ISSN: 2241-4851

Eurobank Research

GLOBAL & REGIONAL MONTHLY

Global economic activity seems on track for a robust recovery in 2021, with the US and China leading the upturn. The global manufacturing upsurge seems to have strengthened at the start of the second quarter due to the easing of mobility restrictions in many parts of the world. Nevertheless, supply-side constraints have led to higher input prices as well as delays in raw material deliveries, which should eventually diminish as the conditions of the global supply chain gradually normalize. Overall, global GDP is expected to increase by 5.5% in 2021, following a contraction of 3.3% in 2020, boosted by extraordinary policy support.

Macro Picture

USA: The economy surprises to the upside boosted by faster vaccinations and fiscal policy

EA: A strong rebound is expected in H2, amid an easing of restrictions and rising confidence

UK: Poised for a vigorous GDP rebound this year thanks to the lockdown relaxation plan

EM: Large EMs with current account imbalances are exposed to a possible taper tantrum saga

CESEE: The region crossed the turning point on tackling the third wave of Covid-19 infections

Markets

FX: EUR strength with EU-US rates differential narrowing as the market is looking to play the EU recovery now

Rates: ECB and Fed remained dovish and EU yields underperformed US yields on the back of accelerating vaccinations in the EU

EM: EM yields little changed as US rates finally stabilized and volatility remained low. Cash is still on the sidelines to be redeployed into EM

Credit: Spreads were unchanged to slightly tighter across ratings and sectors, expected to trade range bound/moderately wider

Policy Outlook

USA: Tapering announcement not expected before Q4, Fed funds rates unchanged until 2023

EA: Very accommodative ECB policy stance, unchanged policy rates in the foreseeable future

UK: The BoE reduced the pace of bond purchases, 2021 GDP growth forecast revised sharply higher

CESEE: Central Banks on hold despite upside inflation outlook risks

Key Downside Risks

Re-imposition of restrictions: New, more infectious variants, slow progress in vaccine rollout

Premature withdrawal of fiscal/monetary support

Covid-19 severe resurgence under a new mutation in India imperils the global economic recovery

Special Topics in this issue:

- Is Turkey headed towards an economic crisis?
- The impact of the Covid-19 pandemic to the economic potential of the euro area

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May 2021

Special thanks to the Global Markets team (Global_Markets_Trading@eurobank.gr), Eurobank Bulgaria and Eurobank Serbia, as well as Economic Analyst Mrs. Anna Dimitriadou, for their invaluable contribution in this issue

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Macro Views

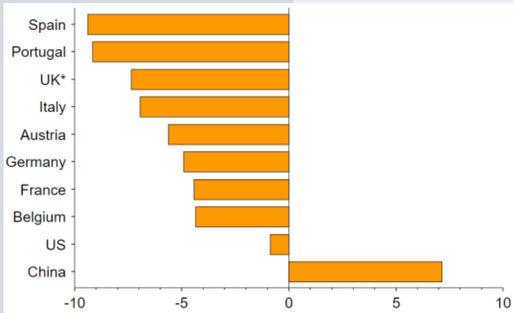
Latest Macroeconomic Developments & Outlook

World Economic Outlook

Global economic activity seems on track for a robust recovery in 2021, with the US and China leading the upturn (Figure 1). US real GDP growth accelerated from 4.3%QoQ in Q4 2020 to 6.4%QoQ saar in Q1 2021, the second highest quarterly rate in almost 18 years, while the exceptional fiscal support, the fast pace of vaccinations and the gradual unwinding of Covid-19 restrictions point to a double-digit quarterly annualized increase in Q2. In China, the Q1 print of 18.3%YoY was relatively soft on a quarterly basis but record high on an annual basis, due to last year's low base effect in the first quarter. The global outlook for Q2 remains positive on the back of stronger household consumption and capex. Nevertheless, extended mobility restrictions to contain the spread of the virus pushed the euro area economy into a technical recession in Q1, while risks seem tilted to the downside for Q2 due to the lockdowns in April before the recovery peaks in the second half of the year.

Figure 1: Uneven recovery across countries

Percentage changes in real GDP from Q4 2019 to Q1 2021

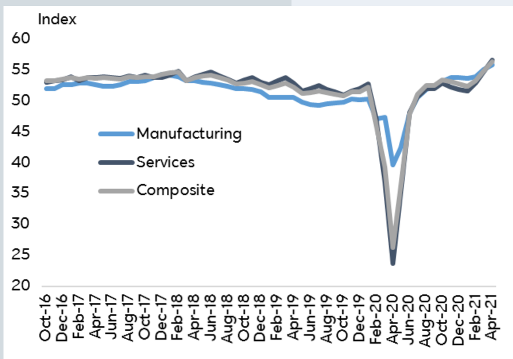


*Data up to Q4 2020

Source: Refiniv Datastream, Fathom Consulting, Eurobank Research

The global manufacturing upturn seems to have strengthened at the start of the second quarter due to the easing of mobility restrictions in many parts of the world, with the PMI manufacturing surging to an 11-year high of 55.8 in April. Manufacturing production advanced for the tenth month in a row, driven by widespread robust growth across major economies (US, UK, euro area, China and Japan). Both total new orders and new exports increased at the fastest pace in nearly 11 years, while optimism about future output levels remained among the highest recorded since the respective series started. However, supply-side constraints have led to higher input prices as well as delays in raw material deliveries, which should eventually diminish as the conditions of the global supply chain gradually normalize. Meanwhile, the services sector outperformed manufacturing production in April for the first time since the onset of the ongoing economic recovery last July, as the Global Services Business Activity Index increased to its highest level since July 2007 (56.6). As

Figure 2: JP Morgan Global PMI



Source: Bloomberg, Markit, Eurobank Research a result, the Global PMI Composite Output Index surged to a 132-month high 56.3 in April from 54.8 in March, with the main pillars of growth being the US (record increase) and the UK (Figure 2).

Overall, global GDP is expected to increase by 5.5% in 2021, following a contraction of 3.3% in 2020, boosted by extraordinary policy support. Fiscal policy is set to remain expansionary in several parts of the world, with several governments moving towards long-term investment in green technology, infrastructure and education that is expected to boost potential output growth (American Jobs Plan in the US, NextGenEU plan in Europe). On the monetary front, major central banks have committed to maintaining favorable financing conditions with an easy policy stance until there is a considerable and sustainable improvement in the economic conditions, the labor market and the inflation outlook.

Developed Economies

US: Q1 GDP growth accelerated to 6.4%QoQ saar from 4.3%QoQ in Q4 2020, with private consumption and fixed investment being the main growth drivers. A robust labor market recovery began earlier than previously anticipated, with higher confidence leading to solid job gains in Q1 2021. Meanwhile, the underlying momentum of housing activity appears to be strengthening, with both housing starts and permit issuances for new construction rising to the highest level in more than 10 years. Nevertheless, IP's weaker-than-expected performance in March is a sign of escalating supply constraints, partly due to the global shortage of semiconductors. Stimulus payments received in late March should boost spending further into April, with a double-digit annualized growth rate expected in Q2. Assuming that the current rate of vaccinations is maintained and ca. 75% of citizens over 12 years of age are vaccinated by July 2021, we expect a GDP growth acceleration to 6.5% in 2021.

Euro area: The preliminary Q1 estimate suggests that euro area has entered a technical recession, as mobility restrictions to contain the spread of the virus seem to have weighed heavily on personal consumption. Although February industrial production data point to existing supply constraints, in part due to the global shortage of semiconductors that weighs on motor vehicles output, stronger industrial production is expected in the months ahead, with manufacturing orders boosted by global manufacturing strength. Overall, the euro area economy is expected to rebound strongly beyond Q1, although the re-tightening of restrictive measures in April and the gradual reopening in May increase the risk for a Q2 GDP growth below consensus estimates of 1.8%QoQ. With the vaccinations' pace picking up further so that 70% of the adult population will be fully protected by September 2021 at the latest, economic activity should accelerate particularly in Q3 as the easing of restrictions and rising confidence leads to growing domestic demand, with overall GDP growth projected at 4.0% in 2021.

Emerging Economies

BRIC: The dramatic resurgence of the pandemic in India dominated the headlines in the BRICs area in April. Casualties and infections are currently standing at record high levels. The formation of a new triple mutation, questionable anti-Covid19 measures by the government and a slow vaccination process are considered the key factors behind the tragedy that keeps unwinding in the second most populous country of the globe. Increased geopolitical risks with Russia at the epicenter have also been in the forefront of attention as the USA has decided to impose sanctions against Russia, the tension with Ukraine has resurged and the diplomatic jitters with the Czech Republic have resulted into massive diplomats' expulsions from both countries. Brazil is still struggling fiercely with the pandemic. The lingering high volume of infections and fatalities, when the pandemic in many parts of the world is receding, has led to sharp criticism against President Jair Bolsonaro. On the economic front, the IMF's World Economic Outlook for April provided us with a view of the outlook of the BRIC economies in 2021 and 2022. Brazil is forecast to post a GDP growth rate of 3.7% in 2021, from -4.1% in 2020, which will ease to 2.6% in 2022. The Russian economy, from a GDP contraction of -3.1% in 2020, is expected to expand by +3.8% both in 2021 and 2022. In India, where the economic recession was contained to -8.0% in 2020, GDP growth is projected to rebound at 12.5% in 2021 and 6.9% in 2022. However, given the still unfolding health crisis in the country, the aforementioned figures, at least that for 2021, will most probably have to be revised downwards soon. Finally, in China, GDP growth is forecast at 8.4% in 2021, before cooling down to 5.6% in 2022.

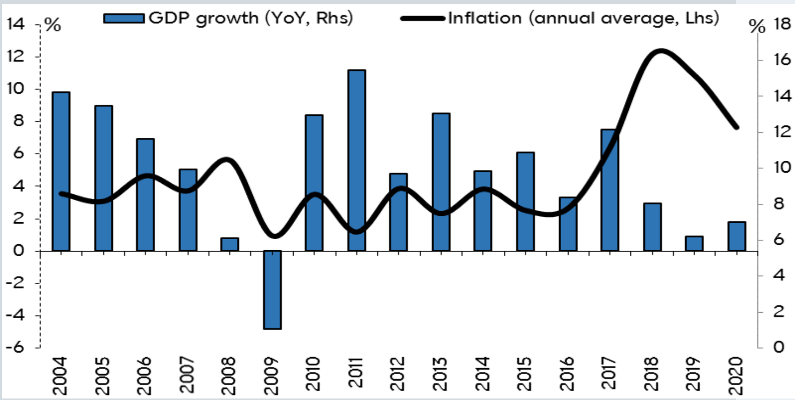
CESEE: As of late April – early May 2021, the epidemiological situation in many countries of the Central, Eastern and South-eastern Europe (CESEE) looked much better than a month ago signaling that the region has crossed the turning point. The reinstated stringent health and social distancing measures and restrictions on public and economic activities have had a positive impact in containing the virus spread across the region. The improvement of the epidemiological conditions together with the smooth execution of vaccination programs across the CESEE region, raised expectations for a more pronounced growth rebound in H2-2021. The resurgence of infections has most probably put a break on the pace of recovery – not limited to the services sector – given that restrictive measures, which had a negative impact on the economic activity in Q1-2021, have already remained in place for the larger part of Q2-2021.

