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As evident in the latest global PMI surveys, economic activity continued to gather momentum at the start of Q2, despite financial market uncertainty. However, headwinds appear to be building. Credit conditions tightened further in the period covering the onset of the banking sector turmoil and loan demand weakened further, while core inflation remained sticky. Banking sector stress has made several major central banks more cautious, and though they left the door open to further tightening, if conditions warrant, they signaled that a pause may be in sight, or the hiking cycle may have come closer to its end.

Macro Picture

USA: data point to further weakness in early Q2, reinforcing worries over recession later this year

EA: recession was avoided in Q1 but tighter credit conditions may weigh on future growth

UK: improving near-term growth momentum but challenges prevail

CESEE: data corroborate the economic slow-down in Q1 amid falling, still persistent inflation

Markets

FX: EUR/USD aiming for new highs of the year as rates differentials are turning in favour of the EUR

Rates: EU rates expected to trade range bound as inflationary pressures remain; US rates have probably reached their terminal range of 5-5.25%

EM: sovereign fixed income steady on lower volatility; duration benefits from the end of the Fed's hiking cycle; risks remain

Credit: investors remain cautious pricing-in a further 25bps hike at the June's ECB meeting; growing chances of rate cuts by the Fed

Policy Outlook

USA: Fed signaled a pause, retaining though the option to tighten further, if conditions warrant

EA: ECB slowed the pace of hikes but left the door open to further tightening

UK: BoE pledge to hike further if there is evidence of more persistent inflationary pressures

CESEE: central banks reluctant to cut rates as inflationary pressures ease at a slow pace

Key Downside Risks

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

EM: global financial conditions tighten further pushing borrowing costs higher and fostering debt distress; weaker global trade growth

Special Topics in this issue:

→ The Banking Sector in Cyprus during 2013-2022 and priorities ahead

→ CESEE Economic Outlook

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Policy Outlook

Macro Views 3

World Economic Outlook 3

Developed Economies....................................4

Emerging Economies......................................5

Markets View..6

Special Topics 8

US.. 18

China 19

Japan 20

Euro area 21

Germany..22

France 23

UK 24

Cyprus 25

Bulgaria...26

Turkey 27

Eurobank Macro Forecasts..............................28

Eurobank Fixed Income Forecasts 29

Research Team...30

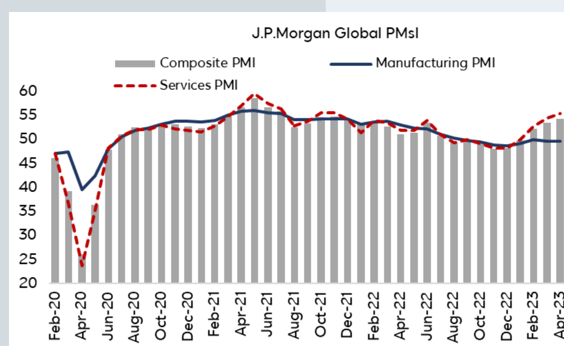
Macro Views

Latest world economic & market developments

April PMIs sent an encouraging signal of resilient global economic activity, but headwinds are building as credit standards continued to tighten

As evident in the latest global PMIs surveys, economic activity continued to gather momentum at the start of Q2, despite financial market uncertainty. The global composite PMI continued to expand in April for the third consecutive month coming in at a 16-month high of 54.2, up by 0.8pts from March, and taking cumulative gains since November 2022 lows to 6.2pts. The activity upturn was driven by the service sector which improved across the board. Mainly driven by higher new orders, the respective global PMI rose from March's 54.4 to 55.4, the highest pace since November 2021, mainly supported by China's reopening and the continued post-pandemic consumer shifting spending from goods to services. However, the manufacturing side looks gloomy (with a few exemptions, notably the US). Led by China's weakness as the initial impact from reopening seems waning, the global PMI remained unchanged at 49.6, i.e., just below the boom-or-bust level of 50, amid softening investment spending and a continued de-stocking process, reflecting softening orders and a decreasing ratio of orders to finished goods.

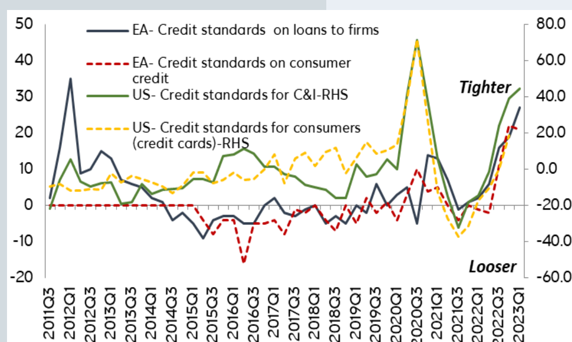
Figure 1: Despite banking stress, global composite PMI took another step up in April



Source: Bloomberg, Eurobank Research

Though April PMIs sent an encouraging signal of resilient global economic activity, headwinds appear to be building. As reported in the recent quarterly bank lending surveys from both the ECB and the Fed, credit conditions tightened further in the period covering the onset of banking sector turmoil in early March — continuing the tightening trend started in H2 2022 — while loan demand weakened further, pointing to risks of a broader contraction in credit growth that could contribute to softer global growth as the year progresses. Meanwhile, global headline inflation continued to ease in March on energy base effects, but core inflation remained sticky and well above central banks' comfort zones, as persistent labor market tightness in several major economies (including the US, in spite of recent signs of easing), contributes to strong wage growth and keeps core services inflation elevated. Notwithstanding concerns over the effects of tighter credit standards on economic activity, inflation persistence kept pressure on several major

Figure 2: Banks continued to tighten their credit standards in Q1-2023



Source: Fed, ECB, Eurobank Research

central banks for further monetary tightening lately, including the Fed and the ECB, which both delivered a widely expected 25bps rate hike at their latest policy meetings in early May. However, uncertainty about banking sector developments has made them more cautious, signaling that a pause may be in sight, or the hiking cycle may have come closer to its end. Even so, they both retained a tightening bias, indicating that rates could go further higher than currently expected or at least could be kept unchanged at their terminal levels for longer, if needed, to restore price stability on a sustained basis.

