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Economic activity continued to gather momentum in May, notwithstanding material head-winds. Meanwhile, core inflation remains well above CB's comfort zones despite aggressive monetary policy tightening, as persistent labor market tightness contributes to strong wage growth, keeping core inflation elevated. Growth resilience, sticky core inflation and still tight labor markets keep major CBs' bias toward some additional tightening, as more hikes and a longer than previously assumed period of restrictive policy may be required to put inflation on a sustainable path to target, provided that financial stress remains subdued

Macro Picture

USA: incoming data point to renewed near-term momentum, but risks are looming

EA: signs of decelerating growth momentum from an already weak pace

UK: the economy is expected to avoid recession this year, but growth outlook still looks weak

CESEE: economies dented in Q1, taking the toll from persistent inflation and high interest rates

Markets

FX: the USD's ability to provide carry and defence has helped it strengthen during May

Rates: EU and US rates are expected to trade range bound from current levels with risks tilted towards lower levels

EM: sovereign fixed income spreads steady for a second consecutive month; risks elevated on higher US front-end rates and concerns on China's growth

Credit: past the debt ceiling crisis, investors to remain cautious, ahead of the Fed and ECB policy meetings in mid-June

Policy Outlook

USA: Fed likely to skip rate hikes in June, but bias remains for further tightening

EA: ECB likely to remain in a tightening mode until core inflation is on sustained downward path

UK: BoE keeps the door open for further tightening if data signal more persistent price pressures

CESEE: amid anemic Q1 growth and abating inflation, signs of some monetary easing loom

Key Downside Risks

DM: financial sector stress intensifies; core inflation turns out stickier than anticipated, requiring even more monetary tightening to tame

EM: China's weaker rebound spills over the wider realm; high borrowing costs squeeze the fiscal space; idiosyncratic political risks intensify

Special Topic in this issue:

→ Italy: recent economic developments and prospects ahead

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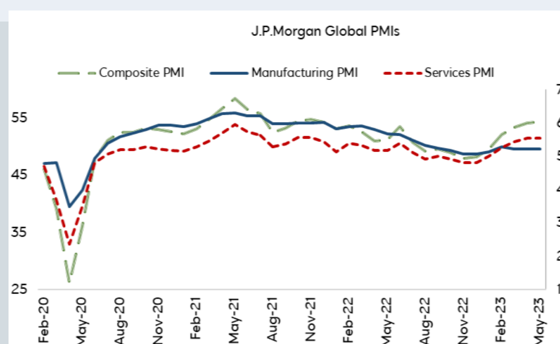
Macro Views

Latest world economic & market developments

Growth resilience, sticky core inflation and still tight labor markets keep major Central Banks' bias toward some additional tightening

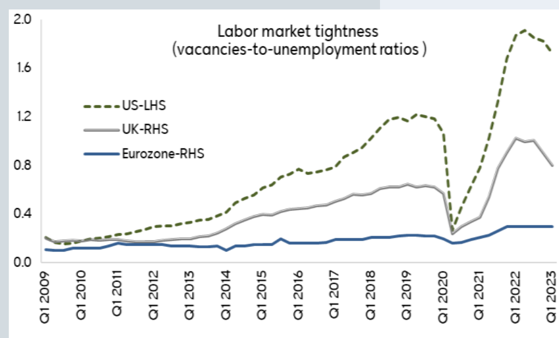
As evident in the latest global PMIs surveys, economic activity continued to gather momentum in May, despite material headwinds, including ongoing uncertainty about the evolution of banking stress. The global composite PMI continued to expand for the fourth consecutive month rising by 0.2pts to a 18-month high of 54.4 and taking cumulative gains since November 2022 lows to 6.4pts. The firmer pace of expansion in global economic activity was heavily driven by the continued vibrance of the services sector, mostly owning to China's reopening and an ongoing rotation in household spending from goods to services. With the exception of the Eurozone, growth of services activity accelerated across the board, with the global PMI rising to 55.5 from 55.4 in April, well above its pre-pandemic average, outperforming manufacturing again. That said, global manufacturing PMI stood at 49.6 in May, unchanged for the third consecutive month, remaining in mildly contractionary territory for the ninth month in a row. Most of the weakness was driven by developed rather than emerging markets amid continued lackluster growth in goods demand, even though supply chain bottlenecks improved further. Meanwhile, global headline inflation continued to ease in May, though modestly, on energy base effects and a slower pace of increase in food prices. However, core inflation continued to run well above central banks' comfort zones despite aggressive monetary policy tightening, as continued labor market tightness across a large number of economies contributes to strong wage growth that exerts upside pressure on core services inflation, highlighting the risk price pressures to stay elevated for longer. Growth resilience, sticky core inflation and still tight labor markets keep major CBs' bias toward some additional tightening at their upcoming meetings and lead investors to readjust expectations for "higher-for-longer" rates, as more hikes and a longer than previously assumed period of restrictive policy may be required to put inflation on a sustainable path to target. Undoubtedly, major CBs are concerned

Figure 1: Global economic activity continued to gather momentum in May



Source: Bloomberg, Eurobank Research

Figure 2: Despite signs of gradual colling, labor market tightness persists



Source: ECB, BLS, ONS, Eurobank Research

about the lagged effects of the unprecedented pace of policy tightening and associated global financial stability risks. That said, some of them may opt to pause rate hikes as they may need time to gather more information about the evolution of growth and inflation before ruling policy decisions thereafter. But with the battle to tame inflation still far from complete and overall labor market conditions remaining tight, a likely pause may not signal that they are done hiking and rates have already reached their terminal levels for the current tightening cycle, especially if global financial stress remains subdued (as was the case with the BoC which, following an unexpected 25bps RBA rate hike, resumed interest rate increases at the 7 June meeting after staying put on rates at the previous two meetings).

Developed Economies

US: Looking into Q2, incoming activity data have been rather mixed, but on net, they have surprised to the upside, pointing to continued resilience of the US economy. The retail control group— the direct input in the BEA's GDP estimate — improved in April more than anticipated, industrial production rose after a flat print in the prior two months, while certain housing indicators also surprised to the upside, although 30-year fixed-rate mortgages rose throughout the month to multi-decade highs. At the same time, overall conditions in the labor market remain tight, in spite of signs of gradual cooling, while price pressures are easing, but only gradually. Amid this resilience, markets are pricing-in almost fully a 25bps rate increase in July after the Fed likely skips rate hikes at the next meeting on June 15— as a number of Fed officials have signaled — in order to have more time to assess the extent of credit tightening and the effect of past policy tightening. The Atlanta Fed's GDPNow model projects annualized GDP growth at 2.0% for Q2, while for the full year 2023, market consensus points to a 1.1% rate, indicating a decline in economic activity later this year, as banking stress will likely accelerate the pass-through from tighter monetary policy to the real economy.

Euro area: Halting a six-month rising streak, the composite PMI fell to 52.8 in May from April's 54.1 mainly driven by a further contraction in the manufacturing output, suggesting a slight easing in the economy's expansionary momentum. Adding to a more concerning Eurozone growth outlook, the negative carryover of hard data (industrial production, retail sales) point to a weak starting point for GDP growth in Q2, while economic sentiment unexpectedly dropped to a five-month low of 96.5 in May and ECB monetary tightening continued to feed through the credit channel in April, with bank lending to households and non-financials slowing further amid weak loan demand and tightening lending standards. Meanwhile, headline CPI continued its downward trend in May falling to 6.1%YoY from April's 7.0%YoY and is expected to move further lower by year-end mainly on the back of energy base effects. Core inflation also decelerated for the second consecutive month, to 5.3%YoY from 5.6%YoY, but it is still too early to conclude that it has embarked on a sustained declining trend, as the new weights of the travel-related components to inflation and the recent acceleration in wages should keep services inflation elevated in the coming months, providing an argument for the hawks at the upcoming ECB meetings.

Emerging Economies

EM: June started with the release of two flagship economic outlooks, that of the World Bank (WB) and that of the OECD, which both held positive surprises regarding the upward revisions of two major developing economies, Brazil and Russia. Both institutions improved sizably their 2023 forecast to 1.2%, the WB, and 1.7%, the OECD, for Brazil while they both trimmed their recessionary expectations for Russia to -0.2% the former and -1.5% the latter. Forecasts in the said reports for the other two economies of the BRIC group, India and China had less remarkable revisions with the Indian economy currently expected to expand above 6.0% and China close to 5.5% in 2023. Since our latest issue, key developments are considered to have taken place in the geopolitical sphere of the EM universe among which we tabulate the outcome of the Turkish elections in May 28 according to which incumbent President Recep Tayyip Erdogan was finally re-elected. The nosedive of the Turkish lira in the aftermath of the continuance of his reign is driven by the appearing abandonment of the unconventional economic policy mix followed in the last 18-months and the pledge of the new Minister of Finance, Mehmet Şimşek, to the adoption of a more rational economic agenda. In our view, the most recent key event pertains to the collapse of the Nova Kakhovka dam in southern Ukraine which apart from the environmental and humanitarian disaster it triggered, it widens the rift among the two countries which could intensify and prolong the war further coming also with a severe economic cost, which is currently under reckoning.