Special Topics

I. Is Turkey headed towards an economic crisis?

This piece aims to describe the implications of the sudden removal of the Governor Naci Agbal from his post for the Turkish economy, discuss the probability of an economic crisis and outline different policy options going forward. The macroeconomic picture has deteriorated visibly in 2017-2020 vs. 2012-2016 with annual average inflation rising sharply to 13.7% up from 8.1% and average GDP growth slowing down from 5.5% to 3.3%.

Figure 3: Macroeconomic picture has deteriorated in 2017-2020



Source: IMF WEO, Eurobank Research

- **Background:** On March 20, the Governor of the Central Bank of Turkey Naci Agbal was unexpectedly dismissed and replaced by Sahap Kavcioglu who had served as a ruling AKP party MP and as deputy CEO of Halkbank. The change of leadership, the third since mid-2019, took place two days after the last MPC meeting, in which a sharper than expected 200bps rate hike took place. Under the leadership of Naci Agbal, CBRT had hiked its key policy rate (KPR) – the 1-week repo rate –by a cumulative 875bps to 19% since early November 2020 helping to restore some of its lost credibility. Besides hikes between November2020-March2021, CBRT during Agbal's term also adopted measures to simplify monetary policy via switching to single-rate funding, simplify the reserve requirement policy as well as improve data transparency and policy predictability via verbal forward guidance.
- **Domestic markets turmoil:** The news came as a shock to the markets. In early Asian trade on Monday, March 22, the lira plunged by as much as 17.5% to 8.48/$ against the close of 7.21/$ on Friday, March 19, little short of the 8.58/$ level touched in early November when the previous change of leadership in the Central Bank and the Ministry of Finance took place, ending the day at 7.80/$. The benchmark BIST-100 stock market index ended lower by 9.79% at 1,379. The 10Y USD denominated government bond yield skyrocketed by 117bps to 7.07%. The 5Y CDS climbed by 132bps to 439bps. On Tuesday, March 23, the lira traded at 7.92/$, the 10Y bond yield traded at 7.37% and the 5Y CDS went further up to 468bps.

- **Central Bank MPC meeting after the change of leadership:** The Central Bank of Turkey (CBRT) left its key policy rate (KPR) – the 1-week repo rate – at 19.0% in late April meeting markets' expectations in the first MPC under the leadership of the recently appointed governor Sahap Kavcioglu. More importantly, all eyes turned to the accompanying statement change of rhetoric. CBRT abandoned its commitment to sustain the tightness of the monetary policy stance in the period ahead and it no longer pledges in its statement to deliver additional monetary tightening if needed. At the same time, in its forward policy guidance the CBRT states that the key policy rate will be set at a level above inflation to maintain a strong disinflationary effect, until strong indicators point to a permanent fall in inflation, in line with the medium-term target. From the latter point of view, the CBRT believes that the decelerating impact of the current monetary stance on credit and domestic demand is envisaged to become more significant in the upcoming period. Finally, the CBRT stressed that the MPC would continue to take decisions in a transparent, predictable and data-driven framework.
- **The new local markets normal**: After the initial shock, markets seem to have stabilized at the new levels. The new CBRT leadership pledge not to resort to premature rate cuts has temporarily put investors on hold. However, lira has always been very susceptible to geopolitical risks. For example, the state of play in US-Turkey and EU-Turkey relations had always an impact. The US recognition of the killings of Ottoman Armenians during World War One as an act of genocide in late April strained further US-Turkey relations (on top of the procurement of the S-400 missile defense systems from Russia and the US case against Turkish state-run Halkbank) and weighed further on the lira. On May 6, the lira traded at 8.31/$, the 10Y USD denominated government bond yield traded at 6.53% and the 5Y CDS stood at 410bps.
- **Concerns** are rooted in a) The risk of backtracking to unorthodox monetary policies, b) the lack of adequate FX reserves and the inability to replenish them, c) relatively high FX liabilities of the private sector and may be magnified, d) unpredictable domestic environment and e) tightened global financial conditions (DMs yields spike - capital outflows from EMs). In more detail:
- **Unorthodox monetary policies**: The timing of the decision has exacerbated concerns about backtracking to unorthodox monetary policies of the past. President Erdogan's strong support for low interest rates aimed at boosting economic activity, has raised fresh doubts about the Central Bank's independence and concerns over CBRT falling significantly behind the curve again. However, it is more reassuring that the new CBRT leadership is also aware of the risks of any premature rate cuts and the need to provide clarity and transparency to the markets for its decision making.
- **High inflation remains a key challenge**. Driven by high food and energy inflation and the continued pass-through from earlier FX depreciation inflation has climbed further to 17.1% YoY in April up from 16.2% YoY in March vs. 15.6% YoY in February, 15.0% YoY in January and 14.6% YoY in December and well above the revised year-end target of 9.4% in 2021 and mid-term target at 5%. In the same months, core inflation also rose sharply to 17.8% YoY up from 16.9% vs. 16.2%, 15.5% and 14.3% YoY. The latest April print came out little below analysts' consensus expectations (Actual: +1.7% MoM vs +1.8% MoM) and suggests that there is no room for complacency.
- **Market expectations adjusting higher**: The rate hikes aimed to rein in elevated inflation expectations. In mid-March, the market on average projected headline inflation to fall to 13.8% YoY (against 13.1% YoY previously) at year-end, the 12-month ahead inflation at 11.8% YoY (against 10.5% YoY previously) and the 24-month ahead inflation at 10% YoY (against 9.2% YoY previously). Factoring in the latest hike and

the previous inflation projections before the market upheaval, the inflation-adjusted rates had climbed to historically high levels from an ex-ante point of view. They were also similar to the yields offered by emerging-market peers, a move that was enough to soothe market concerns and offer a decent rate premium to satisfy investors' appetite.

- **Lack of adequate FX reserves:** The unorthodox monetary policies have led to a drawdown in FX reserves in order to defend the lira, which CBRT has not managed to replenish yet. As of late March 2021, international reserves (FX reserves + Gold) on a gross basis stood at USD90.6bn, with FX reserves alone at USD50.9bn. Net FX reserves (net of the FX reserve requirements) stood at only USD12.5bn. On top, CBRT has been implementing swap agreements with the banking sector and foreign countries (China-Qatar) worth USD58bn to boost its USD liquidity. Factoring in the swap agreements, the underlying position of net FX reserves has already declined to negative levels (**-**USD45.5bn). The latter has raised concerns that Turkey may not have enough to shoulder a disruption in external financing.
- **External financing needs are high**: the corporate sector is short net (Assets-Liabilities) FX by USD156.1bn (January2021). Out of the liabilities stock, 32% is short-term and 68% is long-term. However, the corporate sector has been increasingly long in net short-term FX position (from USD4.6bn in December 2019 to USD25.3bn in January 2021). The domestic banking sector's (both private and state owned banks) short term external debt maturing within 1 year or less stands at USD88.7bn or 12.3% of GDP. Both corporates and banks have maintained comfortable rollover rates in 2020 as a result of their strong international ties. Having improved temporarily to a surplus in 2019, the CAB dynamics deteriorated rapidly in 2020 due to the Covid19 pandemic on lower tourism receipts. As a result, CAD widened again to -4.9% of GDP, widened compared to a surplus of +0.9% in 2019 vs a deficit of -2.7% in 2018 and -4.8% in 2017.
- **Domestic environment has become more unpredictable over the past decade:** On top, despite many verbal messages, the lack of implementation of a more conventional free markets oriented economic policy, threatens to bring structural deficiencies in the forefront again. To make things worse, Turkey is backtracking in a number of areas related to governance, institutional transparency and human rights. In the relevant World Bank survey, the country's scores in 2019 have deteriorated in every dimension (voice and accountability, control of corruption, rule of law, political stability and absence of violence/terrorism, government effectiveness and regulatory quality) compared to ten years ago.
- **Growth EM outlier**: Boosted by heavy credit, monetary and fiscal stimuli, full year GDP growth reached +1.9% in 2020, significantly higher than the government's forecast of 0.3% in last October and the 0.5% projection of the local market participants, making the country one of the few exceptions in the world, which escaped a deep recession. The international organizations latest GDP forecasts in 2021 look bullish. The OECD (March2021) and IMF (January 2021) forecasts stand at 5.9% and 6.0% respectively, very close to the official government one. The most recent forecast issued by World Bank stands at 5% in late April. The private sector's view is less optimistic (Latest Focus Economics survey: 4.5%).
- **Cryptocurrency regulation**: In recent years, Turkey has been experiencing a crypto-currency trade boom. Appetite for crypto-currency assets has been driven by the depreciation of the domestic currency, high inflation, which erodes incomes and assets and the young population's eagerness to adopt new technologies. Following the collapse of two local cryptocurrency exchanges and the ban of cryptocurrency-based payment services, authorities are reportedly planning to introduce new regulations.

According to a Bloomberg report citing an unnamed official, authorities are planning to establish a central custodian bank for cryptocurrency exchanges in order to eliminate counterparty risk and to impose minimum capital requirements as well as education prerequisites for executives in such firms.

- **Policy options**: 1) An *IMF program* seems out of the question according to the government rhetoric, but may become unavoidable at some point, if the situation keeps deteriorating, i.e. capital outflows and/or premature interest rate cuts resume; 2) The imposition of *capital controls* is a politically toxic, short-sighted solution and entails heavy political cost. Some argue that it is not even a feasible solution given the lack of infrastructure and experience to implement it, the low residents' capital outflows, the level of access of private companies to foreign banks and the damage to the foreign investors. Instead of capital controls, authorities could reinstate tough restrictions to deter speculators from shorting the lira; 3) *Bilateral agreements*: Turkey could negotiate the upgrade of existing bilateral agreements or appeal to other countries willing to do so. According to press reports, the central banks of USA, Japan and UK have allegedly declined to establish swap lines in the past. But even if Turkey were able to strike such agreements, they would only be a temporary fix; 4) *Return to orthodox policies:* If the new governor and the Minister of Finance Lufti Elvan (who was appointed together with the ousted official) fail to restore the investment's community confidence, they could be replaced again in order to facilitate the return to more orthodox policies. In either case, whether they remain in their posts or not, Turkey will struggle to regain its credibility and appeal to foreign investors.
- **Economic repercussions:** Turkey's idiosyncratic issues are expected to have a short-lived negative impact on EM markets. Yet those issues are illustrative of the challenges that EMs are confronted with in a time of rising US yields. Raising rates appears to be a politically difficult to implement decision, which leaves the exchange rate vulnerable to depreciation pressures. In turn, those who are borrowed in FX, will struggle more to service their debts. In the case of Turkey, this is reflected on the private corporate sector, which is more exposed. In addition, the lira depreciation will hurt appetite for Turkish assets. European banks are also exposed in the country. Spain, France, UK and Germany are the most exposed countries with \$60bn, \$26bn and \$13.5bn and \$12.8bn respectively, while the Spanish bank BBVA in particular has over 10% of its group loan portfolio located in Turkey. On the other hand, the lira depreciation will benefit the export-oriented industries of the country. From a microeconomic point of view, the lira depreciation will most probably give a price competitiveness boost to domestic industries against international competitors. One of them carries a significant weight in the export basket of Greece: *Tourism.*

II. The impact of the Covid-19 pandemic to the economic potential of the euro area

Following a large hit in global economic activity during 2020 due to the Covid-19 pandemic, global economic activity is expected to advance by about 5.5% in 2021 remaining however more than 3.5% below pre-pandemic projections. Global growth is projected to moderate to around 4.2% in 2022, dragged down by the pandemic's permanent damage to potential growth, while - according to the latest IMF's forecasts - world GDP is anticipated to be about 3.0% lower even in 2024 than pre-crisis projections suggested. The Covid-19 crisis and the associated restrictive measures to limit the contagion are likely to affect most components of potential output[1], although the expected output losses in the medium term from the pandemic shock should exhibit significant variation across economies and regions. Countries with more expansionary fiscal policy measures are projected to experience smaller GDP losses, while economies that are more reliant on tourism and services are expected to experience more persistent losses.

