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Economics - CEEMEA

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Q4 2020
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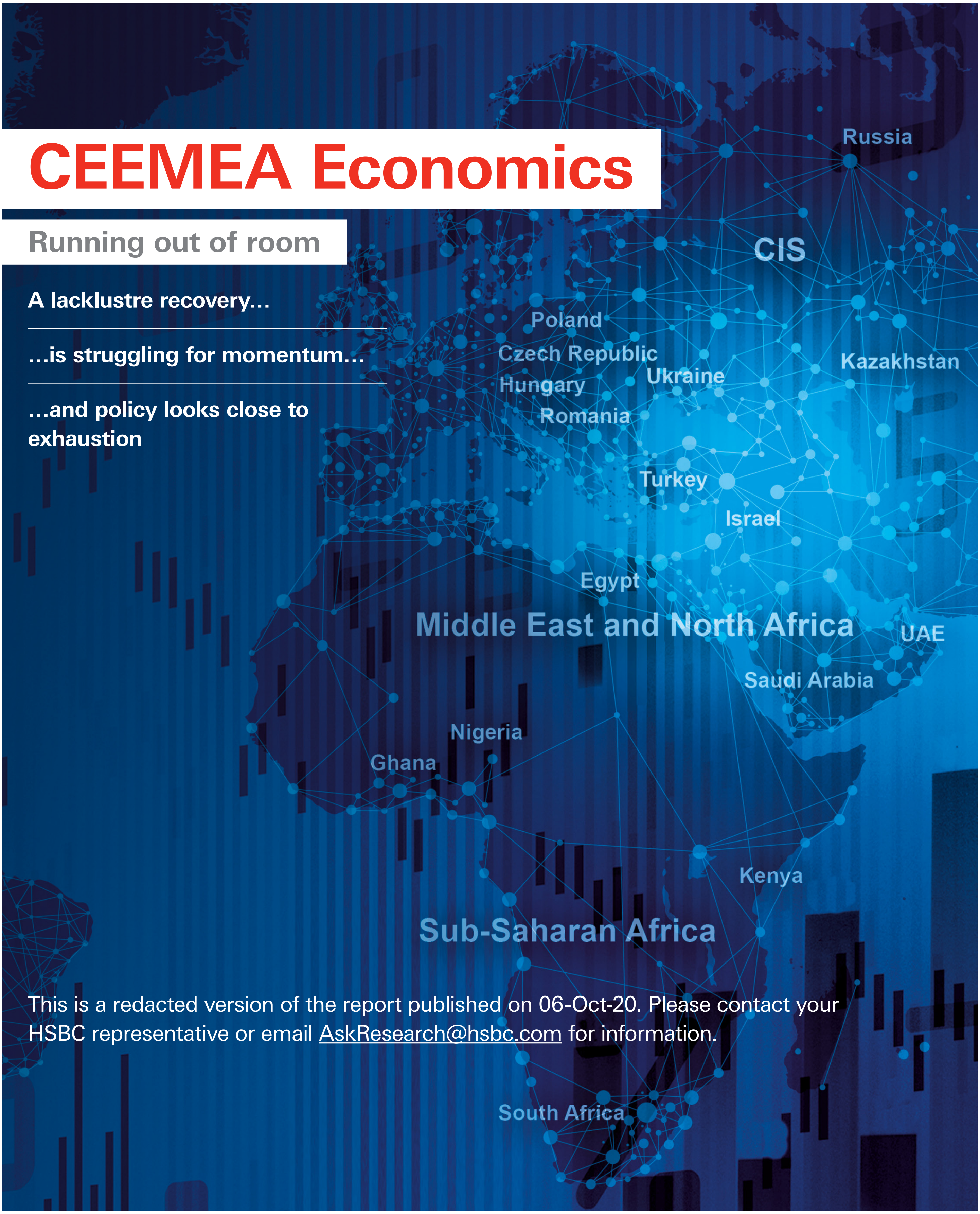
CEEMEA Economics

Running out of room

A lacklustre recovery...

...is struggling for momentum...

...and policy looks close to exhaustion



This is a redacted version of the report published on 06-Oct-20. Please contact your HSBC representative or email AskResearch@hsbc.com for information.

Key events

October 2020

	South Africa: MTBPS
02	**Czech Republic:** Senate election
07	**Poland:** rate decision
09	**Poland:** S&P rating review
16	**Oman:** S&P rating review
20	**Hungary:** rate decision
22	**Israel:** rate decision
22	**Turkey:** rate decision
23	**Russia:** rate decision
23	**Israel:** Moody's rating review
23	**Romania:** Moody's rating review
24	**Egypt:** Parliament election
28	**Turkey:** inflation report
30	**Saudi Arabia:** Moody's rating review
30	**Czech Republic:** S&P rating review
30	**Romania:** Fitch rating review

November 2020

	Poland: inflation report
	Czech Republic: inflation report
	Romania: inflation report
03	**US:** Presidential election
04	**Poland:** rate decision
05	**US:** rate decision
05	**Czech Republic**: rate decision
05	**IMF:** Annual research conference
06	**Qatar:** Moody's rating review
06	**Egypt:** S&P rating review
07	**Egypt:** House of Representatives election
12	**Egypt:** rate decision
17	**Hungary:** rate decision
19	**South Africa:** rate decision
19	**Turkey:** rate decision
20	**Kenya:** rate decision
20	**South Africa:** Moody's rating review
20	**South Africa:** S&P rating review
23	**Ghana:** rate decision
27	**Abu Dhabi:** S&P rating review
27	**Bahrain:** S&P rating review
28	**Kuwait:** General election
30	**Israel:** rate decision