CESEE: with most of Q1-2023 GDP detailed growth readings having been released since our previous issue, regional economies hit the brakes in the first quarter. Indicatively, annual growth rates in all CEE3 peers came in weaker compared to the previous quarter, sealing the broadly convicted economic slowdown. In Hungary, detailed GDP data verified the earlier flash estimate according to which GDP contracted by -0.9%YoY in Q1-2023 from a +0.4%YoY expansion in Q4-2022. The quarterly second reading came in at -0.3% from the -0.2% flash estimate, prolonging the technical recession in which the economy has entered since Q4-2022. The Q1-2023 GDP growth dynamics in Poland and Czechia were identical with those of Hungary as the second reading pointed to a slightly more pronounced contraction. In Poland, the annual growth reading came in at -0.3%YoY from the -0.2%YoY flash estimate and while the quarterly reading held firm at 3.8%, a tad lower than the flash estimate of 3.9% and substantially above -2.3% in Q4-2022, hard data of retail sales and industrial production referring to April suggested that the firmness of the quarterly reading does not pass through onto early Q2-2023. Finally, in Czechia, the flash estimate was revised downwards to -0.4%YoY from -0.2%YoY compared to 0.3%YoY in Q4-2022. Apparently, the loss of steam in the economic activity was the toll needed to be paid so as for inflationary pressures to start to ease in the last couple of months following extensive monetary tightening by all regional central banks for at least the past 12 months. Along these lines, amid anemic Q1 growth and abating inflationary pressures, signs of some monetary easing have started to loom as the Central Bank of Hungary (NBH) decided in May's session to cut by 100bps the one-day deposit rate to 17.0%, signaling, thus, the beginning of monetary policy normalisation, after the emergency meeting held on 14 October 2022 which introduced a series of measures to halt the extensive pressure on the forint at that time. The decision came, among other factors, on the back of some visible stabilisation of inflation, which, besides some meagre drawbacks, has been on

a downward path since the start of 2023, remaining, though, above 20%, both the headline and the core readings (21.5%YoY and 22.8%YoY respectively in May).

Markets View

Foreign Exchange

EUR/USD: the pair retraced significantly lower during May from a high of 1.1091 to a low of 1.0635 driven by the USD's ability to provide carry and defence during the debt ceiling discussions. The story driving the USD higher at the moment is that the US economy continues to surprise to the upside while Europe and China appear weaker than expected and the said divergence will continue to be positive for the USD in the near term. For the view of the USD shallowly depreciating in the medium term to resurface, the current macro landscape will have to change. Technically, the EUR/USD is looking to test a channel support at 1.0580 before a rebound is possible.

EUR/GBP: the BoE has remained a reluctant hiker but the sharp upside surprise in inflation and the gradual rebalancing in the labour market seem likely to tilt monetary policy decisions towards further tightening and driving, in turn, the pair lower, from 0.87676 at the beginning of May to 0.86085 currently. Hawkish ECB members' comments seem to have placed a bottom on the pair and we expect a retracement higher towards 0.8700 in the near term. In the medium term, the pair will remain data dependent in tandem with the respective central banks' policy path.

Rates

EU: swap rates in the EU traded range bound over the past month but with significant volatility. Currently, the 10-year swap rate stands at approximately 295bps, after peaking at 320bps intramonth. The yield curve steepened, with the 5s30s spread trading at -0.42 versus -48bps at the end of April, but during the month it reached -32bps. Front end implied volatility has retraced a few volatility points lower after peaking at the end of May. Moving forward, rates are expected to continue trading within a tight range, with risks skewed to the downside as a hawkish ECB is compensated, for the time being, by worries of China not recovering as sharply as formerly expected.

US: swap rates increased notably intramonth, amid significant volatility, especially at the short end of the curve as solid economic figures have driven the market to reprice Fed hike expectation (an additional 25bps hike). The US President signed the bipartisan debt ceiling deal into law, averting government default. History suggests more flattening, but cycle dynamics are more relevant. A skip at the June meeting opens the door to re-steepening. Currently, the 10-year swap rate stands at 368bps, having reached a high of 388bps. Meanwhile, the yield curve inverted further, resulting in the widening of the 5s30s spread to -44bps from -31bps at the start of May. Looking forward, short-term rates are expected to remain volatile but overall risks are skewed towards lower yields.

Emerging Markets Sovereign credit

For the second consecutive month, sovereign bond spreads were little changed with the EMBI Global Index closing at 400bps at the end of May, just 1bp tighter on the month. However, the macro environment remains blurred and markets remain nervous on higher front-end US rates and disappointment on the China's recovery story. In CEEMEA, South African bonds underperformed due to some tensions with the US over allegations of arms sales to Russia, while the SARB raised its policy rate by 50bps as expected. In Turkey, President Erdogan won the elections with all eyes now being on the composition of the economic team and the credibility of the initial policy response. Having been one of the first central banks in Europe to start hiking rates since June 2021, the National Bank of Hungary (NBH) became the first central bank in the region to start easing interest rates. The NBH announced a 100bps cut to the one-day deposit, taking the rate to 17%. In China, local sovereign bond yields extended their drop as growth momentum appears weak, with the spill over to other EM economies appearing so far to be contained. We remain on the side-lines as the US hiking cycle might not have yet closed and concerns on China's growth prospects keep rising.

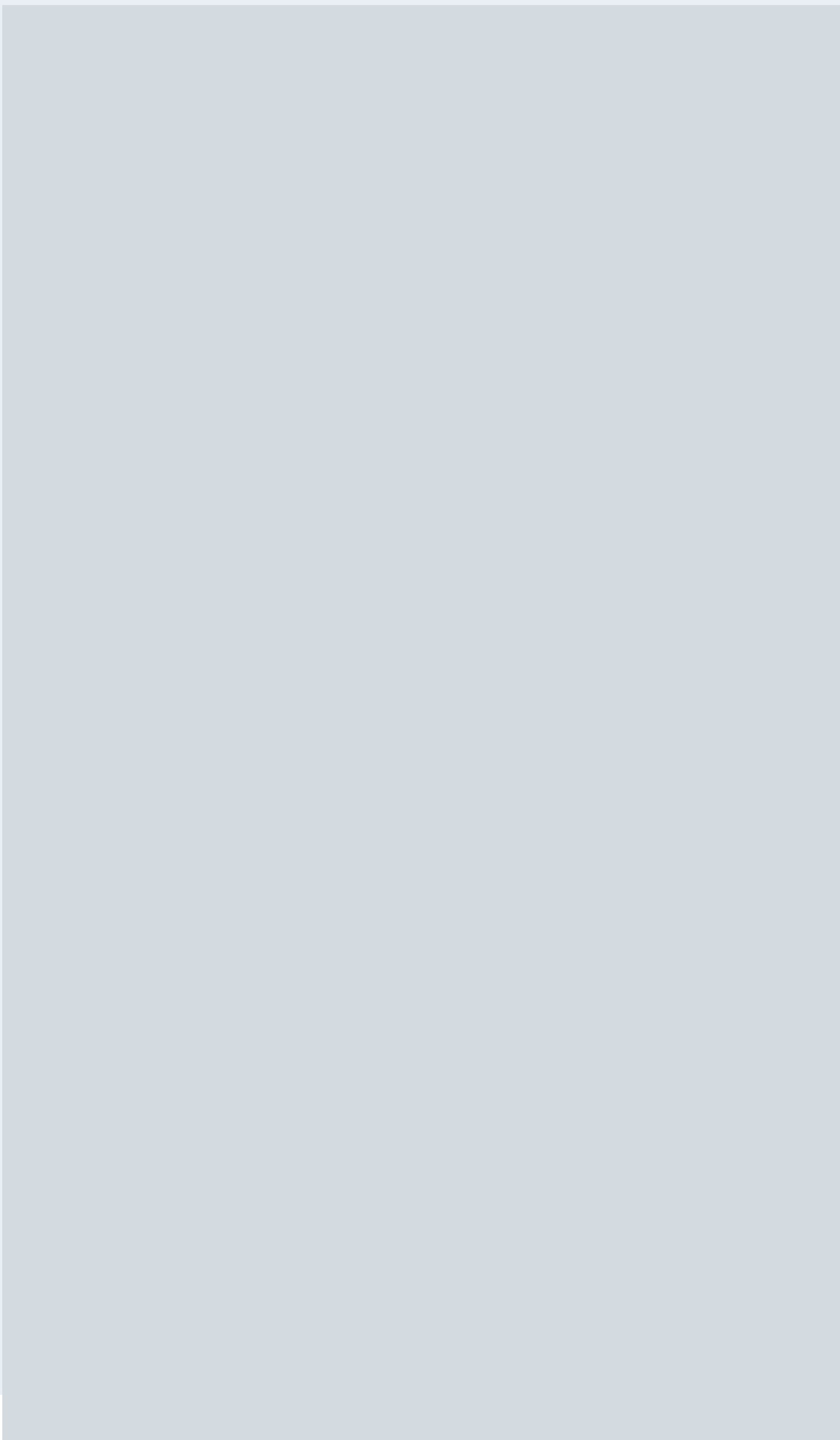
Corporate credit

After a fairly calm April, May was an eventful month for markets, featuring deliberations related to the US debt ceiling, fresh concerns about regional banks, another rate hike from the Fed and the ECB and downbeat US economic data releases, which led to dialed-up expectations for another Fed hike at the June or the July meeting. On May 1st, JP Morgan acquired most of the First Republic Bank's assets, making it the 3rd Federal Deposit Insurance Corporation (FDIC) bank to fail this year after SVB and Signature. On the US debt ceiling front, despite the increased volatility throughout the month, an agreement was eventually reached and passed through the House of Representatives and subsequently approved by the Senate. Meanwhile, the Fed and the ECB delivered a 25bps hike each in early May, bringing the total amount of hikes in the current cycle to 500bps and 400bps respectively. On the commodities front, concerns about the global economic outlook led to continued weakness, with Brent crude oil prices sliding to 72$/bbl but bouncing back to 77$/bbl following decisions by Saudi Arabia to deliver additional production cuts and OPEC+ to extend the recent cut. Finally, tech stocks had a massive outperformance in the last month, as investors continue to assess the implications of AI (Nasdaq +10% vs +2.5% for the S&P 500, led by a > 20% increase in FANG+ index).