Bodnár et al. (2020)[2] provide an overview on the theoretical background of the channels of impact of the Covid-19 crisis on the euro area's potential output. Supply chain disruptions can reduce the effective productive capacity of the economy and businesses might need to reorganize production in order to increase the physical distance between workers or find new suppliers or transport routes. The role of monetary policy interventions is of vital importance for preventing the destruction of productive capacities following large negative shocks (Vinci and Licandro, 2020)[3]. Furthermore, the liquidity strains due to the lockdown measures result in rising firm exits, with persistent unemployment leading to productivity losses should displaced workers' reallocation to other firms be slow and workers' skills deteriorate in the long run. Fatás and Summers (2017)[4] provide some evidence of this kind of hysteresis effects. The short-time work (STW) schemes adopted in many European countries could limit hysteresis and persistent damage (scarring) in the labour market, but as targeted support is gradually scaled back there could be a more persistent rise in the non-accelerating inflation rate of unemployment (NAIRU).

On the other hand, the Covid-19 crisis could adversely affect the capital stock of the economy by lowering investment, as heightened uncertainty could weigh on investment decisions. Sectors that are affected the most by the decline in activity due to the Covid-19 crisis (manufacturing, food and beverage, retail, accommodation, transport, travel) have historically contributed the most to developments in the euro area productive capital stock. Hence, the rapid contraction witnessed in H1 2020 in these sectors could lead to

[1] Potential output is defined as the maximal level of activity that an economy can sustain at current technology, capital stock and labour supply, without causing rising inflationary pressures.
[2] Bodnár K., Le Roux J., Lopez-Garcia P. and Szörfi B.., "The impact of COVID-19 on potential output in the euro area", ECB Economic Bulletin, July 2020.
[3] Vinci, F and O Licandro (2020), "Switching-track after the Great Recession," CFCM Working Paper 02/2020.
[4] Fatás, A and L H Summers (2017), "The Permanent Effects of Fiscal Consolidations," Journal of International Economics 112: 238-250.

a permanent reallocation of capital, with the overall effect on potential output largely dependent on how persistently investments are finally affected.

Recognizing the likelihood of medium-term scarring effects on the potential output, the ECB published its latest economic projections at its March monetary policy meeting under two scenarios (Table 1), presenting alternatives to the ECB staff projections baseline and demonstrating a range of plausible impacts of the Covid-19 pandemic on the euro area economy. According to the mild one, which envisages a more successful vaccine roll out and faster learning effects that limit the economic costs, a phasing out of restrictive measures by the end of the year allows real GDP to rebound by 6.4% in 2021 and reach its pre-crisis level in Q3 2021, with inflation rising to 1.7% in 2023. On the contrary, under the severe scenario, which assumes new variants of the virus and lower effectiveness of vaccines that lead governments to keep some containment measures until mid-2023, real GDP would advance by a mere 2.0% in 2021 and would not reach its pre-crisis level until at least 2023 (inflation projected at just 1.1% in 2023), with substantial and permanent losses to economic potential.

Table 1: ECB's alternative macroeconomic scenarios for the euro area March 2021

(annual percentage changes, percentage of labour force)

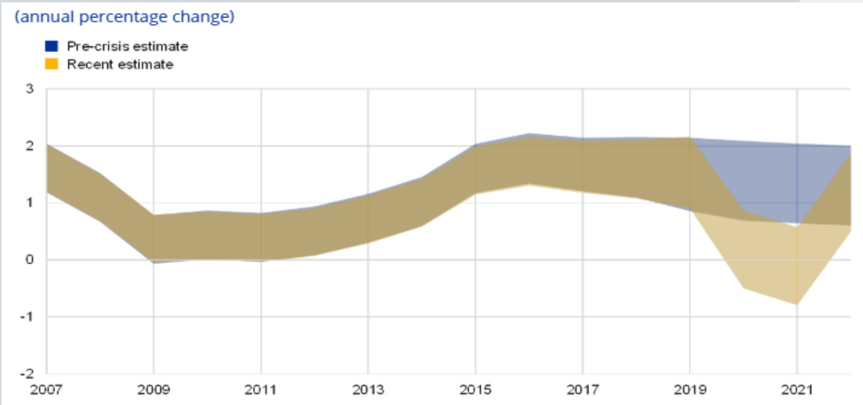
	March 2021 projections											
	Mild scenario				Baseline scenario				Severe scenario			
	2020	2021	2022	2023	2020	2021	2022	2023	2020	2021	2022	2023
Real GDP	-6.9	6.4	4.5	2.2	-6.9	4.0	4.1	2.1	-6.9	2.0	2.2	2.5
HICP inflation	0.3	1.6	1.5	1.7	0.3	1.5	1.2	1.4	0.3	1.5	1.0	1.1
Unemployment rate	7.8	8.2	7.2	6.6	7.8	8.6	8.1	7.6	7.8	9.0	9.3	8.7
	December 2020 projections											
	Mild scenario				Baseline scenario				Severe scenario			
	2020	2021	2022	2023	2020	2021	2022	2023	2020	2021	2022	2023
Real GDP	-7.2	6.0	4.3	2.1	-7.3	3.9	4.2	2.1	-7.6	0.4	3.0	2.9
HICP inflation	0.2	1.1	1.3	1.5	0.2	1.0	1.1	1.4	0.2	0.7	0.6	0.8
Unemployment rate	7.9	8.8	7.5	6.9	8.0	9.3	8.2	7.5	8.1	10.3	9.9	9.4

Source: ECB

The December 2020 CfM (Centre of Macroeconomics)-CEPR survey asked its panel of macroeconomic experts on the European economy to estimate the loss in the level and growth rate of potential GDP in the euro area due to the Covid-19 pandemic. A majority (51%) of the CfM-CEPR panel predicts a 2-5% decline in the level of potential Eurozone GDP in 2025, but no impact on the potential long-run growth rate. The more pessimistic responses highlight that GDP losses in deep recessions are usually permanent, recognizing that factors that are unique to Covid-19 may have a longer-term effect compared to other crises. On the flipside, the optimists noted that Covid-19 may also be viewed as a creative destruction shock, upgrading IT skills and equipment and accelerating the transition to greener technologies. The impact of Covid-

19 on potential GDP will largely depend on policy responses to minimize negative effects, that so far have been appropriate, but there are doubts whether they can be continued long enough without causing rising inflationary pressures and high levels of indebtedness.

Figure 4: Euro area potential growth

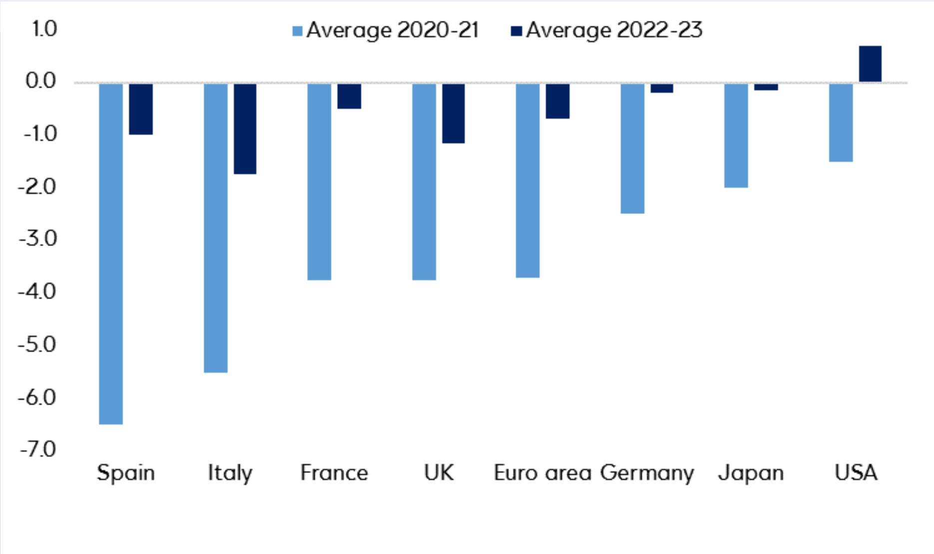


Source: ECB, Bodnár et al. (2020)

Potential growth in the euro area seems to have been adversely affected during the current Covid-19 crisis, based on quantitative estimates of Bodnár et al. (2020), although the scale of this impact is highly uncertain. Potential output estimates were in the range of 1.0%-2.0% annually during 2020-2022 at the end of 2019, based on the Eurosystem staff macroeconomic projections of December 2019. According to the latest estimates based on the September 2020 staff macroeconomic projections, potential growth would average between -0.3 and 1.1% annually during 2020-2022 due to the Covid-19 crisis (Figure 4). Hence, the impact is estimated about 0.9-1.3% per year, larger than the one during the great financial crisis when potential growth fell by somewhere between 0.0%-0.7% per year. It is worth noting that potential output has dropped much less than real GDP since the Covid-19 crisis began, resulting in a sharp decline in the output gap that points to considerable slack in the economy (Figure 5).

To conclude, the amplitude of the economic damage of the Covid-19 crisis in the short term depends largely on how much restrictive measures are going to weigh on potential output. In the long run, the severity of the Covid-19 impact seems highly associated with, inter alia, the eventual duration of the pandemic and the extent to which policy measures will be able to prevent excessive scarring as vaccine coverage improves and supply constraints ease. Fiscal support must be targeted to address supply constraints across sectors affected by the crisis, while government investment should boost both supply and demand as the supply constraints ease. Based on each country's fiscal space, policymakers should tailor their response to help affected households and firms by encouraging employment, supporting productivity and boosting investment.