December 2020

	Hungary: inflation report
01	**OPEC** meeting
02	**Poland:** rate decision
04	**Russia:** Moody's rating review
04	**Turkey:** Moody's rating review
04	**Romania:** S&P rating review
06	**Romania:** Legislative election
07	**Ghana:** Parliament election
15	**Hungary:** rate decision
16	**US:** rate decision
17	**Czech Republic:** rate decision
18	**Russia:** rate decision
24	**Egypt:** rate decision
24	**Turkey:** rate decision

January 2021

South Africa: MTBPS
Turkey: inflation report
US: rate decision
Israel: rate decision
Romania: rate decision
Turkey: rate decision

February 2021

Czech Republic: inflation report
Romania: inflation report
Israel: rate decision
Romania: rate decision
Russia: rate decision
Turkey: rate decision

March 2021

Poland: inflation report
US: rate decision
Russia: rate decision
Turkey: rate decision
Hungary: inflation report

Q2 2021

May	**Eurozone:** Spring commission
Jun	**Qatar**: Shura Council appointment

Q3 2021

Jul	**Egypt:** start of the fiscal year
Jul	**Eurozone:** Summer commission
Aug	**South Africa:** Local elections
Sep	**Russia:** State Duma election

Q4 2021

Oct	**South Africa:** MTBPS
Oct	**Czech Republic:** Chamber of Deputies election
Nov	**Eurozone:** Autumn commission

Running out of room

- A lacklustre recovery…
- …is struggling for momentum…
- …and policymakers are running out of options

This is a redacted version of the report published on 06-Oct-20. To access the full note, including a review of funding risks in Turkey, the shape of South Africa's recovery, Central Europe's risks and upsides along with key forecasts and country sections, please contact your HSBC representative or email *AskResearch@hsbc.com*.

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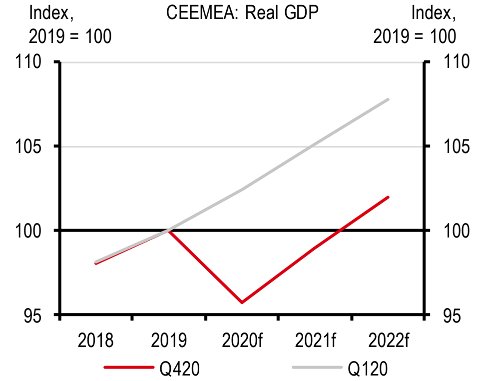
Lasting losses

The good news is that for **Central and Eastern Europe, the Middle East and Africa** (CEEMEA) as a whole, we have revised our forecasts for 2020 significantly higher since our last quarterly review, and now see the regional economy contracting by 4.3% in aggregate compared with the 4.9% drop we had anticipated a few months ago. A resurgence of COVID-19 in parts of the region, and the re-imposition of some restrictions on activity, have created some immediate downside risks (charts 4, 5). But overall, we feel the revisions have a solid base, reflecting Q2 numbers that were stronger than we had feared and high frequency data that suggests sequential recovery persisted well into Q3 as lockdown restrictions continued to ease and activity normalised. Despite the higher base, we have also nudged our 2021 numbers upward, with growth at around 3.4% (3.3% previously).

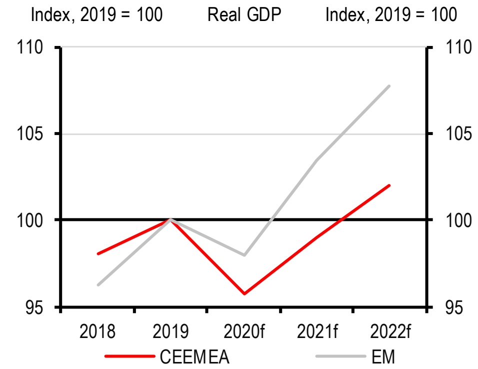
But while these new forecasts offer some relief, we see little to cheer. Even with the upward revision, this year's aggregate contraction remains the steepest in our database, more than 1ppt deeper than the recession that followed the 2009 financial crisis. But it is less the downturn that is the focus of our concerns, than the weakness of the recovery. By the end of 2021, CEEMEA economic output will still be 1% smaller than it was in 2019 as next year's recovery fails to fully reverse this year's economic losses (charts 1,2) . Our first look at 2022 suggests that activity will