Developed Economies

US: The Fed delivered a broadly anticipated 25bps rate hike at the May policy meeting, but the forward guidance was altered, hinting that this rate move may be the last of its current tightening cycle. Worryingly, in the aftermath of the recent banking sector turmoil, bank lending conditions have tightened materially, while, according to the March CPI report, core services excluding shelter— the category the Fed Chair considers as "the most important" for determining whether the disinflationary process is on the right track — dropped to 6.4%YoY from 6.5%YoY, suggesting that, though still at elevated levels, it has likely passed its peak. Nevertheless, the Fed left an implied tightening bias in place, with Powell leaving the door ajar to further tightening if data warrant so. Indeed, in spite of the March easing, it may be too early to conclude that core services excluding shelter has already embarked on a sustained downward trend, taking into account that it is closely linked to the labor market, which, though easing lately, remains tight. Meanwhile, US real GDP grew by a lower-than-expected annualized rate of 1.1% in Q1, while mixed economic data for April suggest that growth is likely weakening further in early Q2, reinforcing worries over recession in H2, as banking stress will likely accelerate the pass-through from tighter monetary policy to the real economy.

Euro area: In spite of significant headwinds, Eurozone GDP growth returned in expansionary territory in Q1 — though slightly — rising by a meagre 0.1%QoQ, according to the flash estimate, after a downward revised 0.1%QoQ contraction in the prior quarter, refuting earlier expectations of a technical recession around the turn of this year. Looking ahead, sentiment indicators suggest that positive growth momentum, though feeble, may continue in Q2. However, as evident in the Q1 2023 ECB Banking Lending Survey, ECB monetary tightening is transmitting forcefully to financial conditions, pointing to risks of a sharp slowdown on future growth. Credit standards tightened further for corporate loans, mortgage loans and consumer credit, leading to a strong drop in demand for loans, while according to the latest credit data, banking lending to households and non-financials remained in a downward trend in March for the seventh and fifth consecutive month. The above, combined with tentative signs that core CPI may have peaked (from March's 5.7%YoY record high down to 5.6%YoY in April, the first decline in ten months), led the ECB to slow the pace of rate tightening to 25bps at the May policy meeting, leaving though the door open for further hikes amid persistently above-target inflation.

Emerging Economies

EM: April's World Economic Outlook (WEO) released tactically in mid-April by the IMF held no major surprises but stamped the prevailing intuition, following the eventful March in the financial sector (SVB and First Republic collapse, Credit Suisse takeover by UBS), that financial uncertainty could render a tangible risk in the months ahead should global financial conditions tighten further, even though the effects of the latest financial market turmoil on emerging market and developing economy sovereign spreads have been short-lived amid soothing contagion fears. Regarding the growth outlook, relevant projections remained broadly unchanged compared to the January's WEO update. EM GDP growth is seen remaining almost unchanged to 3.9% for 2023 (from 4.0% previously), driven primarily by China and India which are both expected to expand their output by 5.2% and 5.9% respectively, tipping in almost half of this year's projected 2.8% global economic growth. As outlined in previous issues, economic prospects across EMs, are on average stronger than those for advanced economies, but prospects vary between developing regions, with emerging Asia expected to lead (+5.3%) because of China and India, while CESEE is seen lagging (+1.2%) given, inter alia, its geographic proximity with Ukraine and Russia and its strong ties with the EU and EA which are both expected to witness a pronounced growth slowdown compared to 2022. Challenges and vulnerabilities, however, remain in the area. According to the WEO outlook, almost 56% of low-income developing countries are estimated to be either already in debt distress or at high risk and about 25% of emerging market economies are also estimated to be at high risk of debt sustainability. Along these lines, elevated political risks in major EMs confronted already with idiosyncratic hardships, either political or economic or both, due to upcoming elections in Turkey in mid-May, Argentina in October and Poland in late 2023, shift the overall balance of risks.

CESEE: while the first small taste from the Q1-2023 GDP growth data could allow for some doubt over broadly convicted economic slowdown in Q1 in the region, additional hard data covering a broader range of the region corroborate the economic slowdown. So far, only Czechia and Serbia have published flash estimates with the majority of flash releases from the rest of peers due in mid-May. In Czechia, GDP contracted by -0.2%YoY beating to the upside market expectations for a -0.5%YoY contraction while on a quarterly level, growth held still inching by a tad (+0.1%QoQ). In Serbia, growth rate was calculated at 0.7%YoY from 0.4%YoY in Q4, with the Minister of Finance stating that the said result surpassed expectations of the Ministry amid lack of market consensus for the said performance. Dynamics on the demand side of the regional economies appear weakened as retail sales growth came in negative in March on both yearly and monthly basis in Czechia, Slovakia, and Poland. The pattern is similar on the supply side as industrial production growth retreated in March when it comes to annual prints in Bulgaria, Hungary and Serbia. With March's prints available for all peers and with a representative sample for some in April, inflationary pressures retreated with April's prints in Croatia and Slovenia returning to one-digit grounds (+8.8%YoY and 9.4%YoY respectively) but with other economies still having a lot of distance to cross as in Hungary (+25.2%YoY in March) and Poland, Czechia, Romania, Slovakia and Bulgaria whose latest available prints range around 15.0%YoY.