Figure 5: Output Gap Projections in advanced economies, 2020-23 (% of potential GDP)



Source: IMF, Eurobank Research

Eurobank

Eurobank Research

Macro Themes & Implications in CESEE

The CESEE region crossed the turning point on tackling the third wave of Covid-19 infections, creating expectations that some of the lost ground will be covered in H2-2021

As of late April – early May 2021, the epidemiological situation in many countries of the Central, Eastern and South-eastern Europe (CESEE) looked much better than a month ago signaling that the region has crossed the turning point. In the past two months, multiple countries across the region have been confronted again with an exponential rise in Covid-19 infections, hospitalizations and fatalities that hit new record highs. The latest wave of infections - the third since the start of the pandemic - is mostly related to the virus's mutations. The sharp deterioration has put the CESEE region in the epicenter of global media attention during the "third wave", because these countries were hit disproportionally harder than their Western Europe peers.

The reinstated stringent health and social distancing measures and restrictions on public and economic activities have had a positive impact in containing the virus spread across the region. The resurgence had also rendered some of these countries' authorities more cautious as regards their reopening plans. Nevertheless, under public pressure and growing opposition to restrictions or, in some cases, relatively better epidemiological conditions, some went ahead with relaxing the restrictions. This is illustrated in the trajectory of the Stringency Index, a composite measure by Oxford COVID-19 Government Response Tracker (OxCGRT), which records the strictness of government policies.

The improvement of the epidemiological conditions together with the smooth execution of vaccination programs across the CESEE region, raised expectations for a more pronounced growth rebound in H2-2021. The resurgence of infections has most probably put a break on the pace of recovery – not limited to the services sector – given that restrictive measures, which had a negative impact on the economic activity in Q1-2021, have already remained in place for the larger part of Q2-2021. On top, most countries have accelerated their vaccination programs converging to the EU average as of late April. Thus, the CESEE region is now expected to cover some of the lost ground in H2-2021 under the assumption that vaccination programs remain on track. Although the rollout of vaccinations had initially spurred more optimism for the growth prospects of the broader CESEE region in 2021, full return to normal conditions will most probably take much longer to materialize. The logistics of the production, distribution and execution of the vaccination program on such a massive scale have required additional investments and time, leading to further delays. There are two notable exceptions to that, Serbia and, more recently, Hungary. As of early May, Serbia ranked first in the vaccination race and Hungary second having provided at least one dose to 50.5% and 29.8% of their population respectively. In both cases, the procurement of vaccines from China and Russia made the difference, avoiding supply bottlenecks.

The April economic sentiment of the region lured market attention in the past week. Having been on a rising trend in Q1-2021, sentiment indicators continued their strong recovery in the past month, climbing above their pre-pandemic levels for the first time since the Covid-19 outbreak. On the positive side, economic sentiment readings in many countries have now surpassed their long-term average. However, on average, the pace of improvement is uneven across the CESEE region and more importantly, it still lags behind the Euroarea. Obviously, these readings convey a message of restrained optimism for the economic outlook and we will be looking for that to be confirmed in the hard data of the concurrent month. Yet the pandemic is still far from over and the road to normalization is still full of challenges. However, the approval and the distribution of a number of vaccines since December has been a game changer. Moreover, the smooth execution of vaccination programs in most cases – albeit at a slower pace than anticipated given the urgency of the matter – has lifted the depressed morale of consumers and corporates and boosted their optimism for the period ahead. In some cases, the partial lifting or plans' announcement for partial lifting of restrictions has also helped. Although the improvement was broad-based, the improvement in industry expectations outpaced that of services and consumers on a monthly basis.

CESEE Markets Developments & Outlook

Bulgaria

Eurobonds demonstrated mixed movements during April, with shorter tenors such as the 2023 and 2024 papers having their yields sliding by 3 and 1 bps respectively. Meanwhile, the medium term and longer maturities all posted increases in their yields, with the most prominent being the 2027 paper with a 7 bps rise and the 2035 and 2050 bonds with a 10 bps spike in their yields. The Ministry of Finance did not hold any auctions during the month of April, while any future auction remains unpredictable as long as there is no stable government in power. Parliamentary elections ended in a stalemate, with neither of the big parties being able to form a coalition government. That said, the President, Rumen Radev announced snap elections in July and is about to appoint a caretaker government.

Serbia

With the economy remaining on track, no structural changes are expected in the current policy of managing the FX space. The robust growth dynamics so far are leading to strong FX reserves, which in turn assist in keeping the FX rate volatility in check. In terms of government papers, the market drivers stopped being locally driven a long time ago. With decompressed rates globally, little change is observed and anticipated in the government papers as well. What is considered as a potential game changer in the local markets is the political risk factor, given the publications in the press that question the quality of the rule of law in the country. Also, the Kosovo issue still represents a major headwind for the country as it delays, among others, the progress towards the EU accession and any sort of solution is still far from sight.

Markets View

Foreign Exchange

EUR/USD: During April the cross made an impressive recovery from the lows of 1.1725 up to 1.2140 before retreating again to 1.2015 on the last day of the month. The EUR rally was directly correlated to the European yields outperformance versus the US yields and now the pair exhibits a medium- to long-term positive technical picture, again viewing the January highs of 1,2250. However, the short term technical picture turned bearish on the last day of the month and the May seasonality points to USD strength in the next period. The support level comes at 1.1850 and it should hold in order for the pair to remain constructive in the medium term. The first resistance level comes at 1.2058 and should it give way, the next target is the 1.2200 level and then the January highs of 1.2350. Implied volatility further retreated and has now approached very low levels, only seen 3 more times in the past.

GBP/USD: The pair moved in an upward fashion during April, mainly due to USD weakness rather than GBP strength. The overall technical picture remains constructive, however, seasonality factors might kick in, as the USD tends to be strong in May at 75% of the time. Support levels come at 1.3750 and resistance at 1.4000. Volatility has also retreated at very low levels unseen since February 2020.

Rates

EU: EU rates rose in April for a fourth consecutive month. The 10y swap rate is trading above 10bps vs 5bps in March. Despite the higher rates, the slope of the curve remained anchored with the 10s-30s trading at 41bps. Looking forward we expect the bear steepening move to persist and the selloff in the long end rates to continue towards 60 bps, as EU countries are expected to lift travel restrictions and allow tourism to reopen. A potential risk to this view could be another wave of Covid-19 infections related to the India variant.

US: US rates fell sharply in April with the 10y swap rate trading at 1.60%, having traded as low as 1.54%. The shift of the curve remained at the same levels with March, with 5s-30s hovering around 115bps. Looking forward we expect the US rates to consolidate at these levels post Janet Yellen's comment about "no inflation problem at the time". The 3 month implied volatility of the 10yr swap rate is trading marginally lower, at 75bps vs 82bps in the previous month. It is expected to remain high, given that recovery in US depends on addressing global vaccination inequality.

Emerging Markets credit

The stabilization and retracement lower in US rates was supportive for total returns in EM external debt sovereign bonds. Volatility has remained low with the exception of some country-specific risks. EMBI Global

Index is currently at 316bps, almost 10bps better than the beginning of the month. In CEEMEA the Turkey cash curve bull steepened and the CDS tightened, particularly after the CB promised a tight policy. In Latin America, spreads were mixed as the low speed of vaccinations is counterbalanced by the strong US growth, low inflation and high commodity prices. Peru was the obvious underperformer as the radical left candidate Castillo leads the polls of June elections. In Asia, the second Covid19 wave raises serious concerns about India's recovery as daily cases have dramatically increased leading to new lockdowns and night curfews. South Africa has outperformed peers, as the budget published has been a positive surprise. We believe that the current environment seems positive for EM carry trades in the short term, even though spreads remain at tight levels. Countries with successful vaccination programs will outperform their peers.

Corporate credit

EUR IG cash corporate spreads were mostly unchanged to slightly tighter in March, with lower grade and higher yielding credits generally outperforming the higher grade ones. CDS spreads were also tighter on a roll-adjusted basis, outperforming cash, with compression between HY and IG indices, on admittedly already tight valuations. ECB increased its buying rate and support early month, while supply was in general well absorbed during the month. Again, credit underperformed the moves in equites, while higher and steeper rates curves especially in US put pressure on longer duration, and some very tight high rated names. Spreads grinded slowly tighter rather uniformly throughout the month. US IG names spread moves were skewed towards unchanged to wider levels, with core Financials +5/8bps wider followed by Basic Materials and Real Estate ~+3bps wider, while Telecommunications, Oil & Gas and Consumer Services were -3bps tighter. Rest of sectors were broadly unchanged. In EUR IG, Automobiles & Parts were the outperformer -4bps followed by Travel & Leisure -2bps, while Personal household goods (in Consumer goods) were +6bps wider, making it the underperformer. Other major sectors were -1/+1bps generally.

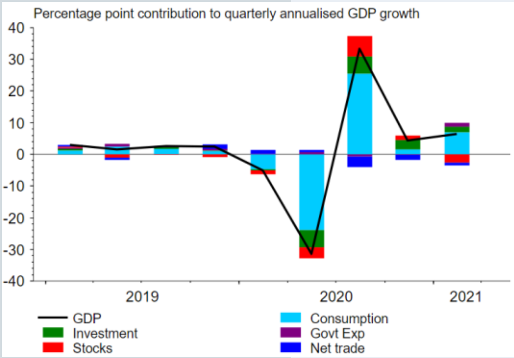
Rating-wise BBB- EUR cash paper was -3.5bps tighter, making it the outperformer of the IG universe, with other grades mostly unchanged (BBB -0.5bps, BBB+ -1bps, A- -0.5bps, A -1bps, A+ unchanged, AA- unchanged, AA +1bps, AA+ -2bps). In the EUR HY universe CCC was -10 bps tighter, B -60bps, while BB was mostly unchanged. Technical for cash continues to remain strong, with subdued supply expected in April, and ECB support and liquidity still there, both being major tailwinds. EUR rates, despite the recent moves, are still on check, and this is also expected to be supportive going forward. We therefore expect that spreads will trade mostly range-bound to slightly wider in the coming month from current very tight valuations. Potential sources of widening, apart from surprise and idiosyncratic events, might come from higher rates and inflation expectations, a subsequent reaction of the equities market, and then a feedback into wider credit, mostly on the US front. Mid-term expected spread direction is range-bound to moderately wider and steeper, given the reopening trade is still on, and inflation expectations and rates are adjusted higher.

