year average, %)	4.6	4.1	2.8	3.7
Government balance / GDP (%) 1	-4.7	-6.7	-14.5	-11.0
Government debt / GDP (%) 1	56.7	63.4	82.1	88.8
Current account balance / GDP (%)	-3.6	-3.0	-0.9	-2.9

(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

SUDDEN STOP

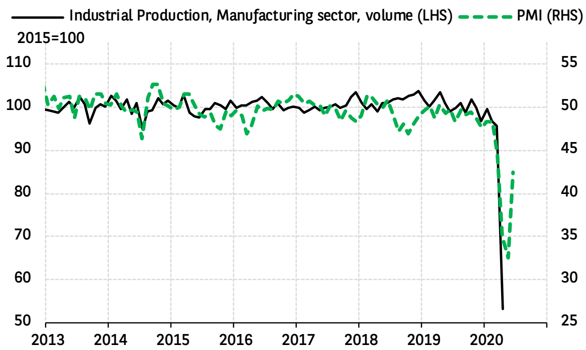

CHART 1

SOURCE: SSA, DATASTREAM

between 3% and 6%). The policy interest rate has been cut by 275 basis points since the beginning of the year (taking the repo rate from 6.50% to 3.75%). Further cuts are likely in the second half of 2020, unless South Africa's financial markets come under stress again.

THE FINANCIAL SHOCK WAS TEMPORARY BUT MAY BE REPEATED

South Africa was one of the hardest hit by the emerging market sell-off episode in Q1 2020. Large capital outflows led to sharp price corrections across all asset categories. The rand lost more than 30% against the

US dollar over the first four months of the year, before gaining 8% since end-April. In spite of the monetary policy easing, yields on 10-year sovereign bonds jumped from an average of 9.1% in December to 11.2% in April, and have since fluctuated at around 10%. Meanwhile, South African EMBI spreads more than doubled to 670 basis points over the first four months of 2020, before falling back to 520bp at the beginning of July.

In fact, financial tensions appear to have been easing since May. South Africa nevertheless remains one of the emerging economies most exposed to the risk of a downturn in foreign investors' sentiment, given its weak macroeconomic fundamentals. While its current account imbalance is likely to narrow this year (thus supporting the rand) due to the drop in imports and improved terms of trade, public-account dynamics are very worrying.

PUBLIC FINANCES UNDER THREAT

The deterioration in public finances, which was already a cause for concern before the health crisis, will worsen much further this year. The central government deficit was 6.7% of GDP during fiscal year FY2019-20 (which runs from April to March), up from 4.7% in FY2018-19 and 3.9% in FY2016-17. Fiscal slippage has resulted from the weakness of fiscal receipts, growing current spending and rising interest payments on debt; all this was further exacerbated last year by the cost of bailing out state-owned company Eskom. The government's primary deficit thus increased from 1% of GDP in FY2018-19 to 2.8% in FY2019-20, its highest level in the past decade. Debt interest payments reached 4% of GDP, swallowing up nearly 14% of fiscal receipts. Although this figure is still not excessive, it is at a record level for the country and will increase still further over the next few years.

Fiscal deficit slippage is now set to accelerate as a result of the economic recession and the massive stimulus package introduced by the government since the end of April. This plan is worth ZAR 500 billion (USD 27 bn), or around 10% of GDP. It includes: ZAR 140 bn in support to struggling companies to help pay wages and protect jobs; ZAR 70 bn in tax cuts for enterprises; ZAR 50 bn in subsidies to households; ZAR 40 bn in new spending in the health sector (staff, infrastructure); and a bank loan guarantee programme (for a total of up to ZAR 200 bn, or 4% of GDP).

The Unemployment Insurance Fund will draw on its reserves to help finance measures to support employment. Other measures will be financed by budget reallocations (notably to the detriment of public investment). The remainder will be an additional cost for central government. In all, the deficit is expected to more than double in FY2020-21, taking it to 14.5% of GDP. With debt redemption totalling ZAR 65 bn, the government's financing needs will reach nearly 16% of GDP in FY2020-21, up from 8% in 2019-20. This substantial increase comes at a time when the deterioration of the public finances over recent years has led to downgrades of sovereign ratings by international agencies, increasing risk aversion amongst foreign investors and a rising cost of financing for the government. The authorities have thus had to adjust their financing strategy in response.