1. Recovery will not recoup this year's losses



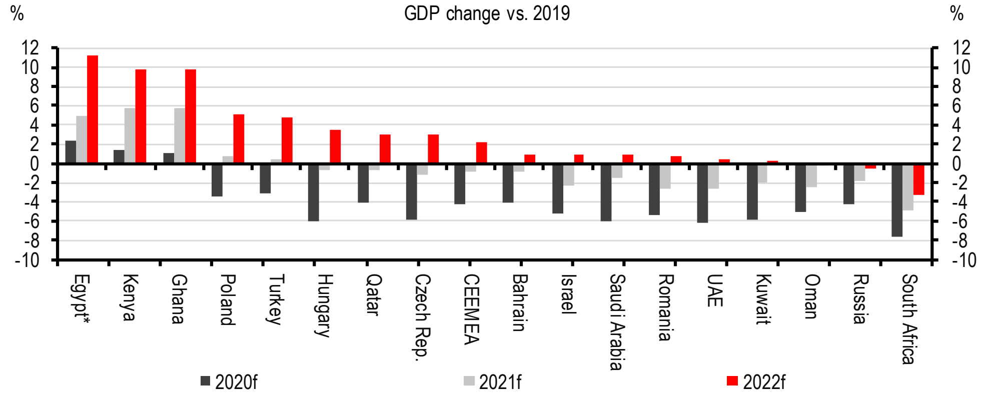
Source: HSBC Global Research, CEIC

2. CEEMEA will fall further and recover more slowly than much of EM



Source: HSBC Global Research, CEIC

3. There are some outperformers. But many more that will continue to lag.



*Fiscal year, ends 30 June
Source: HSBC Global Research

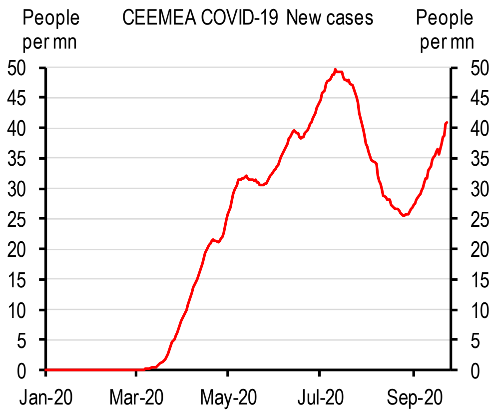
finally be back above pre-COVID-19 levels, but our projections suggest that, rather than building momentum, growth is likely to slow in aggregate to around 3% as cyclical and structural constraints take their toll and policymakers run out of room.

Compared to where we thought economic activity would be before the pandemic hit, the losses are clearer still with output set to be down 6.1ppt in 2021 – a drop that will increase strains on public finances, external debt and corporate balance sheets. The growth trend also means lasting losses to prosperity – at the end of our forecast period we see per capita incomes more than USD1000 below where they might have been but for the COVID-19-driven downturn.

Bright spots, dark sky

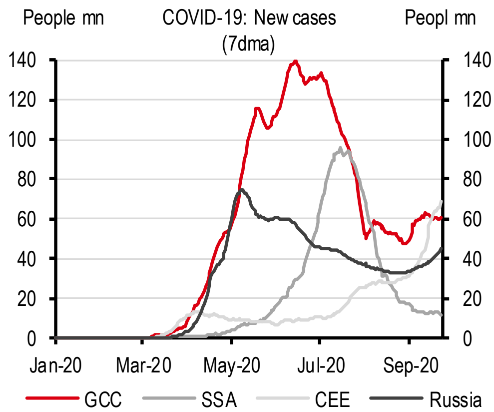
Against the overall average, our forecasts identify some clear outperformers (chart 3). **Kenya**, **Ghana** and **Egypt** (on a fiscal year basis) should avoid a COVID-19-driven recession and will see their economies grow 10% over our forecast period. Better-than-expected Q2 GDP and strong Q3 leading indicators have strengthened our view that **Poland** is set to fare the best in the CEE region and will have fully recovered its 2020 losses by the end of next year – along with **Israel**, it will be the only one of the wealthy economies we cover to have done so. Forecast revisions mean we also now see **Turkey** building momentum next year and into 2022, albeit at the cost of mounting risks.

4. COVID cases are on the rise…



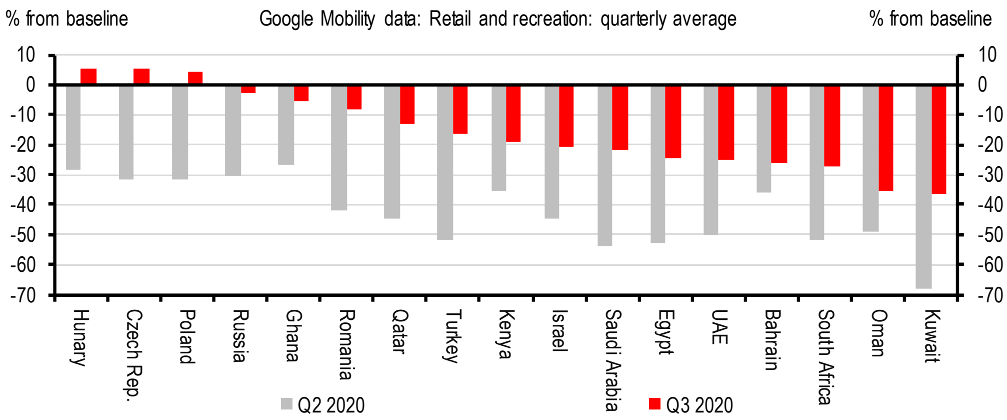
Source: Source: European Centre for Disease Prevention and Control, HSBC

5. …albeit unevenly



Source: European Centre for Disease Prevention and Control, HSBC

6. Activity is off its lows, but remains very subdued



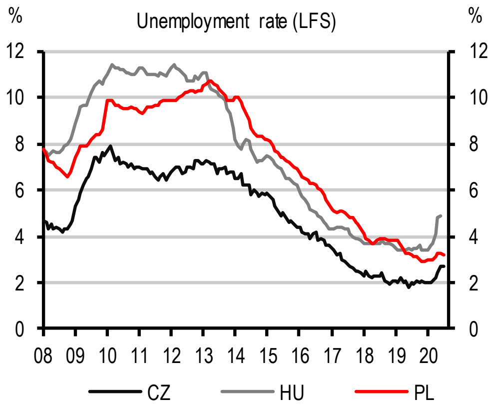
Source: Google Mobility Reports Note: The baseline is the median value, for the corresponding day of the week, during the 5-week period Jan 3–Feb 6, 2020.

But the overall story is much more downbeat, with the upward revisions masking cuts in 8 of the 17 economies we follow for this year, as near-term prospects decline for economies as diverse as **Oman** and **Hungary**. We also see 13 of the 17 proving unable to undo this year's losses in 2021 and four that will still be below pre-crisis levels of output in 2022. **South Africa** is the most dispiriting of this group, with our numbers suggesting the economy will still be more than 3% below its 2019 level in 2022, while nominal GDP will be down 18% in per capita terms.