USA

Economic activity in H1 is set to strengthen more than previously expected, boosted by a faster vaccine rollout and further fiscal stimulus measures

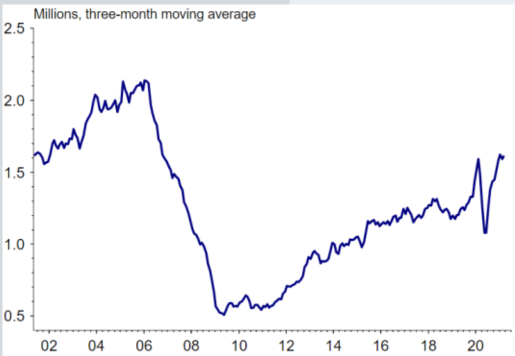
Q1 GDP growth accelerated to 6.4%QoQ saar from 4.3%QoQ in Q4 2020, with private consumption (+10.7%QoQ) and fixed investment (+10.1%QoQ) being the main growth drivers. March retail sales advanced by a firm 9.8%MoM, reflecting a payback from falling sales in February due to adverse weather conditions and a significant boost to household incomes from rebate checks under the American Rescue Plan of 2021. According to the Internal Revenue Service, three batches of Economic Impact Payments had been distributed ($1,400/eligible individual) from 12 to 26 March, totaling $335bn. A robust labor market recovery began earlier than previously anticipated, with higher confidence leading to solid job gains in Q1 2021. Nonfarm payrolls rose by 916k in March, following a 468k increase in the prior month, on the back of a sharp rebound in the leisure and hospitality sector, while the unemployment rate fell to 6.0%, down from 6.7% at the end of Q4 2020. Initial jobless claims fell by 193k to 576k in the week that ended on April 10, the lowest reading since the pandemic started in March 2020, sending out a positive sign for April payrolls. Meanwhile, the underlying momentum of housing activity appears to be strengthening, with both housing starts and permit issuances for new construction rising to the highest level in more than 10 years. Nevertheless, IP's weaker-than-expected performance in March (+1.4%MoM after -2.6%MoM in February) is a sign of escalating supply constraints, partly due to the global shortage of semiconductors. Stimulus payments received in late March should boost spending further into April, with a double-digit annualized growth rate expected in Q2. Assuming that the current rate of vaccinations is maintained and ca. 75% of citizens over 12 years of age are vaccinated by July 2021, we expect a GDP growth acceleration to 6.5% in 2021. On the monetary front, although acknowledging that economic and labor market conditions have strengthened and inflation has risen (largely due to temporary factors) since the start of the year, the Fed repeated at the April meeting that it will keep buying Treasuries (at least $80bn/month) and MBSs (at least $40bn/month) until there is considerable further improvement toward its dual mandate, making any discussion for tapering of asset purchases unlikely any time soon.

Figure 6: US GDP breakdown



Source: Refiniv Datastream, Fathom Consulting, Eurobank Research

Figure 7: US Housing starts



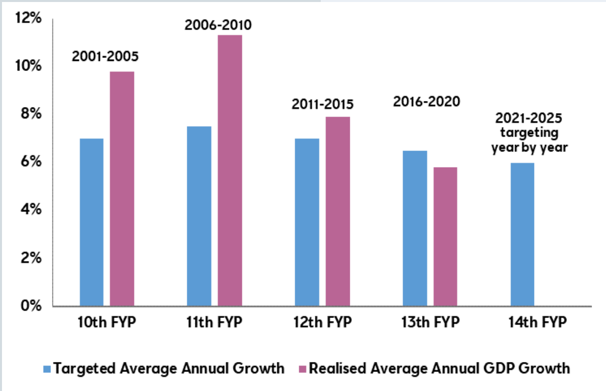
Source: Refiniv Datastream, Fathom Consulting

China

In the last 12 months, the economy has moved from record lows to record highs

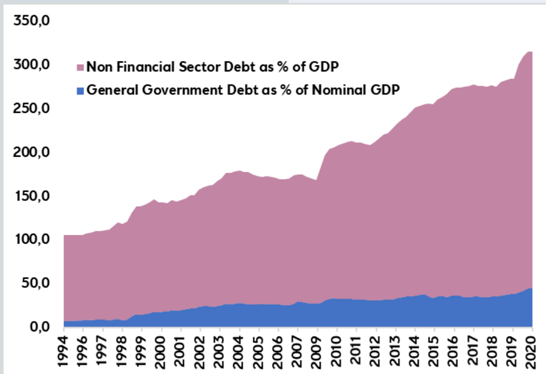
The economy expanded by +18.3% YoY in Q1-2021 compared to +6.5% YoY in Q4-2020. The print - the highest quarterly year-on-year growth rate since data began being published in 1993 - was largely in line with the expectations of the market consensus (18.5% YoY) when only one year earlier, at the beginning of the pandemic, the economy was posting a 24-year record GDP contraction. The GDP print came along additional hard data, among which industrial production and retail sales as of March, with the former losing some steam since the beginning of the year and the latter continuing to gallop. Industrial production expanded by 14.1% YoY, slowing down from a 35.1% surge in January and February, while retail sales grew by 34.2%YoY, up from 33.8%YoY in the first two months of the year and above market forecasts. In terms of soft data, as of April, the landscape remains a bit mixed as well. Both the official manufacturing (51.1 from 51.9 in March) and non-manufacturing (54.9 from 56.3 in the previous month) PMI gauges remained comfortably in expansionary territory, despite some easing, and the Caixin PMI pointed to an acceleration in recovery coming in at 51.9 from 50.6 a month ago. In this context, China's Communist Party (CCP) Politburo, one of the flagship political events of each year, was held in late April with the key takeaways summed up as follows: i. the government is in search of the right window of opportunity to implement costly reforms, such as deleveraging and ii. the motto "continuity, stability and sustainability" regarding the economic policy mix has been reaffirmed. Concluding with the pandemic, by mid-April, the vaccination rate had climbed to 12.2%, which may be the eighth highest in the world but is still far from the goal of vaccinating 560 million people, or about 40% of the population, by the end of June. The initial obstacles in mass production have given their seat to increased doubts among the Chinese people over the efficacy of the jab, as recent official announcements in the press inferred a low level of protection.

Figure 8: More modest and flexible GDP growth targeting between 2021 and 2025...



Source: State Council, National Bureau of Statistics, Eurobank Research

Figure 9:...as private debt accumulation over the years casts shadows on the financial stability



Source: National Institution for Finance and Development, Eurobank Research

Euro area

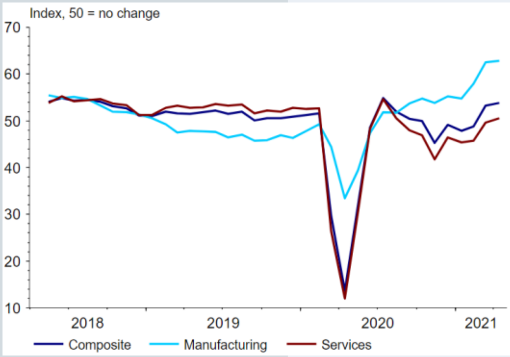
An economic rebound is expected in H2, as the easing of mobility restrictions and rising confidence leads to growing domestic demand

The preliminary Q1 estimate suggests that euro area has entered a technical recession, with real GDP falling by -0.6%QoQ after a -0.7%QoQ decline in Q4 2020, as mobility restrictions to contain the spread of the virus seem to have weighed heavily on personal consumption. Although February industrial production data (-1.0%MoM) point to existing supply constraints, in part due to the global shortage of semiconductors that weighs on motor vehicles output, stronger industrial production is expected in the months ahead, with manufacturing orders boosted by global manufacturing strength. Leading indicators point to an accelerating underlying momentum, with both the composite PMI and the EC Economic Sentiment Indicator (ESI) pointing to an outperformance of the services sector. Final PMI Composite advanced to a 9-month high of 53.8 in April from 53.2 in March, as PMI services rose to an 8-month high of 50.5 from 49.6 in March, surpassing the threshold of 50.0 that distinguishes expansion from contraction for the first time since last August, while PMI manufacturing increased by 0.4pts to a record high of 62.9. Meanwhile, the ESI surged to a 13-month high of 100.9 in March from 93.4 in the prior month, recording the strongest monthly increase since June 2020 due to broad-based strength across sectors. Overall, the euro area economy is expected to rebound strongly beyond Q1, although the re-tightening of restrictive measures in April and the gradual reopening in May increase the risk for a Q2 GDP growth below consensus estimates of 1.8%QoQ. With the vaccinations' pace picking up further so that 70% of the adult population will be fully protected by September 2021 at the latest, economic activity should accelerate particularly in Q3 as the easing of restrictions and rising confidence leads to growing domestic demand, with overall GDP growth projected at 4.0% in 2021. The lack of high inflationary pressures should support the ECB's ultra-accommodative monetary stance. As expected, the ECB maintained its policy at the April meeting, providing no sign on whether the higher PEPP pace will be extended through Q3. We expect large-scale asset purchases in the months ahead, but the exact QE pace will largely depend on the economic developments, with the focus centred on financing conditions as well as the inflation outlook.

Figure 10: Economic Sentiment and GDP

Source: Refiniv Datastream, Fathom Consulting

Figure 11: PMI manufacturing hits a new record high in April



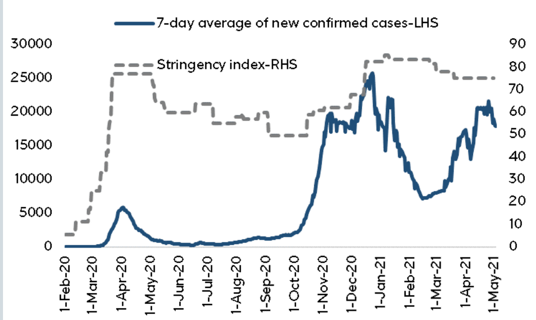
Source: Markit, Refiniv Datastream, Fathom Consulting

Germany

Third wave of infections likely to remain a drag on GDP growth in the short-term

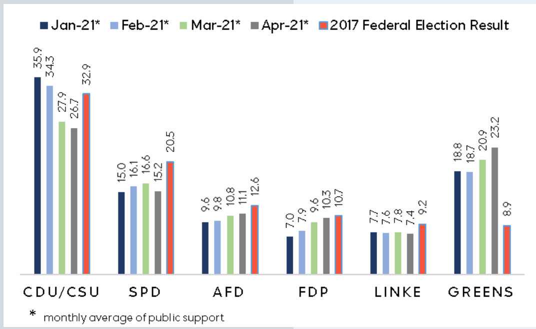
Germany is struggling to contain a third wave of infections, with the 7-day average having stabilized at around 20,000 cases, just under the post-Christmas peak of mid-January. To that end, the parliament voted in support of the government's proposed "federal emergency break" law that forces all 16 federal states to follow the so-called emergency brake jointly decided on March 3, rigidly based on a 7-day incidence rate of above 100 per 100,000 inhabitants. In light of a probably prolonged lockdown and possibly tighter restrictions in the coming weeks due to the automatic application of the emergency break at the municipality level, risks are skewed for a modest positive growth rate in Q2 following a 1.7%QoQ GDP contraction in Q1 that was driven primarily by weaker private consumption. This view is also supported by the virtually unchanged April's IFO business climate (96.8 from 96.6) following hefty gains in the prior two months and the modest decline in the April Manufacturing PMI (66.2 from 66.6). The recovery is unlikely to gain real momentum before late May, when the faster pace of vaccinations is expected to allow a gradual reopening of the economy, with GDP slightly exceeding 3.0% for the full year. On politics, the latest opinion polls suggest that the Conservatives' lead over the Greens has evaporated in recent weeks and the CDU/CSU coalition may finish second at the September elections. In that case, the coalition would move into opposition for the first time since 2005, amid broad dissatisfaction over the handling of the pandemic, an earlier scandal involving purchases of face masks and the public perception that CDU leader Armin Laschet, who was elected as the party sisters' chancellor candidate over the more popular CSU leader Markus Söder, may lack the potential to lead Germany. On the flipside, The Green Party is steadily gaining ground and may emerge first in the upcoming elections, claiming the Chancellery for the first time in its 41-year history. While an outright majority seems unlikely, the Greens could hold a key position in the formation of a new federal government. This development could have important repercussions for Germany and the euro area as a whole, considering that a much deeper EU integration, a reform of the German debt brake to allow more public investment and an easing of fiscal rules in the euro area, are among the central elements in the party's election programme.