In credit, both EU and US credit spreads tightened in the last month. CDX IG stands -8bps tighter since the beginning of May, with CDX HY -36bps tighter. In Europe, the itraxx Main is -9bps and Xover is -39bps tighter May-to-date. In corporate cash, performance was mixed, with IEAC ending 10bps wider and IHYG -17bps tighter since the beginning of May. Financials outperformed among EU IG cash (Sub Financials -2bps, Snr Financials +4bps) while Energy and Consumer Discretionary lagged (+19bps and +18bps respectively). In High Yield, Technology, Energy and Sub Financials fared better (-57bps, -53bps and -51bps respectively) while Comms and Senior Financials relatively underperformed (-4bps and -8bps tighter respectively). The

EU Primary market remained quite active intramonth, with May's issuance at €170bn, bringing YTD volume c. 19% above 2022's respective issuance.

With the debt ceiling crisis behind us, attention shifts once more to recession and rates expectations, with markets weighing the probability of a soft vs hard landing scenario. Investors are likely to remain cautious, ahead of the Fed and ECB policy meetings in mid-June (14th and 15th June respectively), having already assigned growing chances of a pause from the Fed at the next meeting. In the EU primary market, following a particularly strong May in terms of new issuance, June has started on a fairly active footprint.

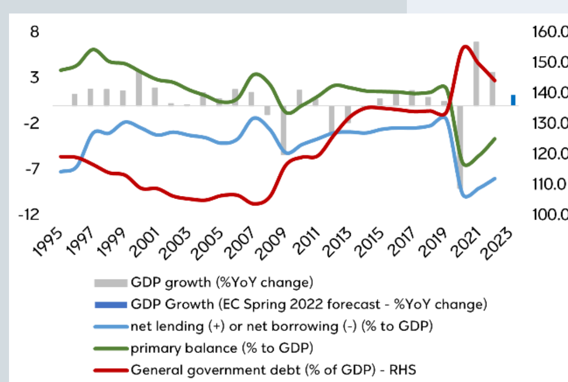


Special Topic

Italy: recent developments in key economic characteristics and prospects ahead

The economy of Italy is facing various challenges in the last years, related mainly to political uncertainty and fluctuations in its public finances. On the other hand, the country steadily achieves a relatively good performance in terms of structural competitiveness, the effectiveness of its labor market etc. The purpose of this special topic is to present the developments in key characteristics of the Italian economy in the last five years, as well as the related challenges in the period ahead. The importance of such an analysis is reinforced by the fact that Moody's, one of the four major credit rating agencies, has not issued on May 19 its scheduled assessment for the country, with its credit rating implicitly remaining at Baa3, one notch above the non-investment grade, with a negative outlook.

Figure 3: The post-pandemic recovery was mitigated by the implications of the energy crisis



Source: ISTAT, Bank of Italy, Eurobank Research

The advantages and weaknesses of the Italian economy are summarized in its credit rating and the reasons behind it. Italy is above the non-investment grade in all four major credit rating agencies with three of them (S&P, DBRS and Fitch) rating the country at least two notches above that threshold, while Moody's has the country one notch above (Baa3) with a negative outlook, as already mentioned. The downgrade to Baa3 took place in October 2018, with a stable outlook at that time. The rating remained unchanged ever since. According to the related Moody's report[1], the key drivers for the drop in credit rating were (i) risks regarding the country's fiscal position amid increased targets for budget deficits and (ii) concerns about possible implications on economic growth due to delays in economic and fiscal reforms. The report did not include concerns on issues of structural competitiveness, labor market volatility, markets competition etc.

Indeed, in October 2018 the government had submitted the Draft Budgetary Plan for 2019 to the European Commission setting a fiscal deficit target at 2.4% of GDP, much higher than the projection under the 2018 Stability Programme (published in April 2018) at 0.8% of GDP. The European Commission initially rejected the draft budget, on the reason that it was not in line with its budget recommendations. Meanwhile, the already high Italy/Germany 10yr bond yield spread rose further after the rejection, reflecting the caused uncertainty (Figure 4). Eventually, the two sides reached an agreement for a 2.04% deficit in December 2018[2].

Ultimately, the fiscal deficit for 2019 stood at 1.5% of GDP from 2.2% in 2018, mainly driven by higher-than-expected revenues mostly through direct taxes and social contributions, as well as a decrease in interest

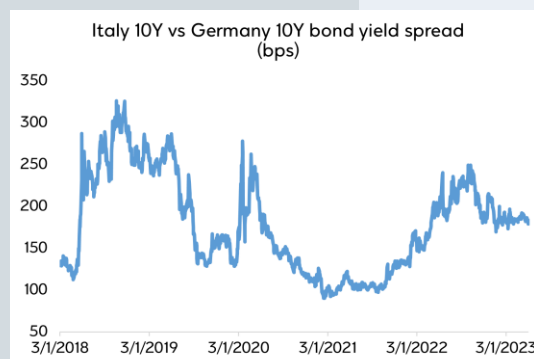
[1] Moody's Rating Action Report, 19 October 2018
[2] https://www.reuters.com/article/uk-italy-budget-defict-idUKKBN1OH2A2

expenses. At the growth front, there was a slowdown in 2019 with real GDP growth decelerating to 0.5% from 0.9% in 2018, driven by sluggish investment growth amid increased global uncertainty owing to the Brexit deal and trade tensions between the US and China, and weak consumption probably due to a deceleration in the increase of disposable income. Nonetheless, employment as a share of population (age group 15-64) rose moderately by 0.5ppts to 59.0% in 2019 and the current account surplus increased from 2.6% to 3.3% comparing to previous year, with rising net exports by 0.9ppts to 3.3% of GDP partially reflecting improvements in price competitiveness, which was even stronger in non-EU markets.

In 2020, Italy's fiscal balance deteriorated significantly, in line with the global trend because of higher public spending for measures that were necessary to tackle the effects of the pandemic. The sudden pause in economic activity after the Covid-19 outbreak had also substantial implications for economic growth, leading to a deterioration in all the major components of GDP. The higher expenditure, in combination with the decline in nominal -apart from real- GDP deteriorated substantially the fiscal balance. Net borrowing rose to 9.7% from 1.5% of GDP in 2019, while the primary balance recorded a deficit for the first time since 2009, standing at -6.2% of GDP against a 1.9% surplus in 2019 and the general government debt to GDP ratio jumped by 20.8ppts to 154.9%.

Public finances slightly improved in 2021 despite the strong economic recovery after the reopening of the global and domestic economy, with real GDP growth at +7.0% from -9.0% in 2020. Fiscal revenues rose by 1.0bps as a share of GDP driven by higher domestic consumption, while the easing of pandemic-related measures led to lower current expenditure. Despite the ease of pandemic-related measures, total expenditures increased by 0.3bps on the back of higher capital expenditure. Furthermore, an accounting reclassification of tax credits for housing renovations, in accordance Eurostat's related guidelines pushed upwards public deficit as a share of GDP by 1.8ppts[3]. All in all, net borrowing and primary deficit both dropped by 0.7ppts compared to 2020, to 9.0% and 5.5% of GDP respectively and the general government debt declined by 5.0bps to 149.9% of GDP.

Figure 4: Italy/Germany 10yr bond yield spread declined over the last months, reflecting eased concerns about the country's fiscal credibility



Source: Bloomberg, Eurobank Research

Government bond yields increased rapidly in 2022, amid inflationary pressures driven by the rise in energy prices, which started to have an impact since the end of 2021, the war in Ukraine and the accommodative monetary policy by the ECB. The Italy/Germany 10yr yield spread jumped in summer 2022 after the decision of the ECB in June to stop net purchases under the APP as of July 1st and a political crisis in the same month leading to the resignation of the former Prime Minister Mario Draghi, which led to snap elections.

[3] According to the 2023 Stability Programme, the total effect of this accounting reclassification on net borrowing for the period 2020-2022 was 4.6ppts of GDP (+0.2ppts of GDP in 2020, +1.8ppts of GDP in 2021 and +2.6ppts of GDP in 2022). However, it had no impact on public debt.

Amid heightened economic and political uncertainty, in August 2022 Moody's changed the country's outlook from "stable" to "negative". According to the report following the credit rating revision[4], the decision was based on (i) higher risks related to the successful implementation of structural reforms, such as the delivery of the NRRP reforms because of political uncertainty, (ii) possible economic implications by obstacles in energy supply and (iii) risks concerning fiscal strength because of sluggish growth, higher funding costs and a possibly weaker fiscal discipline.