Weak investment means potential growth is trending lower

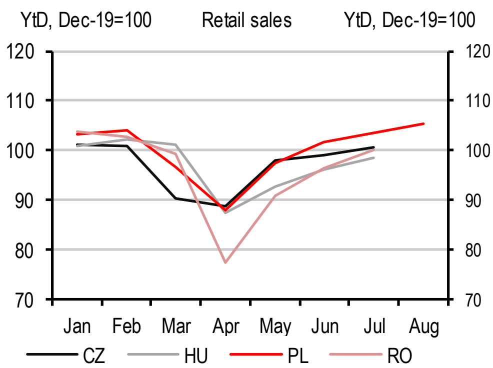
A glance at the growth drivers suggests that it is not just the pace of recovery which will be weak, but also its quality. Consumption will be the dominant driver across the board, though even here the pace will vary widely between economies. In **Central and Eastern Europe** (CEE), employment has stayed strong into the downturn and wage growth firm. And while this is softening as job support schemes roll off, the labour market remains tight and household spending has already recovered much of its early 2020 losses (charts 7,8). In contrast, consumption growth will be much weaker in **South Africa,** which lost 2.2m jobs in Q2, or in the **Gulf** where employment pressures have triggered a surge in expatriate outflows. Even in **Saudi Arabia,** unemployment jumped 3.5ppt q-o-q in Q2 to 15% – the highest in at least ten years –with consumption prospects hit further by a 10ppt hike in VAT that added 6ppt to inflation (charts 9-12).

7. CEE labour markets still look tight...



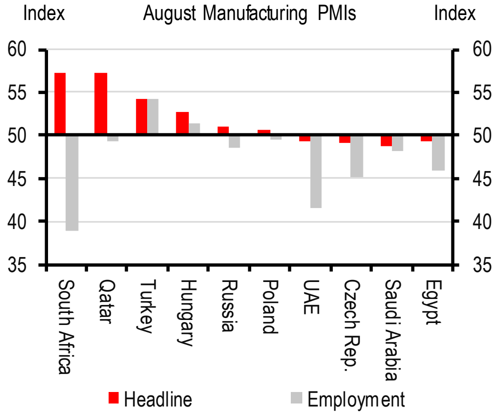
Source: Refinitiv Datastream

8. ...offering consumption strong support



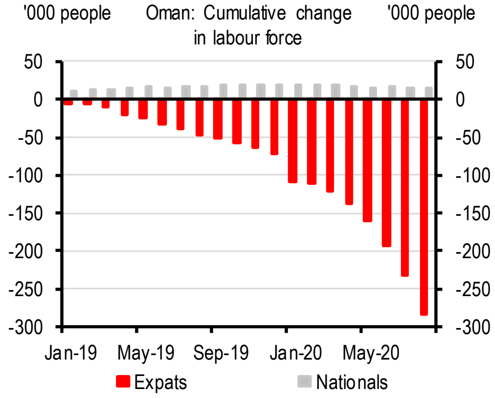
Source: Refinitiv Datastream

9. Activity and employment gains are diverging



Source: Markit

10. The Gulf is shedding jobs at a rapid pace



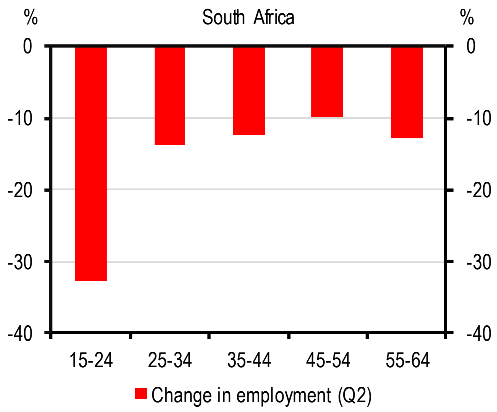
Source: CEIC

Prospects for investment, however, are much weaker across the board. For those economies that have released full Q2 GDP data, capital spending bore the brunt of the declines, with investment in Poland and Hungary dropping 11% and 14% y-o-y, respectively. We recognise that some of this decline is likely a reflection of the lockdowns that made it difficult to continue with capital projects. But with levels of GDP now materially lower than had previously seemed likely, and corporates sensitised to the downside risks the pandemic represents, we expect capital formation to remain weak, and by 2022 still see the gross capital stock across CEEMEA as a whole down by 1.5% on its pre-crisis levels. Given how weak productivity growth was across CEEMEA even before the downturn hit, the investment trend suggests potential growth rates face lasting declines (charts 13-16). **CEE** is again a partial exception, with close integration into broader European production chains and the prospect of EU funding creating stronger pull pressures for capital formation. Elsewhere, however, the losses will be extreme, with **South Africa's** capital stock down 8% on its 2019 level by 2022, for example.