Figure 12: Germany is struggling to contain a third wave of infections



Source: Our World in Data (OWID) Eurobank Research

Figure 13: Conservatives' lead over the Greens has evaporated



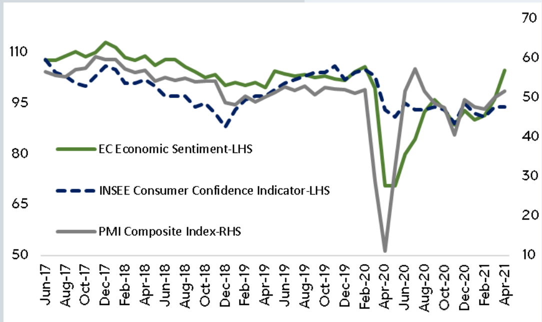
Source: Press, Eurobank Research

France

Sentiment indicators appear resilient to the third national lockdown

The recent flow of sentiment indicators pertaining to the first month of Q2 have surprised positively, suggesting that households and businesses have gotten accustomed to the pandemic-related containment measures, reducing thus their adverse impact on GDP growth. Indicatively, the EC economic sentiment indicator rose by 8.5pts to 104.5, the highest level since February 2020 when the Covid-19 outbreak started, while the INSEE household confidence was stable at 94 against market consensus for a modest drop on the back of a clear deterioration in mobility data. Finally, the April Composite PMI unexpectedly improved (+1.6pts to 51.6) led by the services component, which returned to growth territory for the first time since last August (+2.6pts to 50.4). Meanwhile, despite the still high level of new Covid-19 cases and the still challenging healthcare situation, President Emmanuel Macron announced his intention to deliver on his promises for a gradual reopening of the economy from May 3, presumably on the view that the faster pace of vaccinations and earlier activity restrictions will result in bringing the third Covid-19 wave under control.

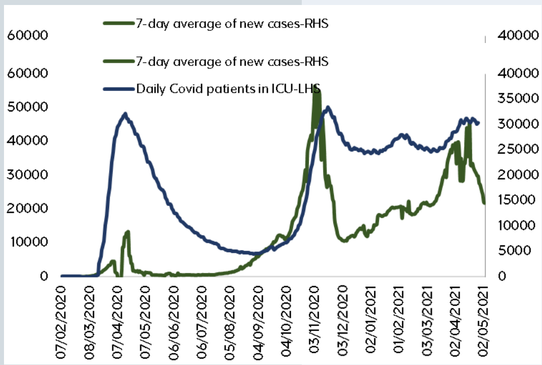
Figure 14: Sentiment indicators for April have surprised positively



Source: INSEE, European Commission, Eurobank Research

Against this background, the expected Q2 GDP growth contraction caused by the four-week national lockdown that the government imposed in April to contain the third Covid-19 wave, is likely to prove rather mild following modest growth of 0.4%QoQ in Q1 mainly driven by a pickup in investment which broadly offset a weakening in net exports. In any case, it will take until Q3 before herd immunity has been achieved, leading to the lifting of restrictions and a boost in confidence, that could push the GDP growth rate to 5.4% for the whole year. France submitted its National Recovery and Resilience Plan (PNRR) to the European Commission, worth c. €40bn of investment (mostly allocated to climate protection and digital transition) that will be claimed from the Recovery and Resilience Facility, alongside a reform strategy (i.e. housing policy reform, new climate law) aiming to boost the country's growth potential. The disbursement of the c. €5bn advance is expected to be obtained by September. EU flows will finance part of France's €100bn so-called "Plan de Relance" national Recovery Plan (4.4% of GDP for the 2020-2025 period).

Figure 15: Still challenging healthcare situation



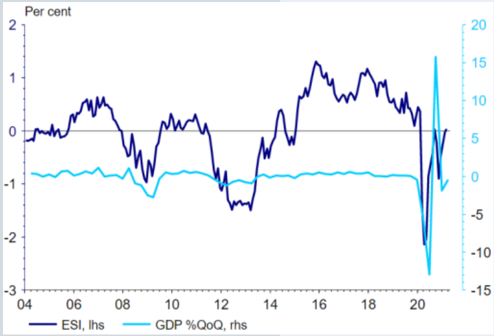
Source: Our World in Data (OWID), Eurobank Research

Italy

A strong rebound is expected in H2 2021, as restrictions gradually ease in May

According to the preliminary Q1 estimate, real GDP declined by 0.4%QoQ (-1.4%YoY), following a larger fall of -1.8%QoQ (-6.6%YoY) in Q4 2020, with domestic demand adding positively to overall growth in contrast to net exports which acted as a drag. The ISTAT's press release points to an increase of value added in the industrial sector but a decrease in services. This is in line with the March PMI Markit, suggesting that the Italian services sector continued its downturn at the end of Q1, with the respective index falling further below the 50.0 threshold that distinguishes expansion from recession (to 48.6 from 48.8 in February) due to weak demand amid renewed Covid-19 mobility restrictions. Nevertheless, confidence in the services sector surged to its highest level in more than 10 years thanks to the vaccine rollout and expectations for a robust economic recovery. Meanwhile, the EC Economic Sentiment Indicator for March rose to a 13-month high of 99.5 from 94.6 in February, with the services sector outperforming. More specifically, the said services confidence indicator increased by a hefty 5.0pts to –11.9 on the month, followed by industrial confidence (+4.1pts to -2.8), construction (+3.5pts to -4.1) and consumer confidence (+2.1pts to -11.5), while the retail trade confidence indicator worsened marginally (-0.2pts to -7.3). Turning into Q2, soft data point to an economic rebound as Istat's consumer confidence surged to a 7-month high of 102.3 in April from 100.9 in March, while the PMI manufacturing hit an all-time high of 60.3 in April from 59.8 in March due to increasing demand and enhanced market confidence. Nevertheless, tighter mobility restrictions from mid-March to 26 April should partially weigh on economic activity in Q2, before rebounding strongly in H2 2021 benefitting from the gradual easing of restrictive measures that started in May. Looking to a domestic demand-driven recovery, the Italian government expects real GDP to advance by 4.5% in 2021 and 4.8% in 2022, returning to pre-pandemic levels by Q3 2022, with a significant deterioration in Italian public finances (budget deficit projected at -11.8% and debt-to-GDP ratio at 159.8% in 2021). Private investment should benefit from the Next Generation EU facility, with the Italian Parliament having approved the National Recovery and Resilience Plan that includes a total of €235bn (13% of GDP) in spending and structural reforms over the next six years.

Figure 16: ESI and GDP



Source: EC, Istat, Refiniv Datastream, Fathom Consulting

Figure 17: Consumer and Business Confidence

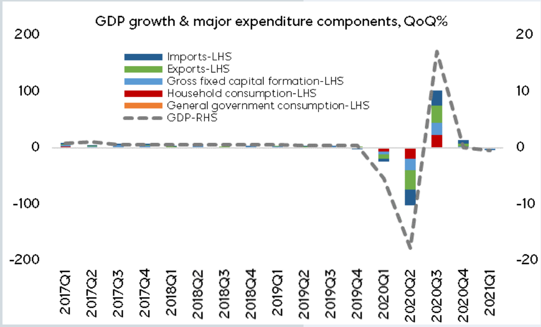
Source: Refiniv Datastream, Fathom Consulting

Spain

Economy set for a progressive recovery after modest contraction in Q1

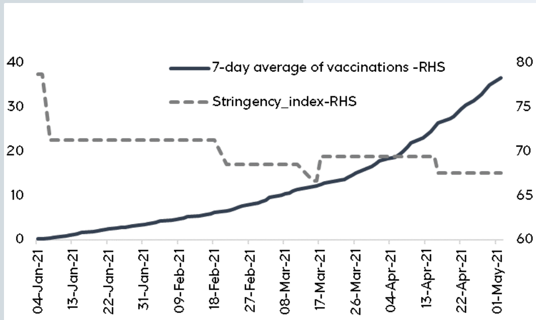
Spain's GDP dropped by 0.5%QoQ in Q1 following a flat figure in the prior quarter, translating into a positive carry-over of 2.2%YoY. In terms of the expenditure breakdown, pandemic-induced weakness in domestic demand was the main drag on economic growth. Investment dropped by 2.2%QoQ as a result of persistent elevated uncertainty over when the pandemic will run its course. Private consumption fell by 1.0%QoQ after an unchanged reading in Q4 2020, reflecting the impact of both tighter containment measures in the first few weeks of the year to combat the third Covid-19 wave and the weakening of the labor market conditions, as the high incidence of temporary labour contracts brought about redundancies. Supporting the above, social security affiliations, a good indicator for employment, fell in March for the second consecutive month (-45K), and declined by a higher-than-expected 0.8%QoQ in the period from January to March after a flat figure a quarter earlier. General government consumption was a growth contributor (+0.5%QoQ) along with net trade, as exports proved more resilient than imports (-0.1%QoQ vs. -1.3%QoQ) thanks to improving global demand, primarily led by China. Looking ahead, the significant pick-up of the vaccination pace (25.2% of the population has received at least one dose), improving weather and the gradual lifting of activity restrictions are expected to allow a progressive normalization of economic activity to begin in Q2. In support of the above, the April EC survey suggested that a strong rebound in economic activity seems to be underway driven by a recovery in all sectors, primarily in services (+23.2pts at 3.7). However, we do not anticipate a meaningful acceleration before Q3 as the economy will reopen supported by tourism and the release of domestic pent-up demand, taking annual GDP to 5.6% for the whole year. EU recovery funds are also expected to contribute to the post-pandemic economic recovery. Spain which is among the biggest recipients of the Next Generation EU facility has been allocated c. €140bn of funds, out of which €72.7bn will be in the form of grants and the rest in loans. As part of Spain's National Recovery and Resilience Plan (PNRR), the EU Commission has requested an overhaul of the labor market aimed at reducing the high share of temporary jobs.