Until the revision by Moody's of Italy's rating in August 2022, the country had received a total financing of €67bn under NextGenerationEU, through the pre-financing disbursement and the first two tranches, satisfying all the necessary conditions to receive the funding. However, the agency justified the change in the outlook based on concerns that the snap elections may procrastinate the accomplishment of some milestones and targets. Furthermore, Moody's mentioned that since gas was used as an intermediate input for electricity generation, the reductions in gas supply from Russia, would boost energy prices and hence inflation. Indeed, inflation in electricity surged over the last months of 2022, standing at 179.7% YoY in Q4 2022 from 97.2% YoY in Q3 2022, by far the highest level in Eurozone, driving upwards headline inflation which stood at 12.5% YoY in Q4 2022 from 9.0% YoY in Q3 2022, higher in most of the major Eurozone economies (Eurozone average 10.0% in Q4 2022 from 9.3% in Q3 2022).

At the growth front, the annual print came in at 3.7% for 2022, driven by robust consumption and investment, due to savings accumulated over the previous two years. However, GDP growth deteriorated significantly at the second half of 2022 (from 1.0% QoQ in Q2 to 0.4% QoQ in Q3 and a small contraction by 0.1% QoQ in Q4), on the back of heightened global economic uncertainty from the war in Ukraine.

The overall fiscal position was relatively improved in 2022 compared to 2021, although in distance from the pre-pandemic performance. Despite the upward pressure on public spending from measures to support households and firms against the energy crisis, the primary deficit shrank to 3.6% of GDP. The improvement in the primary balance can be attributed to the reduction of pandemic-related spending measures, and the rising inflation that led to higher revenues. However, net borrowing came in at 8.0% of GDP, negatively affected from the accounting reclassification of tax credits mentioned earlier. According to the 2023 Stability Programme, excluding this reclassification, the figure would have been 5.4% of GDP. The debt-to-GDP ratio stood at 144.4%, indicating that over the period 2021-2022 more than half of the 2020 sharp increase was reserved, mainly from the GDP recovery.

Employment as a share of total population for the age group 15-64 recovered strongly in 2022 to 60.1% from 58.2% in 2021, exceeding the pre-pandemic levels, on the back of the overall labor market tightness in Eurozone, as a result of the post-pandemic recovery. However, in 2022 the current account balance stood at -1.2% of GDP, recording a deficit for the first time after 2012, supported by a deterioration in energy trade balance and in spite of the benefits of the easier pandemic-related restrictions on tourism and hence exports of services.

Q1 2023 GDP growth rebounded by 0.6% QoQ, one of the strongest increases among the Eurozone countries that have released Q1 GDP data so far. Private consumption was a key driver for growth, rising by 0.5% QoQ from -1.7% QoQ in Q4 2022, on support from the steadily tight labor market that likely boosted households' confidence and hence consumer spending. Projected economic growth for FY2023 will likely

[4] Moody's Rating Action Report, 5 August 2022

slowdown, albeit less than previously expected. In its Spring 2023 forecast, the European Commission revised upwards the projection for 2023 GDP growth to 1.2%, 0.4ppts above that in its Winter 2023 forecast. The elevated prices will likely have a negative impact on consumption in Q2 2023. This impact will be possibly weakened in H2 2023 from an expected recovery in real income on the back of labor market tightness and a gradual slowdown in inflation. The reduction in commodity prices and the resources from the NRRP will likely support private investment. Finally, the recent flood in Emilia-Romagna province is expected to have a negative economic impact.

The primary deficit will likely fall in 2023 due to the reduction in public spending for energy support measures, the elimination of expenses for anti-Covid 19 measures, and a reduction on tax credits for building activities after the modification of the relevant measures at the beginning of 2023, in response to the implications they had on fiscal deficit after the accounting reclassification which was indicated by Eurostat. The reduction in the primary deficit will be likely mitigated by higher public investment, supported by loans for projects eligible under the NRRP and expenditures on social transfers which are expected to widen due to indexation based on past year's inflation rate. Regarding borrowing costs, government bond yields remain elevated in 2023, as global uncertainty persists, in part due to the banking turmoil in March 2023. However, the Italy/Germany 10yr bond yield spread has fell over the last months, standing at 179.2bps at the end of May, down by 70.5bps since September 27, 2022, when it reached a more than two-year peak, possibly reflecting improved market prospects regarding fiscal performance and sustainability. The recent projections by the European Commission for 2023 (Spring 2023 forecast) are 4.5% and 0.5% of GDP for net borrowing and primary deficit respectively, down from previous year's 8.0% and 3.6% of GDP, remaining however in distance from the pre-pandemic performance (-1.5% and 1.9% of GDP respectively). As a result of the lower deficit, public debt is expected to decrease further, with the European Commission projecting it to stand at 140.4% of GDP in 2023, according to the 2023 Spring Forecasts.

Regarding the developments in the labor market, unemployment rate for the age group 15-74 has somewhat fallen from 7.9% in December 2022 to 7.8% in April 2023, while the European Commission foresees the annual 2023 print to stand at 7.8% from 8.1% in 2022 (Spring Forecasts 2023). Exports and imports of goods will likely slowdown due to an expected reduction in global demand. However, an expected increase in inbound tourism will likely boost exports of services, possibly leading to an improved external balance.

As mentioned earlier, the successful implementation of the NRRP was one of the key risks mentioned in Moody's August 2022 report. In January 2023, Italy officially requested the third tranche of the financial support from NextGenerationEU but some concerns by the European Commission delayed the procedure[5]. However, there are signs that the two sides are positive to reach a solution[6]. The disbursement of the next tranches would provide further support to investment.

Overall, there are some positive signs from 2022 and 2023 for the Italian economy, especially in public finances, labor market and external trade, as presented above. On the other hand, weakened private and public consumption will likely act as a drag on economic growth, but less than initially expected. The declining bond yield spreads after last snap election is considered indicative of a gradual possible reduction in political uncertainty, however the falling dynamics faded in H1 2023. There are several challenges ahead for the Italian economy to maintain and strengthen its credibility, not only in the near-term, but also in a

[5] https://www.governo.it/it/articolo/pnrr-la-commissione-europea-esclude-dalle-risorse-lo-stadio-di-firenze-e-il-bosco-di

[6] https://www.ilsole24ore.com/art/pnrr-terza-rata-arrivo-ecco-quanto-vale-e-cosa-serve-AExdIuMD?refresh_ce=1

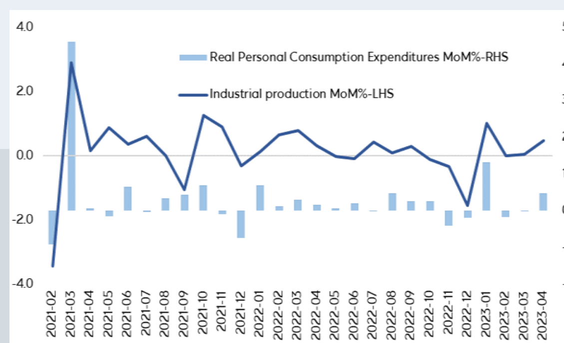
long-term perspective. Indicatively, these comprise the implementation of an appropriate fiscal policies, which would allow for a return to primary surpluses, as well as political stability and continuation in implementing the necessary reforms. The latter issue also concerns the smooth implementation of the NRRP related reforms, as funding from NextGenerationEU is important to support investment, and hence economic growth. Finally, the country needs to stay alert for the broad risks sourced by the uncertainty in the international economic environment.

US

Resilient data strengthen the case of additional Fed rate hikes

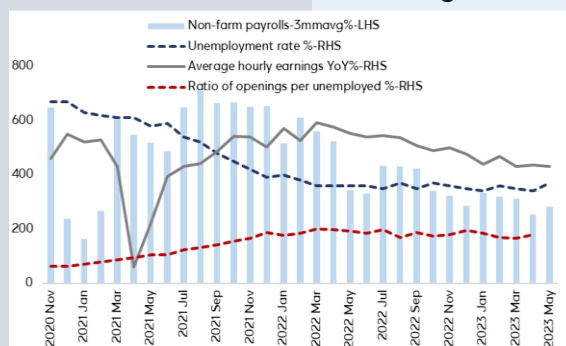
According to the second estimate, US economic growth was slightly stronger than initially estimated in Q1, as GDP was revised up by 0.2ppts to a 1.3% annualized rate on the back of a modest upward re-estimate in most expenditure components other than net exports, and a smaller drag from inventories. Looking into Q2, incoming data have been mixed, but on net, they have surprised to the upside, pointing to renewed near-term momentum in the economy. The ISM Manufacturing PMI fell further in contractionary territory in May (46.9) and the respective services print unexpectedly dropped to a five-month low (50.3). However, the retail control group— the direct input in the BEA's GDP estimate — improved in April by a higher than anticipated 0.7%MoM following March's 0.4%MoM decline, putting consumer expenditure on a stronger trajectory than previously thought, taking also into account a strong 0.5%MoM increase in real consumer spending. Renewed resilience was also evident in industrial production which rose by 0.5%MoM after a flat print in the prior two months, while certain housing indicators also surprised to the upside in April, although 30-year fixed-rate mortgages rose throughout the month to multi-decade highs. At the same time, overall conditions in the labor market remain tight, in spite of signs of gradual cooling. Indicatively, the unemployment rate rose by 0.3ppts to 3.7% in May, but non-farm payrolls increased by a higher-than-expected 339k, and job openings unexpectedly rose to a three-month high of 10.1mn in April, taking the openings-to-unemployed ratio up to 1.8, well above 1.2 posted ahead of the pandemic. Meanwhile, price pressures are easing, but only gradually. Headline CPI dropped further to 4.9%YoY in May and core inflation edged down by 0.1ppts at 5.6%YoY, but still remained within a 5.5-6.0% range since November 2022 while core PCE unexpectedly rose by 0.1ppts to 4.7%YoY. Amid this resilience, markets are pricing-in almost fully a 25bps rate increase in July after the Fed likely skips rate hikes at the next meeting on June 14 — as a number of Fed officials have signaled — in order to have more time to assess the extent of credit tightening and the effect of past policy tightening. The Atlanta Fed's GDPNow model projects annualized GDP growth at 2.0% for Q2, while for the full year 2023, market consensus points to a 1.1% rate, indicating a decline in economic activity later this year, as banking stress will likely accelerate the pass-through from tighter monetary policy to the real economy.