Markets View

Foreign Exchange

EUR/USD is trading around 1.10 slightly higher from 1.09 at the start of April with the 1.11 level proving a very strong resistance for the pair. Despite the significant policy divergence between the Fed and the ECB, post their respective meetings last week, and the fact that the market is pricing around 1% of cuts by Jan 24 for the Fed, the EUR has not been able to break higher versus the USD. We see the pair consolidating at current levels with an eventual break higher once bearish positioning on the USD clears a little

EUR/GBP is trading at 0.8708 from 0.8790 at the start of April as sentiment about the UK is changing rapidly given strong economic numbers and a hawkish BoE. The resilience in UK domestic demand alongside stubbornly high wage growth is facilitating this shift towards relative hawkishness, following a series of reluctant hikes. Although the bar is now too high for the MPC to take a more hawkish position than the market, high and sticky domestic inflation along with strong wage growth are transforming the BoE into a less dovish central bank versus G10 peers. The momentum is for the pair to test 0.86 with resistance at 0.8784.

Rates

EU: swap rates have remained in a tight range during the last month, with the 10-year swap rate now trading around 295bps, having reached a high of 315bps. The yield curve slope has increased, with the 5s30s spread trading at -35bps, a notable uptick from the -50bps recorded earlier in the month. Looking ahead, it is anticipated that the rates will remain volatile and drift higher. The earlier than anticipated termination of the Asset Purchases Program (APP) and the expectation of persisting inflation given the upward pressure on wages, are likely factors that will contribute to that view.

US: swap rates ended the month mixed following significant volatility, especially in the front end of the curve. The 10yr swap rate is trading at 345bps, having traded as high as 360bps. The slope of the curve continued to increase with 5s30s being traded at -18bps, from -40bps at the beginning of April. Going forward, it is expected that the curve will continue its bull steepening trend, given the markets' pricing of four cuts in the next 12 months and the high risk of defaults for regional US banks, attributed, inter alia, to the Fed's monetary policy.

Emerging Markets Sovereign credit

April was a very calm month due to no central bank meetings and no geopolitical curveballs. EM sovereign bonds were little changed with the EMBI Global Index closing at 401bps at the end of April, just 2bps wider on the month. The Fed's meeting at the start of May was in line with market expectations and probably

has brought the end of its hiking cycle. In CEEMEA, volatility in spreads was limited, with Romania performing well. In LATAM, sovereign spreads were also steady, while in Colombia, President Petro announced a cabinet reshuffling where he surprisingly replaced MoF Ocampo with Ricardo Bonilla, triggering negative market reactions. In Asia, Chinese data continue to come in strongly while foreign holding of Chinese bonds marginally increased. Even though volatility has come down sharply and the Fed seems to approach the end of its hiking cycle, we remain constructive but cautious on EM assets as the US economic outlook is still cloudy and the US debt ceiling continues to gather attention.

Corporate credit

After the turmoil in March, April was a fairly calm month for financial markets. Volatility subsided materially, with both the MOVE and the VIX returning to pre-SVB collapse levels (VIX in particular, to lowest levels since the end of 2021). At the same time, the latest data continued to show that inflation remained resilient on both sides of the Atlantic. One developing story that is continuously gaining ground is the US debt ceiling saga and whether an agreement on raising or cancelling it can be reached in time to avoid a default, leading to a noticeable widening in CDS spreads in the US. On the commodities front, the OPEC+ decision to cut production in early April led oil prices higher but recession fears following weak data erased gains. US regional banks continue to be in focus in view of the collapse of the First Republic Bank and its take-over by JP Morgan. Both the Fed and the ECB decided on a 25bps hike, with the ECB delivering a hawkish message, signalling further hikes ahead.

On credit, April returns were positive, albeit subdued. However, news flow related to the collapse of the First Republic Bank wiped out mild gains taking credit spreads wider April-to-date. CDX IG stands +7bps wider since the beginning of April, with CDX HY +39bps. In Europe, the iTraxx Main has managed to remain flattish (+3bps), while the Xover is +14bps wider April-to-date. Industrials, Communication and Technology outperformed in the EU IG corporate cash space (-11-12bps tighter each) while Sub Financials remained a laggard (+10bps wider April-to-date). In High Yield, Energy, Industrials and Consumer Discretionary fared better (-20-35bps tighter each) while Technology, Communication, and Technology Senior Financials underperformed (widening by 50-70bps each).

Looking ahead, investors are likely to remain cautious, with focus on rates and recession risks, having priced-in a further 25bps hike at the next ECB meeting in June and starting to assign growing chances of rate cuts from the Fed over the rest of the year. US regional banks and debt ceiling news flow should also remain at the forefront, as Q1 earnings releases continue in the background. In the EU primary market, following a fairly active April in terms of new issuance, May has started on slightly slower foot-print.

Special Topics

I. Developments in the Banking Sector in Cyprus during 2013-2022 and priorities ahead for soundness and expansion[1]

Introduction

Amidst concerns about the sustainability of Cyprus's public finances, as well as the country's financial sector, the Cypriot authorities requested in June 2012 financial assistance from the Euro area Member States and the IMF. In March 2013, the Eurogroup reached a political agreement on the key elements of a 3-year Economic Adjustment Programme (EAP) for Cyprus with a financial envelope of up to €10bn. The relevant Memorandum of Understanding (MoU) included a number of bank resolution, recapitalisation and restructuring measures. Further regulatory and supervisory measures were designed and implemented in the following years. The extensive restructuring of the banking sector also continued, both across the banking system and within each banking institution. The main purpose of this special topic is to present the most important developments and trends in the Cypriot banking sector during the period 2013-2022, with an ulterior target to depict the challenges ahead ten years after the 2013 crisis, together with relevant measures and policy recommendations.