Figure 18: Modest GDP contraction in Q1 driven by weakness in domestic demand



Source: Eurostat, Eurobank Research

Figure 19: Vaccinations pick-up pace & gradual lifting of restrictions favor growth prospects



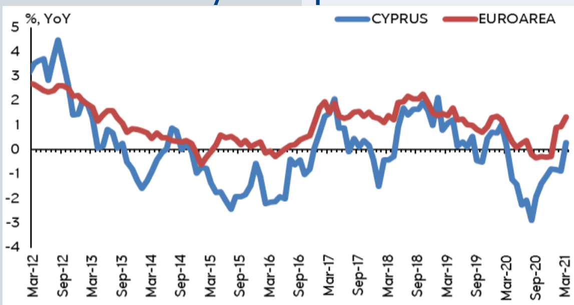
Source: Our World in Data (OWID), Eurobank Research

Cyprus

The rapid epidemiological deterioration leads to a general lockdown

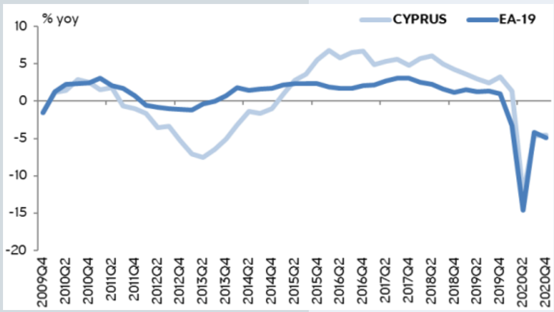
As of early April, the number of new cases and hospitalizations, which had stabilized at high levels in late March, began accelerating again. Thus the daily number of confirmed cases doubled from around 350 in late March to around 900 in late April. The rapid deterioration of Covid19 related metrics deterred the government from proceeding with any further relaxation. Instead, the government imposed a general lockdown, the third since the beginning of the pandemic, for at least two weeks ending on May 9 with small exceptions only applicable for the period of Easter. ECDC data show that 31.2% of the population – vs. 30.4% in EU/EEA – has received at least the first vaccine dose. The government aims to vaccinate about 60% of the population by the end of June, with Cyprus also posting one of the highest testing rates in the EU. The onset of the Covid19 pandemic ended a period of high growth averaging at 4.4% in 2015-2019. The latest international organizations forecasts have started adjusting their expectations for the future growth trajectory to reflect the prolonged pandemic impact. In its latest flagship WEO publication, the IMF downgraded its GDP growth country forecast in 2021 to 3.0% down from 4.7% in the previous report published in October 2020. In addition, the IMF now sees GDP growth at 3.9% in 2022 against 3.6% previously. According to the latest EC winter economic forecasts (February 2021), the economy is anticipated to rebound by +3.2% in 2021 (vs. 3.7% in the autumn 2020 forecast) and +3.1% in 2022 (vs. 3.0% in the autumn 2020 forecast), below the Euro area. Mirroring the deep recession and the government's support measures to cushion the impact on the economy, the country's fiscal position shifted into a deficit after several years of surpluses. The general government recorded a €1,059mn deficit in 2020 or -5.0% of GDP compared to a €325.9mn surplus or +1.5% of GDP in 2019. This led to a significant increase in general government debt to around 118% at the end of the year up from 94% in 2019. According to the latest PDMA report, the 24ppts rise can be attributed to the increase of the cash buffer by 13ppts, the decrease of nominal GDP by 6ppts and the fiscal deficit by 5ppts. Despite the rise, the weighted average cost of public debt servicing reached an all-time low, benefitting from liability management transactions, the low interest rate environment in the European capital markets and the improved credit rating profile of the Republic. Thus, the weighted average cost declined to 1.8% in 2020 down from 2.2% in 2019 and 2.7% in 2015.

Figure 20: HICP inflation has been in negative territory since April 2020



Source: Eurostat, Eurobank Research

Figure 21: GDP contraction in Q4-2020 was in line with Euroarea



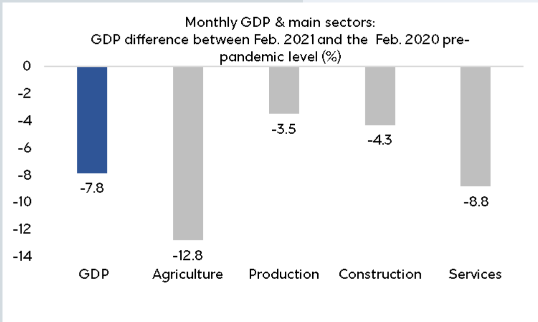
Source: Eurostat, Eurobank Research

UK

Poised for a vigorous GDP rebound this year on impressive vaccine rollout

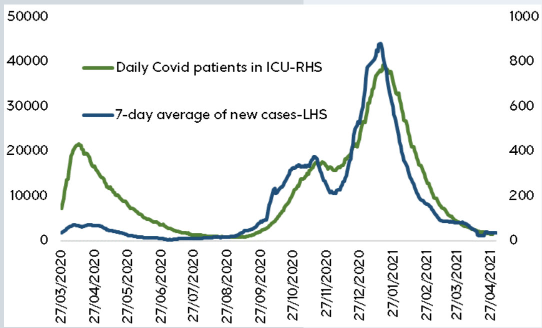
UK GDP rose by just 0.4%MoM in February as the economy remained in lockdown for the entire month and the level of restrictions affecting economic activity remained broadly unchanged compared to January. The services sector grew marginally, by 0.2%MoM, remaining 8.8% below the February 2020 pre-pandemic level. Stronger growth came from both industrial production, which rose by 1.0%MoM primarily driven by manufacturing, and construction, which increased by 1.6%MoM, mostly thanks to new work and repair/maintenance. While the February expansion was modest, January's GDP data were revised significantly higher, showing a fall of -2.2%MoM in output from -2.9%MoM initially reported, entirely due to the firmer services sector and, in particular, hospitality. The limited rise in February's GDP should give way to a bigger increase in the level of GDP in March since social restrictions started to ease, according to the government's lockdown relaxation plan, on account of: (i) the impressive pace of the vaccine rollout that has been the quickest amongst European countries (over 50% of total UK population has received at least one shot of the vaccine); (ii) low infection rates (the 7-day average of new confirmed Covid-19 cases has remained largely constant at around 3,000 for the last two weeks) and; (iii) subdued hospital admissions. If our view of March GDP proves to be correct and taking into account the significant upward revision in January's GDP, Q1 GDP is highly likely to outperform the BoE's projection for a 4.2%QoQ growth contraction. Looking ahead, forward looking indicators of economic activity (PMIs and GfK consumer confidence) point to a further rebound in April, as the economy moved to the second stage of the government's lockdown easing plan with further restrictions lifted, including, the re-opening of non-essential retail, indoor gyms, personal services and outdoor hospitality (all activity restrictions are expected to be removed by 21 June). Beyond H1, economic growth is anticipated to soften marginally as Brexit effects are likely to take a toll on the supply side and the furlough scheme expires in September. For the whole year, UK GDP is expected to grow by 5.6%, also supported by accommodative fiscal policy after the Spring Budget 2021 revealed support measures worth £59bn (2.8% of GDP).

Figure 22: UK February output remained 7.8% below pre-pandemic levels



Source: Office for National Statistics (ONS), Eurobank Research,

Figure 23: The UK public health outlook appears relatively constructive



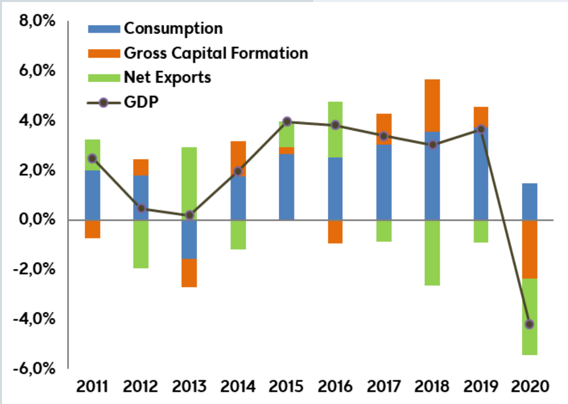
Source: Our World in Data (OWID), Eurobank Research

Bulgaria

Heading for snap elections in the summer following the failed attempts for government formation

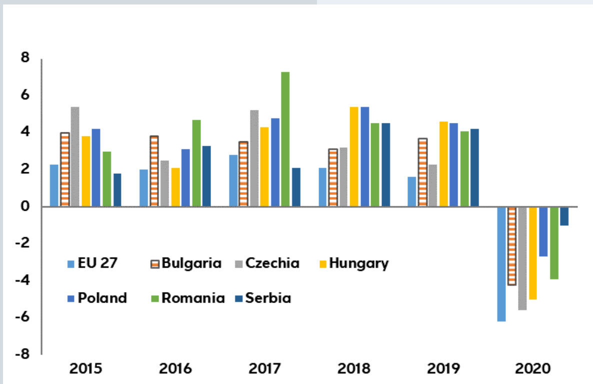
The key development in April comes from the political scene: the parliamentary elections on April 4 revealed a fragmented parliament alongside with an apparent inability thereafter for a stable government formation. The three failed attempts so far have led to snap elections in July and the formation of a caretaker government, which will stay in force at least until that point of time. On the economic front, April was a month with a plethora of flagship reports released by IFIs. In the Europe and Central Asia economic update, the World Bank (WB) cut its 2021 real GDP growth forecast to 2.6%, compared to the 3.3% forecast in January. The deterioration of the outlook for 2021 was broadly based on the increased risks from the slow vaccination progress in the country, the current epidemiological status and its impact on domestic tourism for the remaining of the year along with the political risk, as this has unfolded during the last month. On the flipside, in its spring WEO, the IMF raised its GDP growth forecast to 4.4% in 2021, from 3.6% in February with the said forecast being the most optimistic among the aforementioned of the WB, the forecast of the EC in February, which pointed to 2.7% GDP growth, and that of the Bulgarian National Bank. The latter increased marginally its GDP forecast for 2021 to 3.8% from 3.7% in December 2020 and revised more bravely its forecast for 2022 to 3.9% from 3.6% previously. Taking into account the distance among the above 2021 figures along with the revisions over time by each institution, a high degree of uncertainty over the economic performance of the country in 2021 is more than evident. On the monetary front, inflation rose by 0.6% YoY in March after two deflationary readings in the last two months. The return to positive grounds came as no surprise given the upward trend in the global oil and energy prices. Specifically, the surge in headline prices was broadly driven by the moderation in the fuel prices, as those fell by -2.4% YoY in March and -11.8% YoY in February.

Figure 24: Consumption prevented the economy from contracting further...



Source: National Statistical Institute, Eurobank Research

Figure 25: ...with the FY2020 GDP print similar to the CEE-4 contractions on average



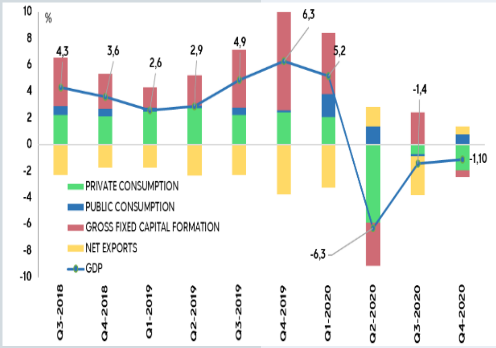
Source: Eurostat, Eurobank Research

Serbia

A second PCI agreement underway will underpin the ambitious reform agenda up to 2023

In our view, the key economic developments of April centre around the fiscal and structural reform fronts. The third wave of the pandemic forced the government to revise the 2021 budget. From an initially targeted -3.0% of GDP budget deficit back in late November, the government adopted in a draft budget the widening of the targeted deficit to -6.9% of GDP, with the proposed changes having already attained parliamentary approval. The budget revision was considered necessary in order to achieve the official ambitious GDP target for 2021 initially set at 6.0% and recently lowered to 5.0%. However, the Q1-2021 GDP growth flash estimate released yesterday came in at +1.2% YoY, beating projections for a -0.5% YoY contraction, and brought back to the table the achievement of the +6.0% target.