Figure 5: Several hard data showed renewed resilience in April



Source: BEA, Eurobank Research

Figure 6: Despite signs of gradual cooling, overall labor market conditions remain tight



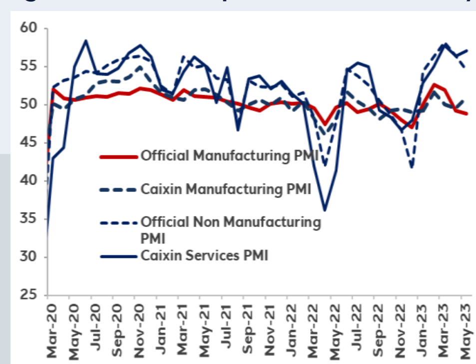
Source: BLS, Eurobank Research

China

Economy stumbled in April calling for policy stimulus ahead

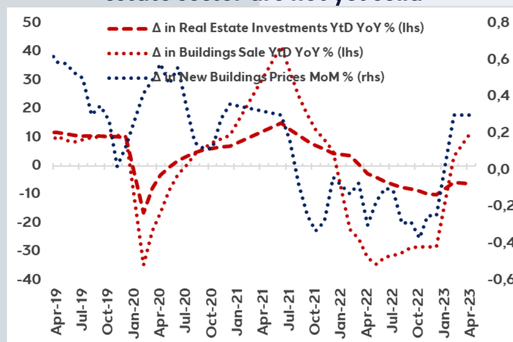
Worries over the longevity of the economic recovery, as outlined in the previous issue, are corroborated based on a plethora of hard data referring to April. Retail sales, after a brisky growth of +10.6%YoY in March, continued to expand, by +18.4%YoY, but this was broadly attributed to low base effects from the Shanghai's lock down that was in effect from late Feb-2022 to early Aug-2022. The said particularity was taken into account by market participants who were disappointed as they expected retail sales to expand by +21.9%YoY in April. On the same footing went industrial production whose growth may have continued to increase compared to March but also beat market consensus to the downside for the same reasons (+5.6%YoY in April vs. 10.9%YoY market consensus after +3.9%YoY in March). Furthermore, industrial profits kept shrinking in April, by -18.2%YoY, compared to -19.2%YoY in March, bringing the year-to April figure at -20.6%YoY. Omens from the real estate sector were not rosy either in April; property investment plunged by -6.2%YoY in the first four months of 2023 compared to -5.8%YoY as of year-to-March while market expected a milder contraction of -5.7%YoY. The residential component of the real estate market also failed to gather a solid footing in May as new home sales by the 100 largest real estate developers rose by 6.7%YoY, but decreased by 14.3%MoM, after picking up by 29%YoY in the previous two months. All in all, recovery has stalled and market participants are proving to be more anxious for the growth prospects ahead. That said, official manufacturing PMI dipped further to 48.8 in May from 49.2 in April staying into contracting territory for a second consecutive month and disappointing market expectations for a rebound at 49.5. The official non-manufacturing gauge also slid for a second month in a row to 54.6 from 56.4 in April, beating to the downside expectations for a 55.2 reading. Apart from real economy and sentiment data that point to a stuttering phase the economy has entered in the last couple of months, the ultra-low CPI figure in April close to zero (0.1%YoY), when almost the rest of the major global economies are hampered by elevated price pressures, and the decreasing producers' prices (PPI -3.6%YoY in April vs -2.5%YoY in March) underline the loss of steam in demand for goods whose impact on the growth dynamics cannot be offset by the strong momentum in services, which is also fading. Concluding, we continue to expect a 5.5% growth rate in 2023 but targeted and presumably extensive policy stimulus should be routed ahead for this to happen.

Figure 7: Inclusive dip in official PMIs in May..



Source: Bloomberg, Eurobank Research

Figure 8: ..while the prospects of the real estate sector are not yet solid



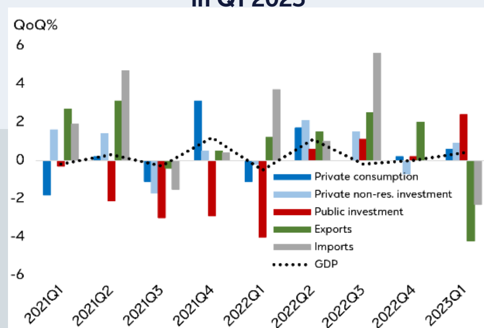
Source: Bloomberg, Eurobank Research

Japan

GDP growth rebounded in Q1 and is expected to moderate in Q2

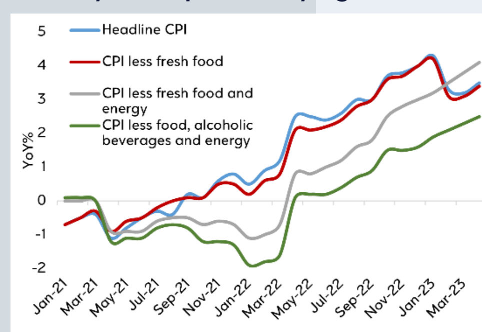
According to the first preliminary GDP estimates, growth rebounded in Q1 2023, with real GDP growing by 0.4% QoQ from 0.0% QoQ in Q4 2022. From the demand side, private consumption was a key growth driver, rising by 0.6% QoQ against 0.2% QoQ in Q4 2022, despite a substantial decrease in the real compensation of employees. The rise in consumer spending possibly reflects expectations of higher wages, following big pay rises agreed in the 2023 spring wage negotiations. Their effects are considered to be reflected at the consumer confidence index, which stood at 35.4 in April, up from 33.9 in March and it has not fallen since December 2022. The easing in Covid-19 restrictions together with the execution of the extra budget for fiscal year 2022 (which ended in March 2023), as approved by the parliament last November, possibly also had an impact in investment, since a part of it was dedicated for investment projects. To this end, private non-residential investment recovered from -0.7% QoQ to 0.9% QoQ in Q1 2023 and public investment rose by 2.4% QoQ against 0.2% QoQ a quarter earlier. Real exports fell by 4.2% QoQ from +2.0% QoQ in Q4 2022, with the fall entirely driven by reduced exports of goods, possibly due to lower global demand, with the ease of pandemic-related restrictions having a positive impact, whereas exports of services rose on the back of increased inbound tourism, albeit slower than in Q4 (+5.6% QoQ from +8.3% QoQ), with the sum of inbound visitor arrivals for Q1 being 70.9% higher than Q4 2022, according to the latest estimates by the Japan National Tourist Organization (JNTO). In Q2 2023, the economy is expected to grow moderately. Activity in services will likely continue to be a key growth driver supported by tourism, with services PMI marking a fresh record high in May at 55.9, up from April's 55.4. Manufacturing sector continues to show positive signs, as supply chain bottlenecks have been removed to a great extent, with the May manufacturing PMI standing at 50.6, up from 49.5 in April, indicating the first expansion since October 2022. On the demand side, consumption is expected to grow moderately in Q2 driven by rising wages but will likely be mitigated by persistently high inflation, which reaccelerated in April to 3.5% YoY from 3.2% YoY in March. Global uncertainty may also negatively affect consumption for the remainder of 2023.

Figure 9: Private consumption and investment were the main drivers of GDP growth in Q1 2023



Source: Cabinet Office Japan, Eurobank Research

Figure 10: Moderate growth expected in Q2, mainly due to persistently high inflation



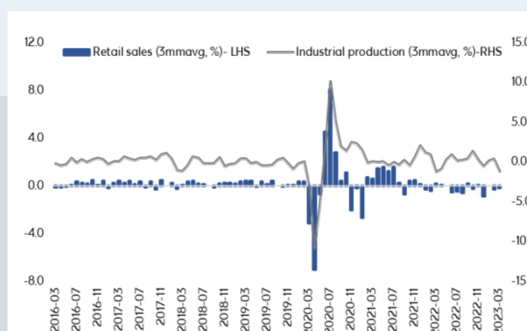
Source: Statistics Bureau of Japan, Eurobank Research