Policies and measures for the banking sector during the EAP and related developments

The bank resolution and restructuring measures were at the heart of immediate policies about the banking sector included in the EAP and implemented in March 2013. Specifically, Laiki Bank was resolved, with the full contribution of equity shareholders, bond holders and uninsured depositors (with deposits > €100.000). Laiki Bank's business, staff, branches and assets in Cyprus, as well as insured deposits up to €100.000 were transferred to Bank of Cyprus. The Bank of Cyprus was recapitalised through a deposit/equity conversion of uninsured deposits (> €100.000) and full contribution of equity shareholders and bond holders. As in the case of Laiki Bank, insured depositors were fully protected. As a result of the above measures and of EU legislation on insuring deposits, 4% of depositors in Laiki and Bank of Cyprus were affected.

Due to the unprecedented market shock and deterioration in confidence because of the bank resolution and restructuring actions, capital controls were implemented after the end of the bank holiday period (Tuesday 19 to Wednesday 27 March), to safeguard the liquidity of the banking sector. The most significant constraints initially placed concerned cash withdrawals, payments for salaries and individual payments via debit and credit cards outside Cyprus. Cashless payments or transfers of deposits/funds to accounts held abroad were banned, with the exception of transactions falling within "normal business practices", e.g., for purchasing goods by businesses.

[1] Based on the Eurobank Research Global & Regional Focus Note for the same topic published in April 2023: https://www.eurobank.gr/en/group/economic-research/diethnis-oikonomia-kai-agores/global-regional-focus-notes-06-04-23

Additional bank restructuring procedures were implemented through the course of the EAP. Specifically, 93 cooperative credit institutions were merged into 18 new entities from October 2013 to March 2014. The Cooperative Central Bank (CCB) and the new cooperative credit institutions were recapitalised from the financial envelope of the EAP, with a capital injection of €1.5bn. The Hellenic Bank successfully completed the strengthening of its capital base in 2013 by raising €358mn in private funds. In July 2014, the Resolution Authority proceeded to resolution measures for the Federal Bank of the Middle East (FBME) branch in Cyprus, on the basis of a decision issued by the Financial Crimes Enforcement Network of the US Treasury Office (FinCEN), which named FBME as a financial institution of primary money laundering concern. After not receiving any offers from credit institutions for the acquisition of the operations of FBME in Cyprus, the Resolution Authority moved on Oct-15 to the revocation of the license granted to the FBME branch.

Besides the above and other restructuring procedures in the banking sector, numerous reforms to its supervisory and regulatory framework were implemented during the EAP. The most significant ones were the following:

- The Central Bank of Cyprus (CBC) amended its capital requirements directive and imposed a minimum Core Tier 1 ratio of 9% on all institutions by end-December 2013, up from the 8% requirement prior to the 2013 crisis, despite capital losses earlier in that year and the ongoing -at that time- restructuring.
- CBC directive in relation to NPLs (June 2013). The definition of NPLs was brought broadly in line with the relevant European Banking Authority (EBA) definition which was to be implemented across the EU since September 2014.
- CBC directive aiming to ensure the prudent application of the IFRS on the issues of loan impairment and provisioning (Jan-14). The directive required banks to have in place adequate provisioning policies and procedures based on conservative assumptions, in order to correctly and promptly identify impairments and take adequate provisions.
- Governance and Management Directive (Aug-14). This directive replaced the Directive on the Framework of Principles of Operation and Criteria of Assessment of Banks' Organisational Structure, Internal Governance, and Internal Control Systems of 2006 - 2012. The main provisions of the Directive concerned (a) requirements on the governance structures of credit institutions; (b) requirements regarding the roles and responsibilities of management bodies and senior management.

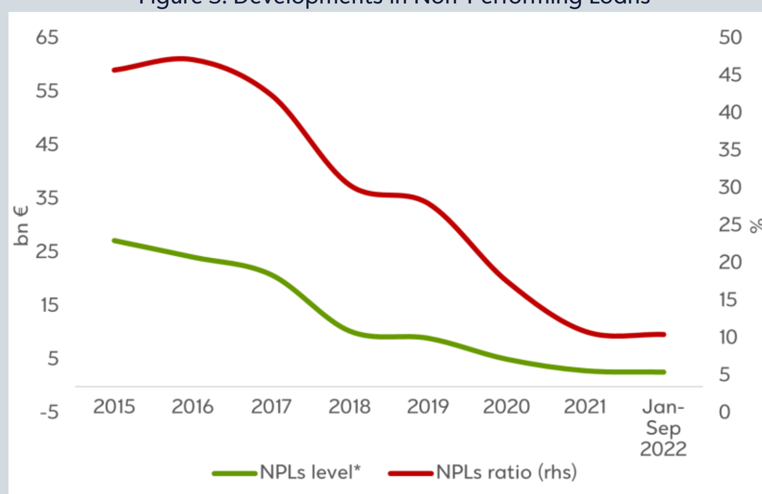
Extensive restructuring processes in the banking sector and uncertainty on whether they would prove adequate for restoring banking system’s soundness, resulted in an average annual decline of loans to domestic non-financial corporations in 2013 by 6.9%, the biggest fall since at least 2007, stronger than that towards households (-5.1%). The downward trend in deposits in 2013 was much stronger compared to that in loans, mainly as a result of the impairment of uninsured deposits at Laiki Bank using the bail-in method, a deterioration in business and household confidence from heightened uncertainty about the viability of some of the banks, but also because of the strong economic recession, as GDP declined by 6.3% in 2013, after a recession of 3.6% in 2012. On the back of these adverse developments, deposits contracted for a second year in a row in 2013, by 16.2%, after a 1.9% fall a year earlier. The shrinkage was more pronounced in non-financial businesses (-22.4%) compared to households (-12.6%). Towards the end of 2013, non-performing loans (NPLs) reached, according to the newly introduced definition since June 2013, 38% and 44% of total credit facilities granted by banks and cooperative credit institutions, respectively.