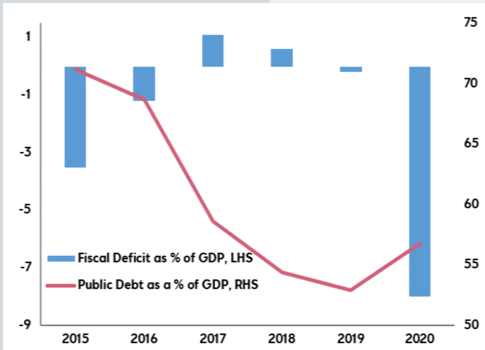
Figure 26: Public consumption and investments supported GDP from shrinking further...



Source: Statistical Office of the Republic of Serbia, Eurobank Research

April was a month with a plethora of flagship reports released by IFIs. In the Europe and Central Asia Economic Update and the Western Balkans Regular Economic Report, the World Bank revised upwards its forecasts for the country to 5.0% for 2021 compared to 3.1% 3 months ago, approaching, thus, the official government forecast. On the same footing, in April's World Economic Outlook, the IMF kept its 2021 GDP growth forecast unchanged at 5%, compared to January when the final review under the PCI was concluded. Upon the completion of the first PCI, which started in July 2018, the domestic authorities and the Fund began talks on updating the reforms framework, which eventually led to a renewal agreement. The new PCI will extend up to 2023 and requires the approval of the IMF Management and Executive Board, expected in the second fortnight of June. Its main priorities will focus on advancing the reform of large and inefficient SOEs, improving the business environment, which in turn will help attract foreign and domestic investments, promoting green growth and enhancing the social safety net for a quicker recovery and a more sustainable development. Concluding with developments on the monetary front, inflation climbed to 1.8% YoY in March from 1.2% YoY in February, with the main upward pressure on the headline index coming from transport prices that rose by 0.7% YoY in March, returning to positive territory for the first time since February 2020, on the back of surging oil product prices.

Figure 27: ...with supportive measures weighing on public finances



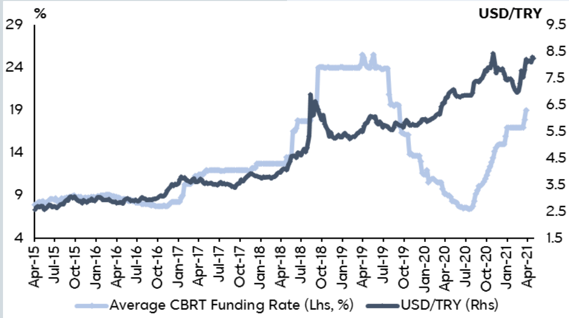
Source: Statistics Office of the Republic of Serbia, Eurobank Research

Turkey

CBRT's new leadership sent a dovish signal to markets

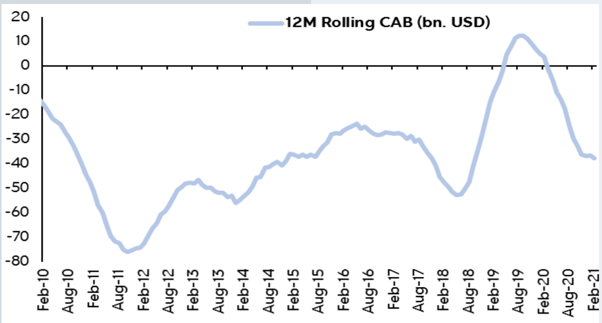
The Central Bank of Turkey (CBRT) left its key policy rate (KPR) – the 1-week repo rate – at 19.0% in late April, meeting markets' expectations in the first MPC under the leadership of the recently appointed governor Sahap Kavcioglu. In our view, there was no major surprise in the CBRT decision this time given the market turmoil instigated by the sudden change of leadership. However, the CBRT change of rhetoric sends a dovish signal to the markets that under the current circumstances no further hikes will most probably be needed. In turn, the latter could open the door for limited rate cuts as of Q3-2021. On the other hand, high inflation remains a key challenge and necessitates CBRT to remain more cautious and vigilant. Inflation currently stands at 17.1% YoY in April up from 16.2% YoY in March and 15.6% YoY in February, well above the recently revised year-end target of 12.4% in 2021 and mid-term target of 5%. On top, upside inflation risks do exist from the food and energy inflation and the continued pass-through from earlier FX depreciation. In the real economy developments, high-frequency indicators point to a strong growth momentum in Q1-2021 despite the negative Covid19 related restrictions on economic activity. From that point on, the Minister of Finance has estimated that GDP may expand by around 5% YoY in Q1-2021 based on the economic activity indicators released in the first two months, following a 5.9% YoY print in Q4-2020. Industrial output expanded by 7.4% YoY in January and 5.7% YoY in February. The calendar-adjusted retail sales increased by 4.6% YoY in February compared to 2.6% YoY in January. The Ministry's view on Q2-2021 calls for a double digit growth rate on the back of strong base effects from last year's initial shock from the beginning of the pandemic (Q2-2020: -10.3% YoY). Yet, confidence indicators haven't started well in Q2-2021. The reinstatement of restrictions together with the turmoil of the replacement of the CBRT governor must have weighed on sentiment. On a seasonally adjusted basis, the consumer confidence index declined by 6.5pts on a monthly basis to 80.2pts in April ending a three-month period of improvement. Confidence in the services, retail trade and construction sectors deteriorated on a monthly basis in April. In seasonally-adjusted terms, the services confidence index fell by 2.2pts to 103.3pts and the retail sector confidence index dropped by 6.1pts to 103.1pts. The construction sentiment remained on a downward trend for yet another month, declining by 2.5pts to 77.3pts.

Figure 28: Lira came under strong depreciation pressure on concerns for CBRT independence



Source: Bloomberg, Eurobank Research

Figure 29: Macroeconomic imbalances have been widening since mid-2019



Source: National Authorities, Eurobank Research

Eurobank Macro Forecasts

	Real GDP (YoY%)			CPI (YoY%, avg)			Unemployment rate (% of total labor force)			Current Account (% of GDP)			General Budget Balance (% of GDP)		
	2020	2021f	2022f	2020	2021f	2022f	2020	2021f	2022f	2020	2021f	2022f	2020	2021f	2022f
World	-3.3	5.5	4.2	3.2	3.1	3.0									
Advanced Economies															
USA	-3.5	6.5	4.0	1.2	2.5	2.2	8.1	5.6	4.2	-3.1	-3.7	-3.3	-15.8	-14.8	-6.5
Eurozone	-6.6	4.0	4.1	0.3	1.5	1.2	7.9	8.6	8.4	2.3	2.6	2.5	-7.7	-6.7	-3.5
Germany	-4.9	3.3	4.1	0.4	2.3	1.4	4.2	4.5	4.8	7.1	6.5	6.2	-4.2	-5.0	-2.0
France	-8.1	5.4	4.0	0.5	1.3	1.1	8.1	8.8	8.7	-2.3	-1.4	-1.2	-9.2	-6.5	-4.5
Periphery															
Cyprus	-5.1	3.5	4.0	-1.1	0.5	1.2	7.8	7.5	7.0	-11.4	-10.0	-9.0	-5.0	-3.5	-2.5
Italy	-8.9	4.2	3.8	-0.1	0.9	0.9	9.1	10.2	11.0	3.6	3.5	3.4	-9.5	-9.0	-5.5
Spain	-10.8	5.6	5.3	-0.3	1.4	1.2	15.6	16.7	16.0	2.0	3.0	2.8	-11.0	-9.0	-5.5
Portugal	-7.6	4.5	4.4	-0.1	0.9	1.2	6.8	8.2	7.2	-1.3	-0.6	-0.4	-8.0	-5.4	-3.2
UK	-9.8	5.6	5.4	0.9	1.6	1.8	4.4	5.8	5.4	-3.7	-4.5	-5.0	-16.5	-8.0	-5.0
Japan	-4.8	3.1	2.3	0.0	0.1	0.6	2.8	2.8	2.5	3.3	3.5	3.3	-12.6	-9.0	-4.0
Emerging Economies															
BRICs															
Brazil	-4.0	3.5	2.5	3.2	3.8	3.5	13.4	14.4	13.4	-0.8	-1.2	-1.4	-14.9	-7.2	-6.5
China	2.3	8.4	5.5	2.5	1.5	2.3	3.8	3.8	3.6	1.5	1.4	1.0	-6.9	-5.8	-4.3
India	-7.7	9.2	N/A	6.4	4.6	N/A		NA		1.1	-0.7	N/A	-7.6	-5.5	N/A
Russia	-3.1	3.0	2.5	3.4	3.9	3.8	5.8	5.7	5.3	1.9	2.4	2.9	-4.3	-2.1	-1.0
CESEE															
Bulgaria	-4.0	3.5	4.2	1.7	2.1	2.5	5.1	4.8	4.5	1.2	2.0	1.5	-3.0	-3.9	-2.5
Romania	-3.9	4.5	5.0	2.3	2.8	2.5	5.0	5.3	5.0	-4.5	-4.0	-5.0	-9.0	-7.0	-5.0
Serbia	-1.0	4.5	4.0	1.4	1.8	2.3	13.4	9.4	8.8	-6.4	-5.6	-5.5	-8.0	-3.2	-1.7
Turkey	1.9	4.8	5.0	12.3	15.0	10.0	13.5	13.3	13.0	-5.5	-3.0	-2.5	-5.5	-4.5	-4.0

Source: EU Commission, IMF, OECD, Bloomberg, Eurobank Research

Eurobank Fixed Income Forecasts

	Current	June 2021	September 2021	December 2021	March 2022
USA					
Fed Funds Rate	0.00-0.25%	0.00-0.25%	0.00-0.25%	0.00-0.25%	0.03-0.30%
1 m Libor	0.11%	0.14%	0.15%	0.17%	0.19%
3m Libor	0.17%	0.22%	0.24%	0.27%	0.30%
2yr Notes	0.16%	0.19%	0.25%	0.31%	0.38%
10 yr Bonds	1.62%	1.71%	1.78%	1.83%	1.92%
Eurozone					
Refi Rate	0.00%	0.00%	0.00%	0.00%	0.00%
3m Euribor	-0.53%	-0.50%	-0.51%	-0.50%	-0.48%
2yr Bunds	-0.69%	-0.69%	-0.67%	-0.64%	-0.62%
10yr Bunds	-0.21%	-0.27%	-0.22%	-0.16%	-0.11%
UK					
Repo Rate	0.10%	0.10%	0.10%	0.10%	0.10%
3m	0.08%	0.09%	0.11%	0.12%	0.13%
10-yr Gilt	0.83%	0.84%	0.90%	0.94%	0.99%
Switzerland					
3m Libor Target	-0.75%	-0.74%	-0.73%	-0.72%	-0.72%
10-yr Bond	-0.22%	-0.25%	-0.21%	-0.15%	-0.11%

Source: Bloomberg (market implied forecasts)

Eurobank

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