Euro area

Signs of decelerating growth momentum from an already weak pace

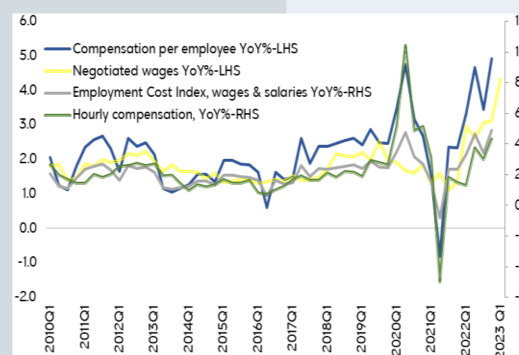
Halting a six-month rising string, the composite PMI fell to 52.8 in May from April's 54.1, suggesting a slight easing in the economy's expansionary momentum. Services PMI edged down only slightly, remaining comfortably in expansionary territory (-1.1pts at 55.1), but manufacturing continued to lag behind, as the contraction in output intensified (-1.0pts at 44.8) amid a further decline in new orders and falling backlogs orders. Consistent with the further weakening of manufacturing PMI, industrial production dropped by a hefty 4.2%MoM in March after strong increases in February and January, pointing to some downside risks to the Q1 GDP second estimate of 0.1%QoQ, considering also the large downward revision in Germany's GDP (final print of Eurozone Q1 GDP on 8 June). Beyond Q1, the March industrial decline pins the Q2 carryover at -2.3%QoQ, indicating a weak starting point for GDP growth in Q2, along with March's retail sales which fell by a further -1.2%MoM. Adding to Eurozone growth concerns, economic sentiment unexpectedly dropped to a five-month low of 96.5 in May, while ECB monetary tightening continues to feed through the credit channel. Bank lending to households (-0.4ppts at 2.5%YoY) and non-financials (-0.6ppts at 4.6%YoY) slowed further in April amid weak loan demand and tightening lending standards, while M1 money supply growth contracted in April by a fresh record high of -5.2%YoY after turning negative in January for the first time ever. In an encouraging note, though, the labor market remains strong, with the number of unemployed falling by a further 32k in April and the unemployment rate dropping to a fresh record low of 6.5%, implying support for private consumption as inflation is decelerating, while upward pressures on wages (negotiated wages up by 4.3%YoY in Q1 2023 from 3.1%YoY in Q4 2022) are unlikely to abate any time soon. That said, headline CPI continued its downward trend in May falling to 6.1%YoY from April's 7.0%YoY, and it is expected to move further lower by year-end mainly driven by energy base effects. Core inflation also decelerated for the second consecutive month, to 5.3%YoY from 5.6%YoY, but it is still too early to conclude that it has embarked on a sustained declining trend, as supportive basket weights of the travel-related components to inflation and the latest acceleration in wages should keep services inflation elevated in the coming months, providing an argument for the hawks at the upcoming ECB meetings.

Figure 11: The negative carryover of hard data points to a weak starting point for GDP in Q2



Source: Eurostat, Eurobank Research

Figure 12: Significant acceleration in wage growth



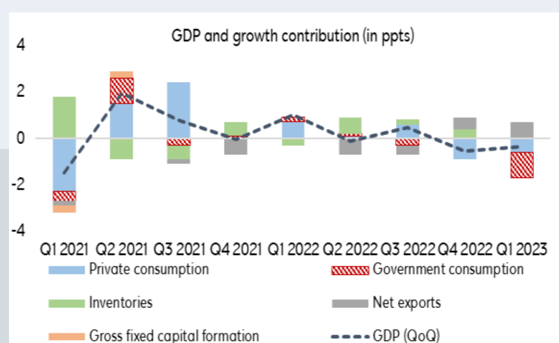
Source: ECB, Eurobank Research

Germany

The economy entered recession in Q1, not quick recovery yet in sight

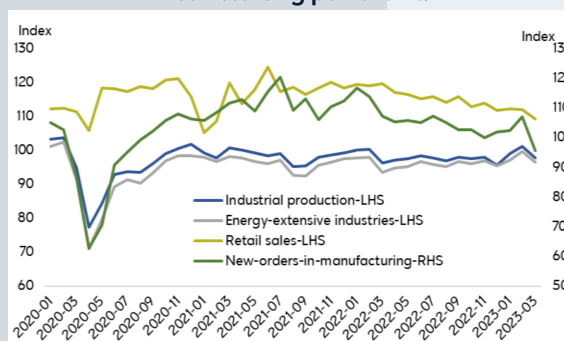
According to the detailed release by the Federal Statistical Office, Q1 2023 GDP was revised lower from 0.0%QoQ to -0.3%QoQ after economic activity also contracted in the prior quarter, by -0.5%QoQ, suggesting that Germany experienced a technical recession in winter. The breakdown of the expenditure side showed that the largest negative contributor to growth was government consumption which plunged by 4.7%QoQ, the largest drop ever, taking off 1.1ppts of growth, as various pandemic related support measures were phased out (the Q1 2023 fiscal deficit was still relatively large, though, at €22.4bn, but less than €34.9bn in Q4 2022). Private consumption also acted as a drag, falling by -1.2%QoQ, the second consecutive quarterly decline, as the massive increase in energy prices continued to undermine household purchasing power, subtracting 0.6ppts of GDP growth. On the flipside, business fixed investment was surprisingly strong, rising by 3.0%QoQ, partially thanks to improved construction activity amid favorable weather conditions, while net exports were another positive contributor to growth, as imports dropped by 0.9%QoQ and exports grew by just 0.4%QoQ. Looking ahead, activity data suggest that the economy is still lacking dynamism, and, thus, a quick recovery out of the recession is not yet in sight. Disappointing hard data for March (e.g., retail sales, IP) provide a weak starting point for Q2, while sentiment surveys for May and April were mixed (PMIs, IFO business climate, ZEW economic sentiment), indicating that any recovery would be, at best, anemic, in an environment of rising borrowing rates and lower global trade growth. Hopefully, recent strong wage settlements combined with falling inflation should support real disposable income. However, amid exceptionally low consumer sentiment (GfK up at -24.2 in June, though still well below the 5.7 historical average) it is uncertain to which extent that support would pass into spending (note that the saving rate stood at 11.2% in Q1 2023, in line with the pre-pandemic average). Taking also into consideration that the US —Germany's most important export market— is likely to slip into mild recession later this year, and ECB policy tightening continues to feed through to the real economy, we expect full-year GDP to stagnate in 2023, with Germany remaining one of the weakest growing EA economies.

Figure 13: Government consumption was the main drag on GDP growth in Q1 2023



Source: German Federal Statistical Office, Eurobank Research

Figure 14: Disappointing March hard data provide a weak starting point for Q2



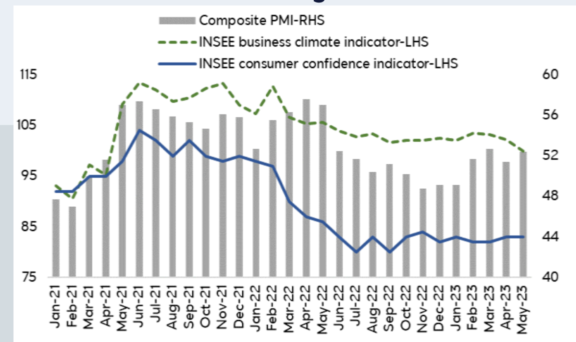
Source: German Federal Statistical Office, Eurobank Research

France

GDP growth is expected to remain sluggish by the end of the year

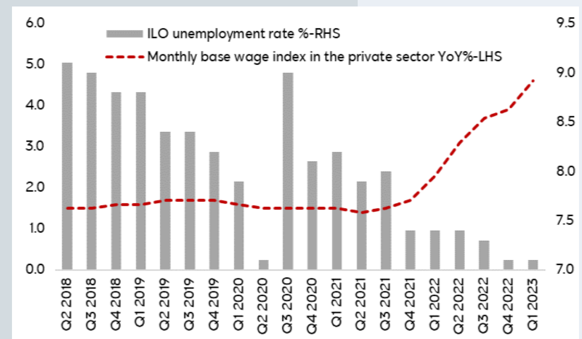
Solely supported by net trade, France's GDP accelerated in Q1 2023, rising by 0.2%QoQ from 0.0%QoQ in the prior quarter, as the economic impact stemming from strikes and social protests against the pension reform was limited. That said, the underlying details on final domestic demand were less rosy, as private consumption remained sluggish amid persistently elevated price pressures and gross fixed investment dropped for the first time since Q4 2021, driven by business investment which continued to decline, reflecting the negative impact of tighter financial conditions. Looking ahead, leading indicators suggest that economic activity retained its positive, though subdued, growth momentum in April and May, with France's statistical office INSEEE expecting GDP to settle at 0.2% in Q2, the same as in Q1. Led by a drop in the services print, the flash composite May PMI declined from April's 52.4 to 51.2 with the April-May average, though, still standing above the respective average of the first three months of the year (51.8 vs. 51.2). Similarly, the INSEE business climate indicator moved lower in May for the third consecutive month, by a further 2.2pts, matching its long-term average of 100 that also marks its lowest level since April 2021, while INSEE consumer confidence was stable at the April's below-long term average level of 83, but remained a tad higher from 82 in March and February and identical to the January's print. On a more encouraging note, recent data continued to confirm that, in spite of subdued growth, the labor market remains strong, contributing to a pickup in nominal wage growth. The unemployment rate stood at a 31-year low of 7.1% in Q1, unchanged from the prior quarter, while base wages growth rose to a multi-year high of 4.6%YoY from 3.9%YoY in Q4 2022, supported by a higher minimum wage which increased in Q1 due to indexation rules of inflation by 1.8% following a cumulative 8.0% rise in the period September 2021-December 2022 before rising again on May 1st by a further 2.2%. However, the expected recovery in consumer spending should remain limited as inflation is seen continuing to drop but only slowly by year-end, while credit conditions are likely to tighten further in the coming quarters, intensifying the drag on investment. All in all, we stick to our view for sluggish GDP growth this year, at 0.5%YoY vs. 2.6%YoY in 2022.