After the establishment of the Single Supervisory Mechanism in October 2013, which renders the ECB the central prudential supervisor of financial institutions in the Euro area, as well as in non-euro EU countries that choose to join the SSM, a review of banks, determined as significant by the ECB, was undertaken in 2014 and was concluded in October of that year. In Cyprus, the Bank of Cyprus, the CCB, the Hellenic Bank and the Russian Commercial Bank (RCB) were considered to be significant. The ECB review was based on a Core Tier capital ratio of 8%. All four banks in Cyprus were found to be adequately capitalised under the stressed scenario, except for Hellenic Bank that presented a small capital shortfall, which was covered before the end of 2014 with the issuance of capital to existing shareholders.

The results of the SSM assessment, along with the successful implementation of the EAP in 2013 and 2014, reflected in the programme reviews,[2] strengthened the confidence of businesses and households to the prospects of the Cypriot economy and paved the way for the full lift of the capital controls in April 2015, two years after they came into force. The improved confidence was also reflected in the strong deceleration in the fall of deposits during 2014, the trend being stronger in non-financial businesses (from -29.7%YoY in Jan-14 to -2.6%YoY in Dec-14) compared to households (from -15.2%YoY to -3.6%YoY). The lift of the restrictive measures in April 2015 resulted in a reversal of the deposits' trend in households from August 2015 onwards and in non-financial businesses from October 2015 onwards.

Despite successful recapitalisations, enhancements in numerous aspects of the regulatory framework and the significant ease in the decline of deposits in 2014 (turned positive next year), the very high level of NPLs deterred banks from providing more credit to the economy. By end-2014 NPLs stood at 47.8% of total loans or €28.4bn, whereas one year later their level was slightly lower, at 45.8% (€27.3bn, Figure 3). As a consequence, the decline in bank credit to the non-financial sector (excl. general government) accelerated in 2014, to 7.3%YoY from 4.1%YoY in the previous year, with the downward trend easing in 2015 (-2.2%YoY). The fall was more pronounced in 2014 among other intermediate financial organisations (-24.6%YoY) and in 2015 in insurance companies and pension funds (-62.9%YoY).

Figure 3: Developments in Non-Performing Loans

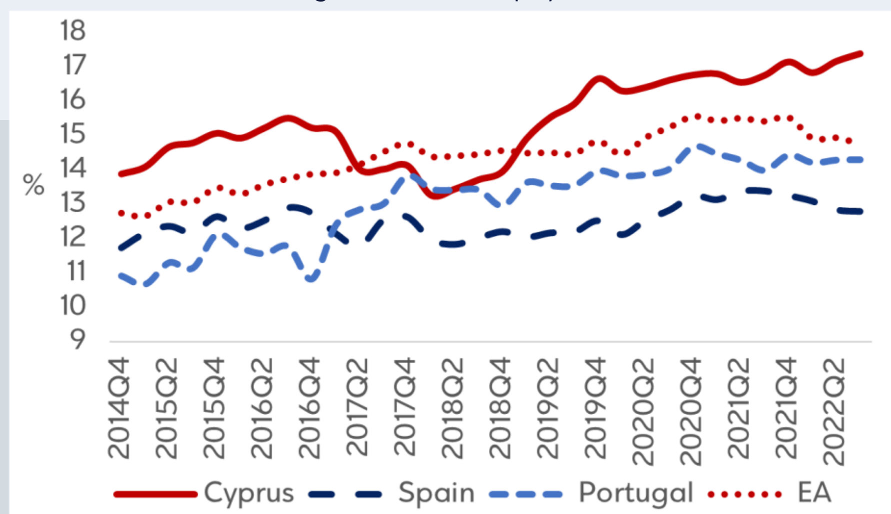


*End-year/period outstanding amounts
Source: Central Bank of Cyprus, Eurobank Research

[2] In the reports following the reviews, it was highlighted that the fiscal targets were met with significant margin, along with advances in the implementation of restructuring plans and capital raising for banks and enhancements towards strengthening supervisory monitoring and operational capacity to address NPLs

Finally, regarding trends in capital adequacy, the Common Equity Tier 1 (CET1) ratio was almost steadily increasing from March 2014[3] up to the completion of the EAP (early 2016), rising from 12.5% to 15.2%, standing well above the EA average (Figure 4).

Figure 4: Common Equity Tier 1



Source: Central Bank of Cyprus, ECB, Eurobank Research

Cyprus successfully completed the Economic Adjustment Programme in March 2016, making use of €7.8bn out of €10bn of the related financial envelope.