One point of comfort for the government is that nearly 90% of its debt is in rand and local financial institutions make up the bulk of its creditors. Banks, insurers and pension funds held 52% of local Treasury bonds at mid-2020 (from 48% at end-2019). Such institutions should be able to cover almost half of the government's borrowing requirements this year (or around 7% of GDP), but not more, especially as the banks have already bought up a large share of the securities sold by foreign investors in recent months. Foreign investors held only 30% of local-currency Treasury bonds at end-June, down from 37% at end-2019, and their withdrawal is likely to continue in the short term. As a result, the government plans to draw on its deposits and reserves (for an amount equivalent to 2.5% of GDP) and hopes to borrow in international markets (for a total of some 0.5% of GDP). It will also turn to new sources of financing. Firstly, it has been negotiating with multilateral creditors to arrange financing of about USD 7 bn (or 2.5% of GDP). The IMF's 'rapid financing instrument' could provide USD 4.2 bn, with the rest coming from the BRICS' New Development Bank (USD 1 bn), the World Bank and the African Development Bank. Secondly, the central bank has begun to purchase Treasury bonds on the secondary market. Its purchases amounted to ZAR 20 bn at end-June (around 0.5% of GDP) and could climb to 2% of GDP over the year as a whole. The sums committed by the central bank would thus be modest and are unlikely to have a significant macroeconomic effect.

GOVERNMENT DEBT: A WORRYING TREND

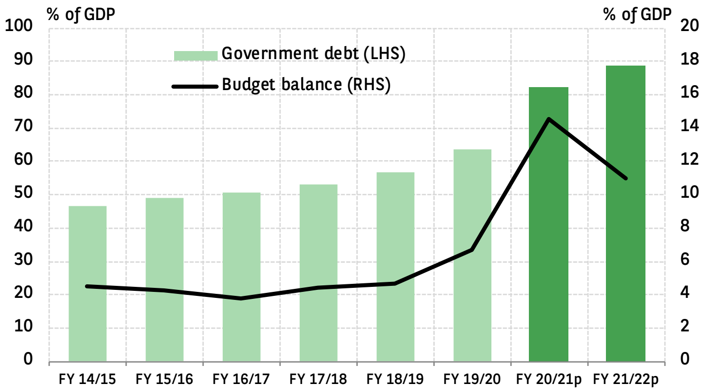

CHART 2

SOURCE: SSA, SARB, BNP PARIBAS

The rapid deterioration in sovereign solvency is a cause for concern. Total government debt had already risen from 51% of GDP in March 2017 to 63% in March 2020, and is projected to hit 82% by March 2021 due to larger deficits and shrinking nominal GDP (plus a small effect from the depreciation in the rand). Only major structural reforms, notably ones that increase South Africa's potential economic growth rate, will be able to change the trend in government debt over the medium term. Therefore, even when the health crisis is over, the Ramaphosa government will still face an immense challenge.

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NIGERIA

DOUBLE WHAMMY HITS WEAKENED ECONOMY

Although the pandemic is well contained from a health perspective, the Covid-19 crisis combined with the downturn in oil prices will have severe economic consequences. With no real fiscal leeway, the government has implemented a very modest economic stimulus plan, while massive capital outflows and the collapse of oil exports have fuelled the rapid erosion of foreign reserves, bringing the naira under pressure. The deterioration in public and external accounts despite support from donor funds hampers any prospects of a recovery. Just four years after the last recession, real GDP is expected to contract significantly again in 2020. Without an upturn in oil prices, the rebound will be mild in 2021.

With just 684 deaths reported in early July and more than 30,000 confirmed cases for a population of 200 million inhabitants, the coronavirus pandemic has been relatively mild so far. Yet the number of new cases is rising constantly. Nigeria is one of the African countries that tests the least, and it is in the midst of easing the lockdown restrictions that were implemented at the end of March. Although reintroducing a strict lockdown does not seem very feasible given its socioeconomic consequences (the informal sector accounts for more than 40% of the economy according to the World Bank), persistent health risks will continue to weigh heavily on the prospects of an economic recovery. Above all, with its deteriorated macroeconomic fundamentals, Nigeria must deal with a powerful oil and financial shock.