11. In parts of the region, employment fell off a cliff in Q2…

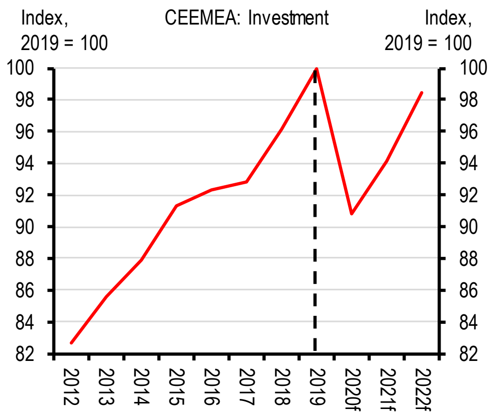
Source: Statistics South Africa

12. …with youth hit especially hard



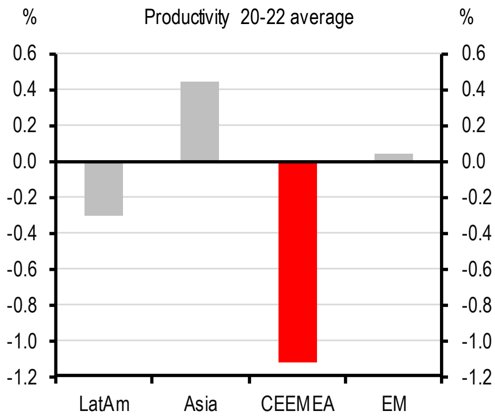
Source: Statistics South Africa

13. Years of lost investment...



Source: Local Statistic Agencies, HSBC

14. …are going to make chronic productivity problems worse…



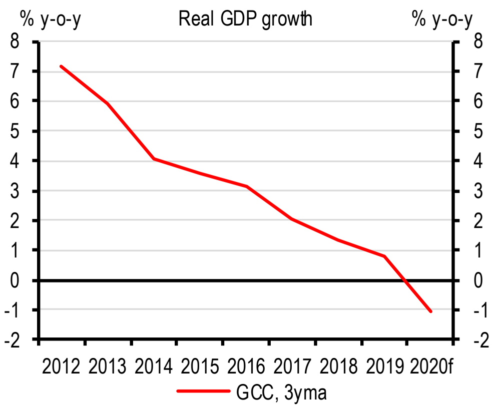
Source: Penn world table 9.1, HSBC

FDI is unlikely to offer a boost given how difficult a struggle the region has faced historically to draw in productive capital. The broader region's weak integration into global value chains also suggests that it will in aggregate gain relatively little from the muted pick-up in global growth. This will be especially true for the commodity producers – we have changed our energy price assumption and now see oil averaging USD45/b in 2020 (USD50/b previously) and remaining soft into 2022. This will leave **Saudi Arabia's** oil production over 2020-22 worth USD200bn less than in the previous three years. There will also be sustained external headwinds for economies such as **Egypt**, **Dubai**, **Turkey,** and **Kenya** where tourism is an important source of foreign exchange and driver of domestic activity. Numbers should rise from this year's shutdown lows, but our forecasts assume that the pace will lag the broader recovery in global growth for as long as health concerns remain pronounced.

Policy options wearing thin

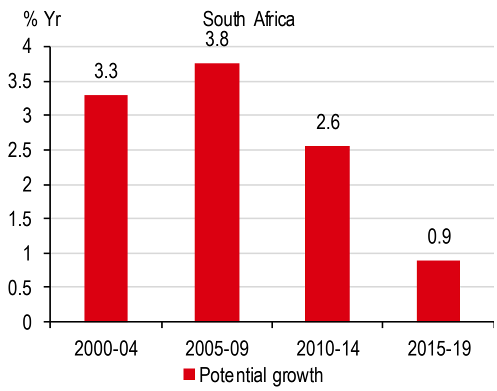
In the face of these pressures, policymakers' capacity to contain the shock, let alone reverse the losses, is wearing thin. Monetary policy has done much of the heavy lifting, with central banks across the region seizing the opportunity offered by accommodative policy globally and a drop in domestic inflationary pressures to ease. In aggregate, CEEMEA central banks have now

15. …meaning that trend growth rates are coming down…



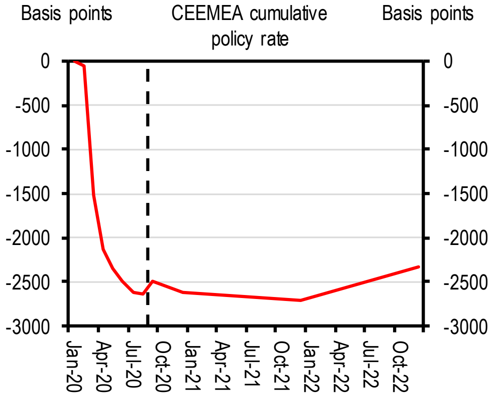
Source: HSBC

16. …as potential falls away



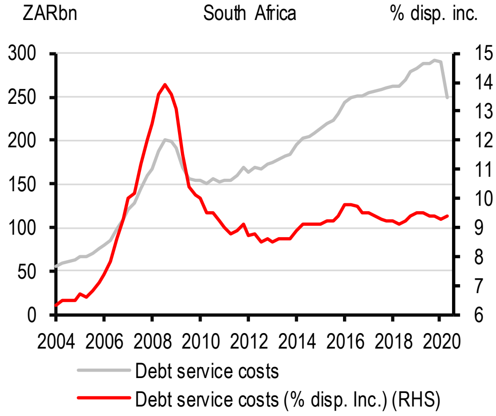
Source: SARB

17. Monetary easing has run its course



Source: HSBC Global Research, CEIC

18. Falling income has offset lower servicing costs



Source :SARB

delivered an aggregate 2500bps in rate cuts since the COVID-19 crisis escalated in February, including 140bps delivered in Q3 (chart 17).

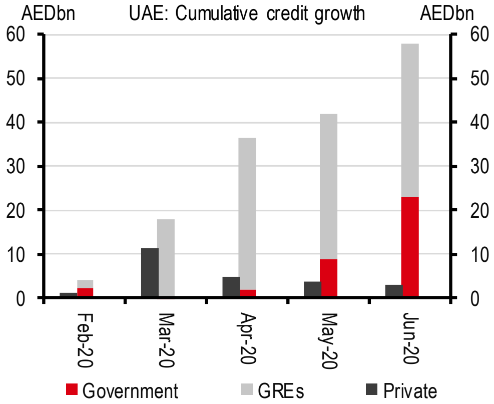
In addition to policy rate cuts, central banks have delivered widespread reductions in capital and reserve requirements in a bid to bolster liquidity conditions further, while others such as **Hungary, Poland and Romania** have gone further, launching bond purchase programmes to drive rates lower along the curve. Even the Central Bank of **Turkey** has been able to intervene, with bond purchases reaching 2% of GDP in Q3. Central banks have also continued to champion low cost, low risk credit facilities to support the corporate sector, extending the terms of these facilities into the new year as the nature of the downturn has become clear. In other cases, the intervention has been more direct, with some **Gulf** banks obliged to offer payment holidays to corporate customers, and to maintain existing funding lines.