Developments in the post-programme period (2016-2022)

The restructuring of the banking sector continued after exiting the EAP in early 2016, up to the current period, so as to take advantage of economies of scale and synergies, of the legal framework for the reduction of distressed loans etc. The most significant relevant actions are the following:

- Sale of €2.8bn of NPLs by the Bank of Cyprus in August 2018 (project Helix)
- Sale of certain assets and liabilities of Cyprus Cooperative Bank to Hellenic Bank (September 2018), after the former officially collapsed in August 2018, and transformation of CCB into a credit acquisition company (Cyprus Asset Management Company – CAMC). The latter company took over the management of approximately €7bn of NPLs not transferred to Hellenic Bank, reducing significantly the amount of NPLs in the banking system (Figure 3) and contributing decisively to the return of Cyprus' sovereign rating to investment grade in September 2018.
- Completion in October 2019 of the acquisition of USB by AstroBank
- In July 2021, Eurobank announced the Acquisition of a 9.9% stake in Hellenic Bank and the conclusion of a share purchase agreement with Third Point Hellenic Recovery Fund L.P. for the acquisition of an additional 2.7% stake (completed December 2021)

[3] Starting period of application of CET1

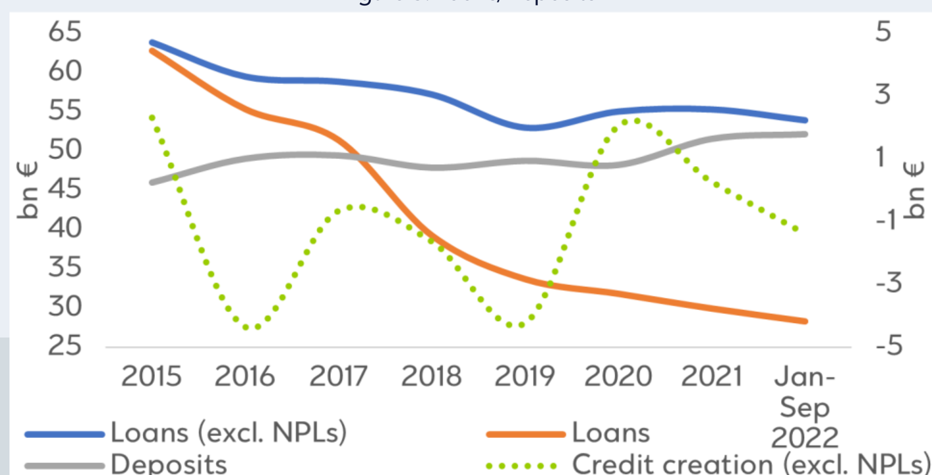
- In February 2022, a few days before the Russian invasion in Ukraine, VTB bank, a Russian majority state-owned bank, sold its controlling stake in RCB to Cypriot shareholders, thus making RCB entirely Cypriot-owned. In March 2022, the ECB announced its decision to phase out the operations of RCB. The winding up process was completed in October 2022.
- In early December 2022, Eurobank Cyprus raised its stake in Hellenic Bank from 12.6% to 26% by buying the stake of Wargaming. In end December 2022 Eurobank bought the 3.2% share of Senvest Management LLC. For companies listed on the Cyprus stock exchange, once the stake of a shareholder is 30% or higher, a public proposal for the majority stake must be submitted.

Besides these intra-sector developments, the return of the sovereign rating to investment grade was a very crucial development for reinforcing confidence, not only to the Cypriot economy, but also to the banking sector. The implications of the pandemic in 2020 affected the sector, but the lift of restrictive measures during most of the time in 2021, in combination with the financial support policies backed by the ECB (e.g., Pandemic Emergency Purchase Programme, PEPP) strengthened the liquidity and economic activity of banks in that year. Accordingly, fluctuations in deposits, loans, economic results etc. during 2016-2021 can be interpreted mostly based on the effects of these developments.

Specifically, the abolition of capital controls in 2015 and the exit from the EAP in early 2016 are considered to be the main reasons behind the steep rise of deposits in the latter year (Figure 5). With the return to investment grade pending and amid restructuring processes in the banking sector in 2018, deposits moderately fell in 2017-2018 and returned on a growth path afterwards, temporarily halted in the first year of the pandemic. They were most possibly reinforced in 2021 by emergency support measures to tackle the implications of the pandemic for the private sector, a trend that eased in 2022, as Cyprus had exited the health crisis and household consumption widened significantly (+7.7%YoY, the strongest increase since 2009).

Regarding developments in the critical issue of non-performing loans, which also affected credit expansion as will be shown next, most of the drastic reduction in the absolute level of NPLs during 2016-2021 was achieved through sales (e.g., the aforementioned transfer of €7bn of NPLs to CAMC, project Helix, as well as project Helix 2 Portfolio A (€886mn of NPLs sold in June 20)). The reduction of NPLs was in part achieved through the more careful provision of new loans, e.g., by following a wider set of lending criteria or amending existing criteria to be more demanding. These lending strategies are reflected in credit growth excluding changes in NPLs (Figure 5), which was negative in four out of six years in the period 2016-2021, resulting to a compound annual growth rate (CAGR) of the outstanding amount of loans of -2.4%. The CAGR of the amount of NPLs during the same period was -30.8%, resulting to an overall strong fall of 89.1%. As a result of these two falls, the NPLs ratio stood at 11.0% at end-2021 from 45.8% at end-2015 (Figure 3). According to the most recent data available, the NPLs ratio stood in December 2022 at 9.5%. Despite the progress in reducing NPLs, their ratio in Cyprus remains much higher than the Euro Area average.

Figure 5: Loans/Deposits*



*End-year/period outstanding amounts

Source: Central Bank of Cyprus, Eurobank Research

Besides the strong downward trend in NPLs, the amount of Stage 2 loans (according to IFRS 9)[4] remained elevated at end-2021 compared to the pre-pandemic period, at 16.1% of serviced loans from 12.6% in December 2019. At the beginning of the pandemic, Cypriot banks moved a large part of their exposures to tourism and transport businesses into Stage 2, which entails a higher level of risk, as both sectors were heavily affected by the COVID-19 pandemic. Later, part of these exposures was re-classified as Stage 1. Cyprus remained in 2022 among the EU countries with the highest proportion of Stage 2 and Stage 3 exposures, together comprising 24% of the loan portfolio. [5]

Regarding trends in capital adequacy, after improving during the EAP, the CET1 ratio decreased moderately in 2017 and 2018 relative to previous years, mainly because of additional provisions for doubtful debts (Figure 4). In 2019 the CET1 rose significantly, by 230bpts, to 17.4% and improved marginally in 2020-2021 (17.7% in both years), despite the implications of the pandemic. The latter were to some extent tackled by means of the prudential measures adopted in June 2020 in the context of the Capital Requirements Regulation (the so-called "Quick Fix" set of measures), mainly from the advanced application of the SME and infrastructure supporting factor, which allows for a more favourable treatment of certain exposures, thus supporting credit flows to these two segments of the economy. Banks' cautiousness in providing loans in 2020-2021 also kept the CET1 relatively unaffected by the pandemic. Based on the latest data available, in September 2022, the CET1 had improved further (18.0%).