Figure 15: Leading indicators point to still positive, albeit subdued GDP growth in Q2



Source: INSEE, Bloomberg, Eurobank Research

Figure 16: Wage growth is rising fast



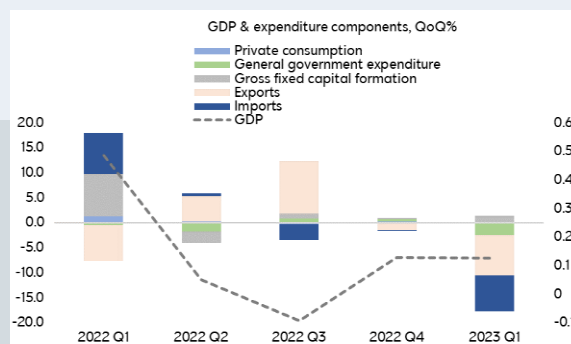
Source: INSEE, Eurobank Research

UK

Expected to avoid recession this year, but growth outlook still looks weak

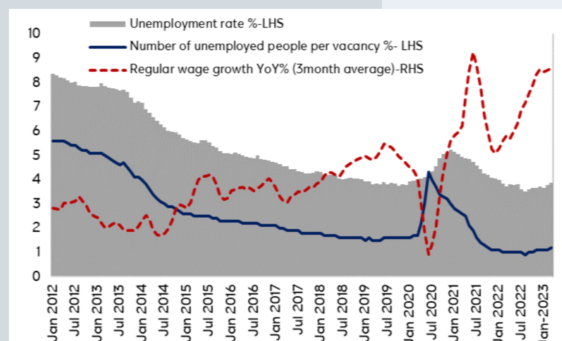
March GDP unexpectedly fell by -0.3%QoQ, driven by weaker services (-0.5%MoM) on the back of exceptionally wet weather and continued strike actions, that were only partially offset by strong manufacturing production (+0.7%MoM) and a relatively modest increase in construction (+0.2%MoM). In spite of the disappointing March GDP print, the economy eked out 0.1%QoQ growth in Q1. This was entirely driven by a 0.1ppts upward revision in the January GDP print to 0.5%MoM —that marked a rebound after a strike-driven fall in December — followed by flatline activity in February. That said, the economy managed to perform in a more resilient manner against the real disposable income squeeze and higher BoE interest rates relative to earlier expectations for a Q1 GDP contraction and the BoE's latest projections of 0.0%QoQ. Nonetheless, it should be noted that, despite the upside surprise, GDP still stands 0.5% below its pre-pandemic Q4 2019 level. Looking into Q2, the weak March GDP print translates into a carryover at -0.1%QoQ, pointing to risks of a contraction, albeit marginally, taking also into account the extra bank holiday in May for the King's Coronation. Looking at activity, though, more broadly, there is some potential for very modest growth in H2. The income squeeze is likely to lessen —inflation is expected to slow further on energy base effects, while wage growth is seen remaining strong on persistent labor market tightness— consumer confidence is steadily improving, though marginally from January's lows, and fiscal policy is turning more supportive from April (the Spring Budget envisions additional fiscal support worth £21.6bn or 0.8% of GDP for FY 2023-24). All these should act as an offset to prevailing headwinds, taking into account that BoE rate tightening has yet to fully feed through to the real economy and the external backdrop is likely to turn gloomier around the turn of the year amid risks of a global slowdown as major CBs' tighter monetary policy would weigh on global growth. All in all, we have revised upward our 2023 GDP growth projection as we now expect flatline growth rather than a modest contraction, with risks, though, still assessed to be to the downside amid tightening financial conditions.

Figure 17: Q1 GDP growth in expansionary territory, though marginally



Source: ONS, Eurobank Research

Figure 18: Wage growth is still accelerating in spite of signs of easing in labor market conditions



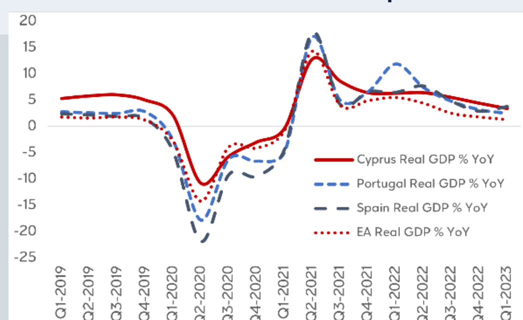
Source: ONS Eurobank Research

Cyprus

Household consumption to sustain growth beyond Q1-2023, albeit at a slower pace

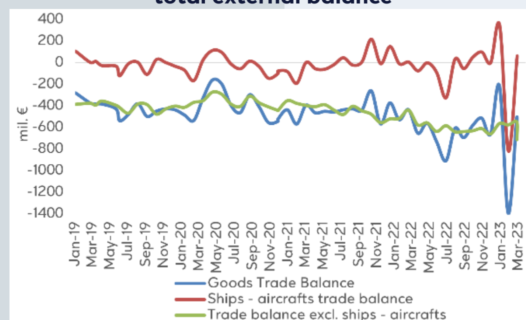
GDP growth eased for the third consecutive quarter in Q1-2023, to 3.4%YoY from 4.4%YoY in Q4-2022. However, output continued growing on a quarterly basis at an almost stable pace (+0.8% against 0.9% in the previous quarter). Growth determinants changed compared to Q4, with investments – the cause of deceleration at that time- becoming the main growth driver, due to an increase of 70.5%YoY, not owing to base effects but to a very strong, most likely one-off expansion of capital formation in transport equipment (+566.8%YoY), from acquisition of ships. The contribution of the household consumption (+5.1%YoY) to growth lagged that of investments. The upward trend in exports of services, the second most significant growth driver last year, weakened further, to 2.3%YoY vs. 3.6%YoY in Q4. In combination with a similar rise in exports of goods (+3.0%YoY) and a strong increase in imports of goods (+42.3%YoY), related to the extensive investments in shipping, the external deficit skyrocketed to 15.9% of the quarterly GDP, holding back growth. Most of the changes in the ranking of growth determinants in Q1-2023 are expected to be gradually reversed in the next quarters. The continuous ease of inflation during October 2022 – May 2023, from 8.8%YoY to 3.0%YoY, will be sustained in the coming period by the imposition since early May of a zero VAT rate on a list of basic goods, which is expected to be extended in June to more food products, likely boosting household consumption. The robust annual increase in tourist arrivals at the start of the tourism season in April, by 18.5%YoY, led the number of tourists higher than in April 2019 by 4.1%. This trend, together with spending per capita at last year's levels achieved since March, signals a potential stronger support from exports of services to GDP from Q2 onwards. On the other hand, the dynamics of exports of goods are volatile, especially with EU trade partners. The boost of shipping in Q1 to fixed capital formation and to imports is not expected to recur in the next quarters. Conversely, the termination of the real estate protection scheme and the forthcoming introduction of a reduced VAT rate for sales of first residences, are expected to heat up credit expansion and investments. The above dynamics will sustain a milder growth in the remainder of 2023, bringing the average growth rate to 2.5%.

Figure 19: In terms of YoY GDP growth, Cyprus performed better in Q1 2023 than all the other Euro area countries but Spain



Source: Eurostat, Eurobank Research

Figure 20: The fluctuation of the goods trade balance is largely affected by the ships - air-crafts balance, as was evident in the Q1-2023 total external balance



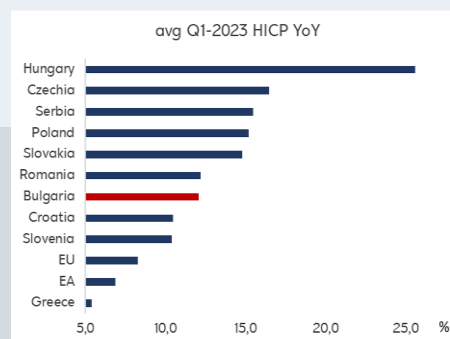
Source: CYSTAT, Eurobank Research

Bulgaria

Economic cooling to intensify as carry over effect fades after Q1

The Q1-2023 GDP growth flash estimate released in mid-May pointed to a modest deceleration compared to Q4-2022, both in annual and quarterly terms as respective growth rates came in at 2.0%YoY and 0.4%QoQ from 2.1%YoY and 0.5%QoQ. High frequency indicators coming from both the supply and demand side of the economy bode well with the said performance of the first quarter as industrial production contracted by -9.0%YoY in March from -2.7%YoY in February and retail sales growth cooled to 1.1%YoY from 4.3%YoY and 5.6%YoY in February and January respectively. Meanwhile, inflation pressures remained on a downward trend in April. Headline CPI came in at 11.6%YoY from 14.0%YoY in March with April being the seventh month in a row with decreasing CPI readings. Easing price pressures were also evident in the monthly reading which came in at 0.3% from 0.5% a month ago. On the flipside, average wage growth continued to accelerate by 17.26%YoY in Q1-2023, posting the fourth quarterly increase in a row. While increases up to the end of 2022 were considered as necessary for the support of the disposable income which was hampered by the spiraling inflation, we read beneath the latest wage growth the persistent tightness of the labor market in the country and we flag it as a possible headwind towards the expected decompression of inflation in the medium term. Specifically, ultra-low unemployment continued to decrease in April, coming in at 5.2%, down by 0.1pps and 0.2pps on annual and monthly terms respectively. We also map an additional impact of the gaining speed wage increases have been posting during the past 12 months, that on the fiscal front as more than half of the amplified fiscal deficit target of 6.4% as a percentage of GDP for 2023 consists of wages and pensions. In detail, the EC estimated in its recently released Spring forecasts, the cost of the said expenditure at 3.5% of GDP when the general government deficit in 2022 was 2.8% of GDP. Despite the challenging tradeoff between inflation and unemployment with the first variable on a downward trend so far in 2023 but with the latter posing hurdles on the quicker decrease of CPI in the remainder of the year, the EC lifted by a tad its 2023 GDP growth forecast to 1.5% from 1.4% in the Winter Edition, fitting well with our view which stands at 1.3% since March. Nevertheless, it should be highlighted that almost half of the FY forecast growth rate appears at large driven by the positive carry over effect from 2022 as the EC forecasts the economy to remain in a stand still mode in the next three quarters after forecasting, accurately, Q1's growth (flash estimate 0.4%QoQ vs EC forecast 0.5%QoQ).