Softening the blow, not reversing the downturn

This policy stance has softened what would otherwise have been an even harder landing for the corporate sector in the face of the sudden stop in demand. In the **UAE**, for example, some 20-30% of corporate lending is now under the Targeted Economic Support Scheme (TESS) which allowed loan payments to be deferred by up to six months. The drop in the cost of funds must also have benefited the cash flow position of households and firms with credit on floating rates. The provision of liquidity has also helped counter what might otherwise have been a rapid tightening in monetary conditions due to the state's own borrowing needs. In **Saudi Arabia**, for example, bank claims on the public sector increased by 12% in the first seven months of the year, but the cost of commercial credit has fallen and private sector lending has continued to grow at its pre-crisis pace. Helped by lower rates, asset prices across the region have, by and large, held up well, preventing a negative feedback loop that could have deepened the downturn in confidence.

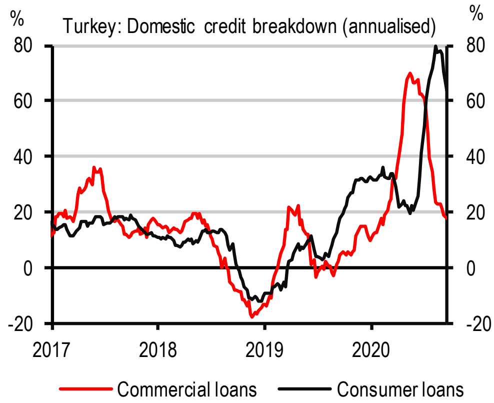
But though the monetary stance has cushioned the blow, the limits have also been clear to see. For one, policymakers' success in protecting private sector access to funding at a time of soaring government borrowing needs has been uneven. Net commercial bank claims on the public sector in **Oman**, for example, soared by 8ppt of GDP in the first seven months of 2020, as the financing needs of the state sector crowded out the private sector. This has also been the case in the UAE (chart 19). Elsewhere, monetary policy transmission has been impaired either because liquidity has remained tight, the curve has steepened, or credit quality fears have dominated. The impact

19. For some, it's been very hard to get the private sector to borrow…



Source: CEIC, HSBC Note: GRE – Government Related Entity

20. …while elsewhere a short-lived boom went quickly sour



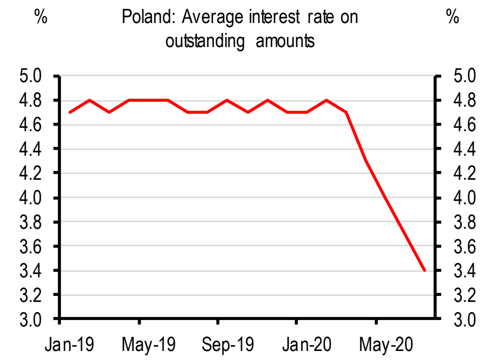
Source: BDDK, HSBC

of lower funding costs that have been delivered have also been countered by the sharp drop in income. This has been true for corporates but also for individuals, with data from **South Africa** showing that while household interest payments dropped by ZAR40bn y-o-y in Q2, they were flat as a proportion of disposable income (chart 18).

Pushing on a string

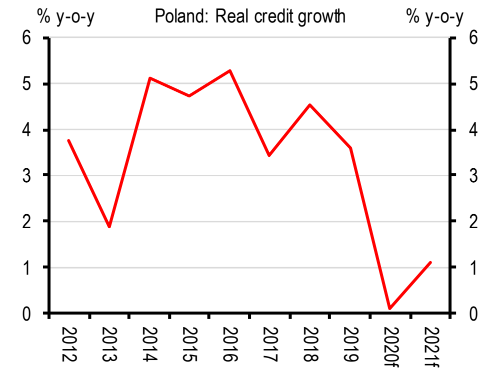
Indeed, we see few signs that monetary easing is creating conditions for a positive credit impulse that might give recovery momentum. **Turkey** was perhaps the short-lived exception: there was a clear and immediate link between monetary easing and a surge in credit in H1 and the distinctly V-shaped recovery in Q3. But the magnitude of easing required was so pronounced, with the real policy rate falling to a low of -5%, that it exacerbated domestic and external account imbalances. In turn, this has already forced the CBRT to start tightening again as the currency fell to an all-time low. Elsewhere, the gains have been much more limited, with the generous terms of the TESS in the **UAE** prompting an initial increase in lending as corporates accumulated a working capital buffer; but claims have since started to decline with lending contracting m-o-m in June and July.

21. Even with a strong outlook and falling interest rates...



Source: NBP, HSBC

22. …it has been hard to generate a credit impulse



Source: CEIC, HSBC

We think this will continue, with corporates reluctant to take on additional leverage even on generous terms when the economic outlook is so unsure. For lenders, too, there is hesitancy, with banks seeing their margins squeezed by payment holidays, and recognising that underlying credit problems generated by the downturn will emerge once support schemes expire. Inevitably, reservations are greatest where economic prospects are weakest, and we see real credit growth running at just 0.8% y-o-y in **South Africa**, for example, over the coming two years with the real terms contraction reported in August putting the risks to the downside. Even where the outlook is more robust, however, we expect 2020 shocks to keep appetite subdued, with lending in **Poland** for example rising just 1% in real terms next year, 3ppt below the pre-crisis five-year average (charts 21,22).