Besides the significant achievements in the banking sector which were initiated by the EAP, a reference should be made to the front-loaded, sustainable fiscal consolidation in Cyprus, also because of the programme related policies. The drastic reduction of the general government deficit was based both on expenditure cuts, mainly in personnel costs and interest savings, and increased revenue, from higher social security contributions, EU capital inflows and indirect tax payments. Excluding the two pandemic years, Cyprus is steadily achieving positive fiscal balances (excl. emergency support to banks in some years) from

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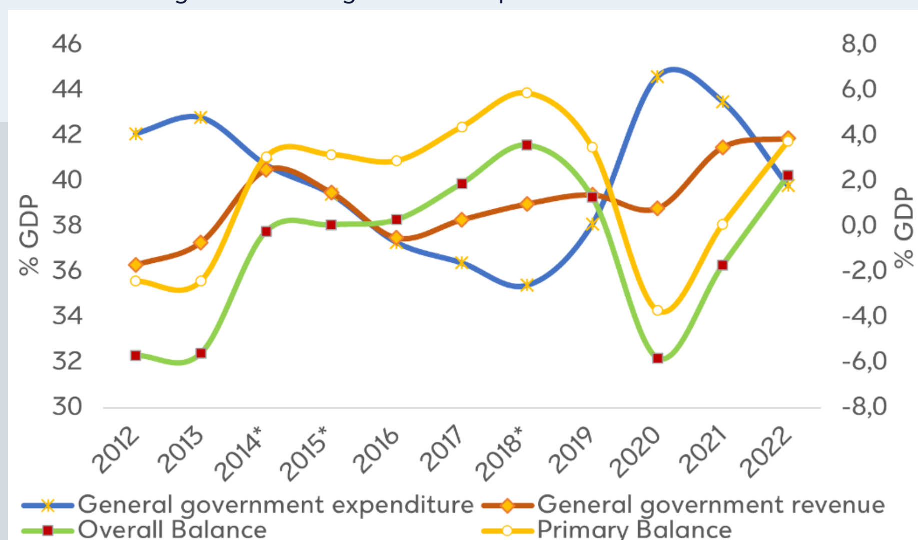
[4] Stage 2 assets are financial instruments that have deteriorated significantly in credit quality since initial recognition but offer no objective evidence of a credit loss event

[5] European Commission (2022), Post-Programme Surveillance Report - Cyprus, Autumn 2022, Institutional Paper no 189

2013 onwards (Figure 6). Solid public finance is reflected at the country's sovereign rating upgrades after 2013. As already mentioned, in September 2018 Cyprus returned to an investment grade (S&P BBB- notch). In recent relevant developments, in March 2023 Fitch upgraded the long-term credit rating by one notch to "BBB" from "BBB-" with a stable outlook.

Figure 6: General government expenditure-revenue-balance



Source: Central Bank of Cyprus, Eurobank Research

Challenges and priorities for the banking sector ahead

The banking sector in Cyprus underwent a massive restructuring process during the EAP period, but also after it, concerning a) streamlining internal governance and management practices, as well as asset impairment and provisioning procedures, b) strengthening the supervisory role of the CBC, but more importantly c) restoring capital adequacy. However, there is still room for further progress in some of these issues. Furthermore, given the improved conditions, other, sector growth-related priorities can be set.

Specifically, a further reduction of banks' NPLs could be achieved with means of the systemic solution that will emerge from the relevant study recently commissioned by the Central Bank of Cyprus to a consortium of international consulting firms. The scope of the study extends over other problematic assets of the Cypriot banking system as well. The new approach is not intended to replace the existing tools for reducing NPLs but to have a role complementary to this procedure.

As the reduction of NPLs was partially based on cautious new lending to limit exposure of loan portfolios to potential further threats for their quality, which led to credit contraction in most years from 2013 onwards with implications for economic growth, the restoration of credit expansion on a relatively permanent basis should be included in the main targets of the banking sector. Financial resources from NextGenerationEU and the MFF 2021-2027 are considered of vital importance for strengthening credit expansion towards businesses in the medium-term. The economic sectors which are expected to be mostly benefited by the two EU programmes and will be in need also of bank financing, are energy, tourism, transports, ICT, real estate.

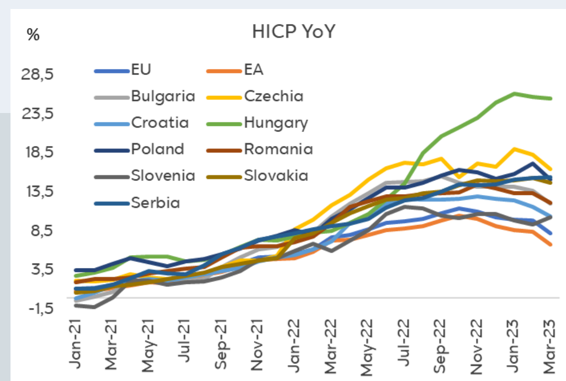
On the issue of improving the quality of loan portfolios, the course of the tourism sector is of paramount importance. If the strong recovery in the sector in 2022 continues in the coming years, even with a slower yet fast pace, a significant part of exposures to tourism and transport businesses currently falling under IFRS 9 Stage 2 assets due to the pandemic, could be gradually moved from this class of assets to Stage 1. For this to happen, an improvement in debt servicing on the part of businesses in these sectors is also essential. Such a shift in loan classification, in combination with a further reduction of NPLs, would also contribute to the strengthening of measures of capital adequacy, such as the CET1 and the Capital Adequacy Ratio (CAR).