FORECASTS

	2018	2019	2020e	2021e
Real GDP growth (%)	1.9	2.3	-4.2	2.4
Inflation (CPI, year average, %)	12.1	11.5	13.0	12.0
Gen. Gov. balance / GDP (%)	-4.3	-5.0	-7.1	-6.0
Gen. Gov. debt / GDP (%)	23.1	25.0	31.0	32.5
Current account balance / GDP (%)	0.9	-3.6	-3.4	-2.6

TABLE 1

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

EXTERNAL ACCOUNTS: PERSISTENT PRESSURE

Nigeria's external position is not nearly as comfortable as it was during the previous shock of 2015. After three years of surpluses, the current account balance swung back into a deficit in 2019 due to surging imports of goods and services. In 2020, imports will decline with the drop-off in domestic demand, but this will not be sufficient to fully offset the loss of oil exports (90% of total exports). In addition to the collapse of Brent oil prices, commitments taken by Nigeria under the Opec+ agreement should reduce its oil production by more than 10% over the full year. All in all, oil exports are expected to be slashed in half in 2020 to less than USD 30 bn. To make matters worse, there has been unusual pressure on remittances from the Nigerian diaspora, which has accounted for more than 25% of current-account receipts in recent years.

Consequently, the current account balance will continue to post a large deficit, estimated at more than 3% of GDP. The financial situation is also precarious. Massive capital outflows beginning in H2 2019 have led to a steady erosion of external liquidity. After declining to USD 35 bn at the end of April 2020, FX reserves have been rebuilt slightly thanks to the USD 3.4 bn emergency assistance from the IMF. Yet this respite is bound to be short-lived. In Q1 2020, the stock of portfolio investments in short-term naira debt securities amounted to more than USD 20 bn, the equivalent of 60% of FX reserves. Non-resident investors sold a large share of their stock of securities issued by the central bank. After peaking at USD 18 bn in mid-2019, this stock has fallen back to about USD 8 bn, 70% of which matures by year-end 2020. Sovereign spreads are still high at 753 basis points, signalling the persistent aversion to Nigerian risk.

Despite upcoming financial assistance from several donors (about USD 3.5 bn), FX reserves are expected to decline again in H2 2020 to end the year at less than USD 30 bn. This is barely equivalent to 4.7 months of imports of goods and services, compared to 9.3 months at year-end 2017. This would bring FX reserves back to the 2015-2016 level, when the authorities decided to restrict considerably their foreign-currency allocations. The emergence of a significant spread in the parallel forex market since the beginning of the year despite the devaluation of the naira suggests that this might already be the case (see chart 1).

EXCHANGE RATE ADJUSTMENT AGAINST THE US DOLLAR

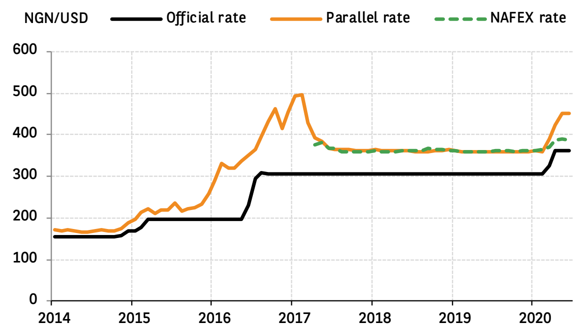

CHART 1

SOURCE: CBN, BLOOMBERG, ABOKI FX

NAIRA ADJUSTMENTS: NECESSARY BUT INSUFFICIENT

Under this environment, the exchange rate system has become a key issue again. After virtually four years of stability, the monetary authorities adjusted the official exchange rate by 15% on 20 March. At 360 NGN per USD, the naira is nearing the NAFEX rate (70-80% of commercial and financial transactions) without completely eliminating the spread: the NAFEX rate is still about NGN 390 per USD. The central bank has indicated that it might unify the two exchange rates in the near future. The project is still vague but seems to be advancing.

According to Bloomberg, at an auction for importers on 4 July, the monetary authorities asked that bids for foreign exchange be made at NGN 380 per USD, implying another 5.3% devaluation.

Although unifying exchange rates would be an undeniable step forward, the strength of the naira will continue to be a problem. Even aligned with the NAFEX rate, the official exchange rate would still be 20% lower than in the parallel market. Fierce downward pressure can also be seen in the offshore market, where the 1-year forward rate is NGN 460 per USD. Moreover, nothing says that the monetary authorities are prepared to move towards greater flexibility. Persistently high inflation amid a stable exchange rate leads to an appreciation in the Real Effective Exchange Rate (REER), which is a source of external imbalances. Despite the nominal adjustment of the exchange rate in March, REER is still 22% higher than at year-end 2016.