Monetary policy has hit its limits

Moreover, we think the easing cycle has hit its limits. In some cases, this is for positive reasons. As domestic demand builds momentum in CEE, the super-accommodative stance adopted in response to COVID-19 will no longer be required and we see **Poland**, the **Czech Republic** and potentially even **Hungary** gradually taking rates higher in 2021 to ensure inflationary pressures are contained. But where the outlook is still poor, scope for monetary easing appears exhausted. Despite the deep deflation with which Gulf states like **Qatar, Oman** and the **UAE** are wrestling, real rates remain very high as the dollar-peg leaves no scope to cut further if the integrity of the FX regimes are to be maintained. Despite its poor recovery prospects and inflation at target, we think **South Africa's** cutting cycle is also complete, with the SARB arguing that the sharp drop in potential growth rates has left no scope for further easing. Fiscal strains have also clearly played a role, arguing against South Africa pursuing a more aggressive QE strategy despite the pace at which the interest rate curve is steepening and inflation at the bottom end of its target band.

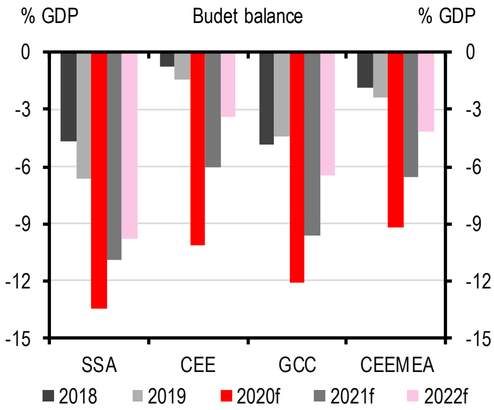
We are also starting to see risks to easing in economies where policy action has been delayed. We had expected **Kenya** to cut in Q4, but global conditions no longer seem supportive, while prospects for a further cut in **Egypt** are contingent on global risk appetite keeping portfolio inflows strong to support the currency, despite weak growth, very low inflation and high real rates. We had looked to **Russia** to cut in September, but a surge in geopolitical tensions instead required it to keep rates on hold, with the still-weak rouble leaving the cut we have pencilled in for Q4 in doubt. **Romania's** easing cycle is on hold, with further easing dependent on the outcome of the December general election and the stabilisation of public finances.

Fiscal policy is exhausted

Fiscal policy also appears to be running out of space. In aggregate, we now see the budget deficit in CEEMEA running at USD550bn this year, the equivalent of just over 9% of GDP. The sum is vast – a 7ppt deterioration in a year – but more striking is the slow pace at which the shortfall looks set to narrow, with the deficit still close to double its 2019 level in 2022, at around 4.2% of GDP (chart 23). The projections point to a borrowing requirement over our full forecast period of USD1.2trn, more than the previous 10 years combined. We expect this to lift public debt by 15ppt of GDP over the three-year period, and by 10ppt of GDP this year alone (chart 24).

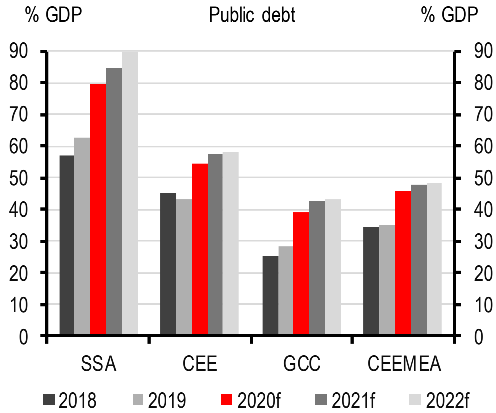
The aggregate figure again masks the wide divergence across CEEMEA, with those that entered the crisis with public finances on a sound footing both better placed to absorb the COVID-19 shock and to maintain an expansionary fiscal stance to help consolidate the recovery. Here again, CEE stands out with the discipline of EU membership capping budget shortfalls and

23. The COVID-19 shock has unanchored public finances...



Source: CEIC, Local Statistic Agencies, HSBC

24. ...and debt is rising quickly

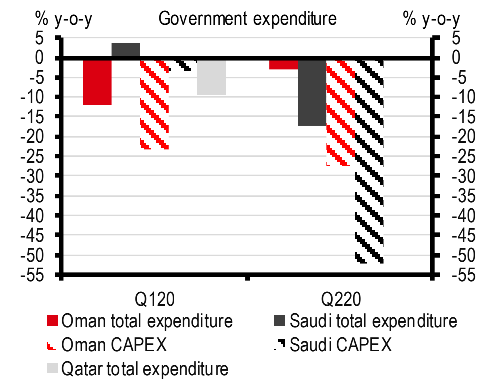


Source: CEIC, Local Statistic Agencies, HSBC

putting debt on a downward path before this year's crisis hit. This has allowed policymakers to cut taxes and boost spending to support domestic demand, without breaking the fiscal anchor. We expect strong fiscal support to continue in the Czech Republic next year, with plans for a substantial personal income tax cut and additional in-work benefits already laid out.

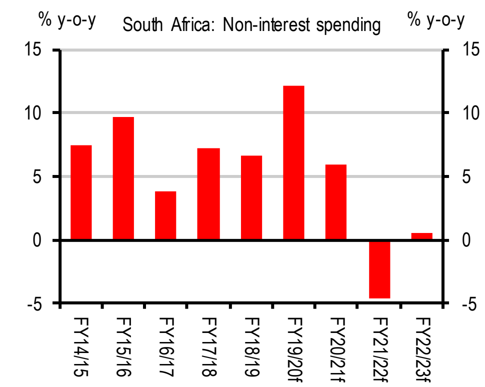
But even among those economies that do have space, we have some concerns. In CEE debt levels will have jumped by more than 10ppt by the end of this year, and though more support could be offered if required, we see the broader fiscal stance tightening. Instead, policymakers are looking to EU funding to maintain budget support, but ongoing disputes between the European Commission, parliament and member states over conditionality puts the scale and timing of new disbursements in some doubt. These concerns extend to both the multi-annual funding framework and the EU Next Generation fund, with **Romania**, **Poland** and **Hungary** having the most to lose if disbursements are cut or delayed. Away from CEE, we continue to be struck by the muted fiscal support **Russia** has elected to offer, despite it looking set to record the smallest budget deficit in CEEMEA and facing a sharp downturn in growth. As a consequence, we think Russia will be one of the four economies in the region where GDP has not returned to its 2019 levels by 2022.