Figure 21: inflationary pressures in Q1 less severe compared to intra-CESEE



Source: Eurostat, Eurobank Research

Figure 22: ...with Q1-2023 growth firmer, than in other peers

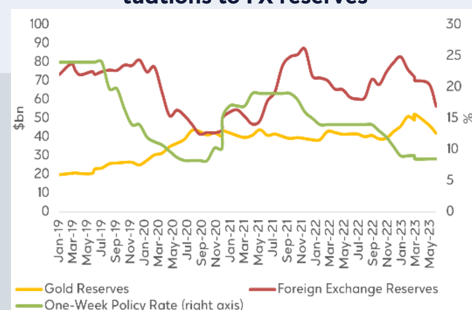
Source: Eurostat, Eurobank Research

Turkey

Signals for changes in monetary policy, on the back of pressures on the lira and foreign reserves

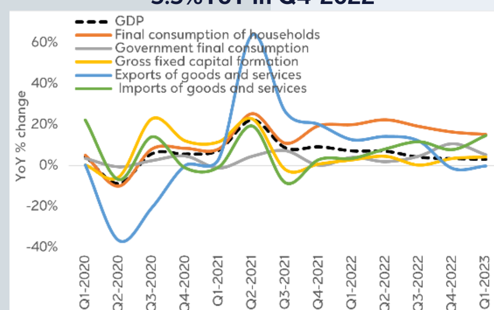
The overall economic activity in Turkey was not severely affected by the February earthquakes, at least in the short-term, as GDP rose by 3.0%YoY in Q1-2023, the slowest pace since Q3-2020, albeit slightly below the 3.5%YoY growth rate in Q4-2022, while growth continued on a quarterly basis (+0.3% vs. +0.9%). The GDP increase is mainly due to a widening of household consumption by 15.3%YoY and investments expansion (+4.2%YoY). Public consumption expanded by 5.3%YoY, posting, however, a strong deceleration compared to a quarter earlier (10.7%YoY), despite emergency measures to address the implications of the earthquakes. The impact of the external sector was negative, as exports were broadly unchanged (-0.1%YoY), after a mild decline in the previous quarter (-1.3%YoY), while imports widened much further (+14.8%YoY vs. +7.9%YoY). These dynamics in exports and imports imply that the prolonged loose monetary policy that led the lira (TRY) to protracted sliding does not improve the external balance. Economic developments not only in the near-term, but also in a longer-term perspective, will be drastically affected by the economic policy priorities of the new government under the re-elected President Recep Tayyip Erdogan, especially those concerning monetary policy. Prior to the elections, the ruling party had signaled that the low-rate policy followed since September 2021, leading to negative real interest rates and a sharp TRY devaluation, would be continued in case it won the elections. However, the newly appointed Minister of Treasury and Finance Mehmet Simsek stated at the handover ceremony that Turkey has no choice but to return to a rational basis in the handling of the economy, adding that price stability will be his main target. These statements are considered as signaling of a shift to conventional economic policy principles and monetary policy tightening, with the degree of the turn, however, largely depending on the level of independency Simsek will be granted, e.g., from the president's and the central bank's (TCMB) views. Meanwhile, the TRY weakened by a further 7.4% against the USD since the first round of elections on May 14th and up to June 2nd, with TRY/USD falling below 0.048 (-10.9%YtD), while the TCMB foreign reserves declined during 05-26 May by 13.7%, down by 23.5%YtD, to USD98.5bn. These developments indicate the urgency for monetary policy decisions to improve the above and some other crucial parameters in the economy (e.g., inflation).

Figure 23: The Central Bank has been consistently increasing gold reserves to tackle potential implications of key policy rate fluctuations to FX reserves



Source: Central Bank of Turkey, Eurobank Research

Figure 24: No signs of strong short-term implications to GDP from the earthquakes, as growth eased to 3.0%YoY in Q1-2023 from 3.5%YoY in Q4-2022



Source: Turkstat, 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)		
	2022e	2023f	2024f	2022e	2023f	2024f	2022e	2023f	2024f	2022e	2023f	2024f	2022e	2023f	2024f
World	3.4	2.6	2.7	8.7	5.5	3.5									
Advanced Economies															
USA	2.1	1.1	0.8	8.0	4.1	2.6	3.6	3.8	4.6	-3.7	-3.1	-3.1	-5.4	-5.6	-5.7
Eurozone	3.4	0.6	1.0	8.4	5.6	2.5	6.7	6.8	6.9	-0.7	1.5	1.7	-3.6	-3.5	-3.0
Germany	1.8	0.0	1.1	8.6	6.1	2.8	5.3	5.6	5.4	4.4	5.0	5.1	-2.6	-2.7	-1.7
France	2.6	0.6	1.0	5.9	5.5	2.5	7.3	7.4	7.4	-2.1	-1.7	-1.0	-4.7	-5.0	-4.7
Periphery															
Cyprus	5.6	2.5	2.9	8.1	3.4	2.0	6.8	6.3	6.0	-9.1	-8.0	-6.0	2.3	1.5	2.0
Italy	3.7	1.2	1.1	8.7	6.3	2.4	8.1	7.8	7.7	-1.2	0.7	1.0	-8.0	-4.5	-3.7
Portugal	6.7	1.1	1.5	8.1	5.5	2.6	6.0	6.5	6.3	-1.4	-1.0	-0.9	-0.4	-1.2	-0.9
Spain	5.5	1.8	1.4	8.3	3.9	2.6	12.9	12.8	12.6	0.6	1.0	1.1	-4.8	-4.4	-3.7
UK	4.3	0.0	0.9	9.1	6.9	2.7	3.7	4.1	4.4	-4.9	-3.5	-3.5	-4.9	-3.5	-3.5
Japan	1.0	1.0	1.1	2.5	2.9	1.7	2.6	2.5	2.4	2.1	2.0	2.2	-6.7	-5.5	-4.0
Emerging Economies															
BRICs															
Brazil	2.9	1.1	1.6	9.3	5.2	4.3	9.5	8.9	9.5	-3.0	-2.3	-2.3	-4.6	-7.8	-7.1
China	3.0	5.5	4.9	2.0	1.6	2.3	4.9	4.5	4.5	2.2	1.5	1.1	-4.7	-5.0	-4.6
India	7.0	6.0	6.3	6.7	5.3	5.1		NA		-2.1	-1.9	-1.9	-6.4	-5.9	-5.3
Russia	-2.1	-0.7	1.3	13.8	5.8	5.0	3.9	3.7	3.7	10.2	4.6	3.6	-2.2	-3.4	-1.9
CESEE															
Bulgaria	3.4	1.3	2.5	15.3	9.7	4.1	4.3	4.5	4.4	-0.7	-0.8	-0.4	-2.8	-3.6	-3.0
Turkey	5.4	2.2	3.5	72.0	41.4	23.6	10.5	12.0	11.5	-5.5	-6.8	-5.5	-0.9	-2.5	-1.3

Sources: European Commission, World Bank, IMF, OECD, Bureaus of National Statistics, Bloomberg, Eurobank Research

Eurobank Fixed Income Forecasts

	Current	June-23	September-23	December-23	March-24
USA					
Fed Funds Rate	5.00-5.25%	5.06-5.30%	5.04-5.30%	4.90-5.15%	4.52-4.75%
3m SOFR	5.24%	5.13%	5.07%	4.88%	4.50%
2yr Notes	5.25%	5.30%	5.30%	5.15%	4.75%
10yr Bonds	5.00%	5.06%	5.04%	4.90%	4.52%
Eurozone					
Refi Rate	3.75%	4.00%	4.15%	4.10%	4.05%
3m Euribor	3.48%	3.55%	3.56%	3.51%	3.37%
2yr Bunds	2.83%	2.72%	2.53%	2.33%	2.16%
10yr Bunds	2.36%	2.46%	2.40%	2.22%	2.14%
UK					
Repo Rate	4.50%	4.65%	4.70%	4.65%	4.45%
3m Sonia	4.80%	4.53%	4.49%	4.36%	4.22%
10-yr Gilt	4.20%	3.71%	3.55%	3.36%	3.32%
Switzerland					
3m Saron	1.69%	1.80%	1.80%	1.80%	1.73%
10-yr Bond	0.87%	1.35%	1.38%	1.34%	1.30%

Source: Bloomberg (market implied forecasts)

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