PUBLIC FINANCES: LITTLE FLEXIBILITY

The double whammy of the pandemic and the downturn in oil prices has made the fiscal equation even more complicated. Based on an initial assumption of oil prices at USD 57 a barrel, the budget had to be modified repeatedly before being approved using the conservative hypothesis of USD 28 a barrel. With the oil sector generating over half of its resources, one of the world's narrowest fiscal base (non-oil revenues barely exceeded 4% of GDP in 2019) and capital expenditure amounting to less than 1% of GDP, fiscal flexibility is virtually non-existent. Despite adjustments in non-essential spending and the elimination of energy subsidies, the consolidated fiscal deficit could reach 7% of GDP this year, which is two points higher than in 2019.

Covering financing needs will continue to be problematic. Faced with deteriorated conditions, the government is unlikely to tap the international bond markets this year. Despite major support from donors, the central bank will be largely called on once again. In 2019, 75% of the fiscal deficit was monetised, essentially via overdraft facilities. Given the squeeze on domestic liquidity, this year the proportion should be relatively similar. Yet direct financing from the central bank is costly (key rate +3%). Although public debt is small (31% of GDP in 2020, less than a third of which is in foreign currencies), interest payments could absorb more than 40% of general government revenues in 2020, more than twice the 2019 figure. In comparison, the state allocated less than 10% of its resources to interest payments in 2014. Given this environment, the rating agencies S&P and Fitch downgraded Nigeria's sovereign rating in March-April, while Moody's switched to a negative outlook. There is also regular speculation that the authorities seek to benefit from a temporary freeze of their debt servicing with official creditors, although the finance ministry denies this.

REAL GDP GROWTH: ANOTHER RECESSION

Economic growth was still positive at 1.9% year-on-year in Q1 2020, but leading indicators signalled a sharp drop in Q2 GDP. Despite a slight rebound since May in tandem with the easing of lockdown restrictions, PMI is still below the 50 threshold (see chart 2) after hitting an all-time low of 37.1 in April. The economy will continue to face powerful headwinds because the drop-off in oil exports is having numerous repercussions on the economy as a whole. Faced with this situation, the fiscal stimulus package seems small (1.6% of GDP) as do the support measures implemented by the monetary authorities.

In addition to liquidity injections in the banking sector (2.4% of GDP) and the possibility of temporary loan restructuring for clients hit hardest by the crisis, the central bank has cut its key rate by

DRAMATIC FALL IN ECONOMIC ACTIVITY

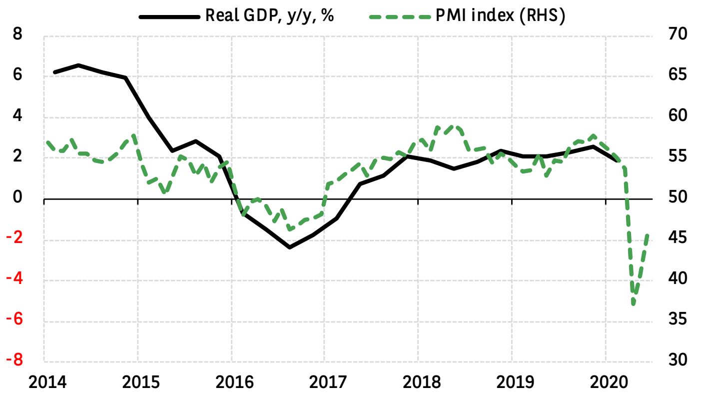

CHART 2

SOURCE: NBS, STANBIC IBTC

100 basis points to 12.5%. This was a surprising decision because it coincided with accelerating inflation (+12.4% in May). Moreover, the transmission channels seem to be reduced. The banking sector will come under pressure given its high exposure to the oil sector (27% of loan portfolios) and the high level of dollarization (40% of loans are in foreign currencies). Moody's expects to see the doubtful loan ratio more than double to between 12% and 15%.

All in all, real GDP is expected to contract by more than 4% in 2020, just four years after the previous recession. Without a significant rebound in oil prices, the expected recovery in 2021 is bound to be mild, estimated at 2.4%, which is even lower than demographic growth. Although a positive outcome is still possible (thanks to reforms), this time the alarming erosion of macroeconomic fundamentals could force the authorities to request a financing programme with the IMF. They were opposed to such a move during the previous shock.

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