25. Pressure has already forced some to tighten their fiscal stance…



Source: CEIC

26. …and for others it's on the cards



Source: South Africa National Treasury

Oil producers come to terms

Where the fiscal limits are showing even more clearly, however, policy options are more constrained still. For the energy producers, the headwinds are especially clear, with this year's oil price slump forcing policy onto the defensive. Those in the Middle East have done what they can, with **Saudi Arabia** paying part of the salaries of those working in the private sector, for example, and joined the **UAE** in delaying the collection of fees and taxes. But the support has started to roll off and data show that the overall bias has been contractionary as the revenue decline has taken its toll. Capital spending fell by more than 30% in Saudi Arabia in H1 and by 25% in **Oman**, with the sharp decline in reported projects planned and underway suggesting the Gulf as a whole is following the same spending pattern. **Saudi Arabia's** decision to hike VAT 10ppt at a time when much of the rest of the world has looked to cut underscores the Gulf's pro-cyclical bias more clearly still (charts 25, 26).

While we think that the most acute phase of the consolidation is over, if our assumption of oil trading in a range of USD45-55/b over our forecast period proves correct, deficits will remain large and the policy stance will remain cautious. Indeed, Saudi Arabia's preliminary budget statement for 2021 – the first fiscal plan to be released for next year – points to a 7% cut in spending on this year's estimated outturn. Spending intentions will also be vulnerable to both fresh oil price weakness or more troubled access to funding. Here, **Oman** and **Bahrain** stand out because of their high breakeven oil prices and elevated levels of net debt. The level of policy discord in **Kuwait** could prompt fresh consolidation pressures there despite the wealth it commands.

Running out of rope

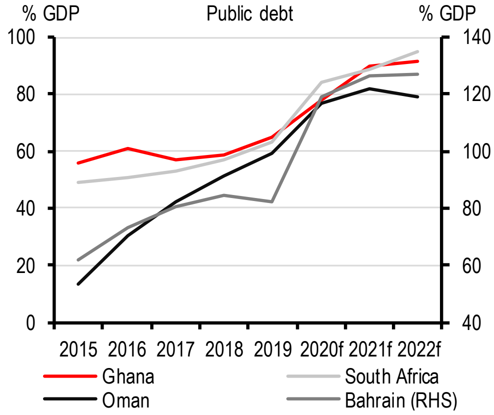
We are equally concerned at the policy risks we see building among some of CEEMEA's more troubled non-oil states, where the pace of fiscal deterioration not only constrains the scope policymakers have to counter the downturn, but creates vulnerabilities that could send recovery into reverse.

In some cases, this reflects policy choices made in response to the downturn which we do not feel the economy can sustain. We are anxious at prospects for **Romania**, for example, which in September voted in favour of large increases in social benefits and a 40% pension increase, despite facing a 9% of GDP budget shortfall. Romania was already the only economy in CEEMEA where we saw the budget deficit rising y-o-y in 2021, and any further deterioration would leave it exposed to potential ratings downgrades and EU sanctions, setting the scene for a period of painful consolidation that would put finances back on track, but at the expense of slowing growth. We have similar concerns in **Ghana**, which formally abandoned its 5% of GDP deficit ceiling to boost spending to combat COVID-19, but also to prime growth ahead of the year-end general election. We are not optimistic that either of the leading presidential candidates is ready to return to an orthodox fiscal path and we thus fear the deficit will remain elevated and the country exposed to a tightening of funding conditions.

Our biggest fiscal concerns, however, centre on **South Africa** which has seen its pre-existing fiscal frailties exposed and exacerbated by the impact of COVID-19 on health-related spending needs and a recession-driven drop in revenues. In contrast to some others facing intensifying fiscal stress, South African policymakers appear keenly aware of the risks budget slippage represents and have shown intent to stabilise public debt. We expect some tightening measures to be adopted over our forecast period, a shift that will put an end to this year's more accommodative stance.

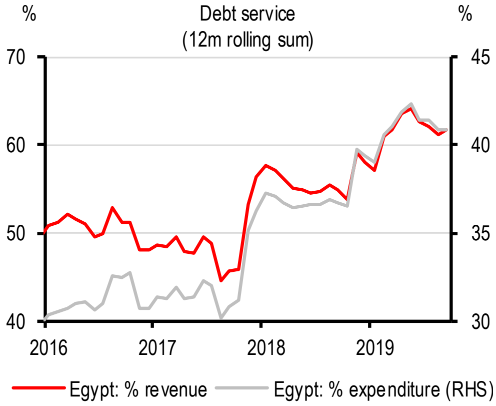
But we do not believe that policy will do enough to contain spending pressures, or that growth will revive to boost revenue sufficiently to re-anchor public finances. As a consequence, we see the deficit remaining at double digit levels throughout our forecast period, lifting the debt stock to 95% of GDP by 2022 – an increase of more than 30ppt on its already concerning/elevated pre-crisis levels, and a pace of deterioration that could yet force a more painful period of consolidation should market conditions sour. Even in the absence of such a shock, the scale of the borrowing requirement will make fiscal policy a drag on investment as it keeps rates high and absorbs so much of the economy's already low savings levels.

27. For some, the debt trajectory looks difficult to sustain...



Source: Local Central Banks, HSBC

28. …and rising servicing costs leave less room for productive spending



Source: MoF, HSBC

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