Given the extensive restructuring that the banking sector has been during the last decade, what the sector mostly needs in the next years is organic growth. This can be based on a number of factors, such as the above presented sector growth prospects, the significantly upgraded credit rating of banks to attract equity and the previously presented ample sources for investment funding (NextGenerationEU, MFF 2021-2027). Along with the already identified measures for the challenges ahead, organic growth could contribute to further reducing the NPLs ratio and strengthening capital adequacy and profitability, thereby safeguarding the key role of the banking sector in the long-term growth dynamics of the Cypriot economy.

II. Central, Eastern and Southeastern Europe (CESEE) Economic Outlook

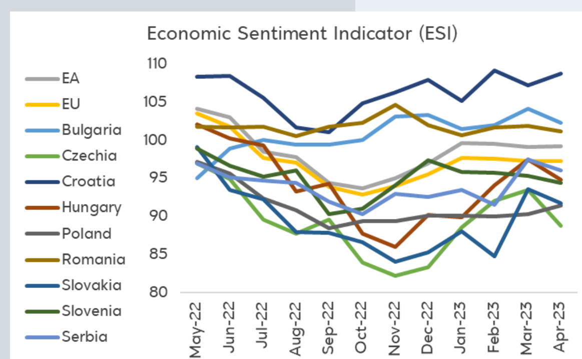
While the first small taste from the Q1-2023 GDP growth data could allow for some doubt over broadly discounted economic downturn in Q1, additional hard data covering a broader range of the region corroborate the economic slowdown. So far, only Czechia and Serbia have published flash estimates, with the majority of flash releases from the rest of peers due in mid-May and the final and detailed prints at the end of the same month. In Czechia, GDP contracted by -0.2%YoY beating to the upside market expectations for a -0.5%YoY contraction while on a quarterly level, growth held still inching up by a tad (+0.1%QoQ). In Serbia, growth rate was calculated at 0.7%YoY from 0.4%YoY in Q4, with the Minister of Finance stating that the said result surpassed expectations of the Ministry amid lack of market consensus for the said performance. Dynamics on the demand side of the regional economies appear weakened as retail sales growth came in negative in March on both yearly and monthly basis in Czechia, Slovakia, and Poland and in Croatia and Serbia on annual terms with varying extend cross-country. Romania was the bright exception where retail sales volume increased both in yearly and monthly terms (+6.8%YoY, +2.9%MoM) while in Hungary they dipped by 13.1%YoY with the seasonally adjusted monthly expansion by 0.8% considered temporary. The pattern is similar on the supply side as industrial production growth also moved on the same footing with retail sales growth in March when it comes to annual prints but picked up for the month in Hungary (+0.2%MoM sa) and more prominently in Serbia (+1.5%MoM sa). Whereas the trend of consumption is seen in a bend as of Q1-2023, as outlined above, given the trim in the disposable income initially from persistently high inflation throughout 2022 and then from tighter financial conditions as a result of the policy combat against inflation, the gradual curb of inflation across the region spurs some hope over the course of consumption for the remaining three quarters, albeit the disinflationary process proceeds on a rather slow pace. With March's prints available for all peers and with a representative sample for some in April, inflationary pressures

Figure 7: Disinflationary process on a downturn, albeit rather slow, pace..



Source: Eurostat, Eurobank Research

Figure 8: ..leaves serious points of concern among economic agents, reflected on ESI



Source: Eurostat, Eurobank Research

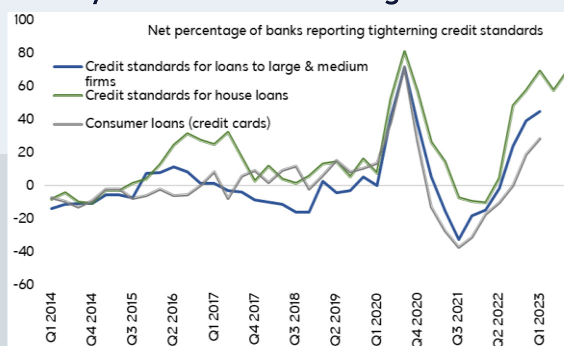
retreated with April's prints in Croatia and Slovenia returning to one-digit grounds (+8.8%YoY and 9.4%YoY respectively) but with other economies still having a long distance to cross as in Hungary (+25.2%YoY in March) and Poland, Czechia, Romania, Slovakia and Bulgaria whose latest available prints range around 15.0%YoY. Even though the course of the aforementioned data allows for some optimism, when it comes to inflation, it leaves serious points of concern among economic agents which are mirrored on forward looking data. In our view, while there is some progress on the disinflation process, there is a wider impression that this is happening rather slowly keeping the cost of living prolongedly high and growth subdued. April's PMIs which are surveyed in Czechia (42.8) and Poland (46.6) slid further into contracting grounds, while the ESI, which covers all regional peers appeared broadly off beat with only a few exceptions marking improvement (Croatia and Poland) and with the said gauge in EU and the EA remaining broadly stable.

US

Activity is losing steam, while the labor market, though easing, remains tight

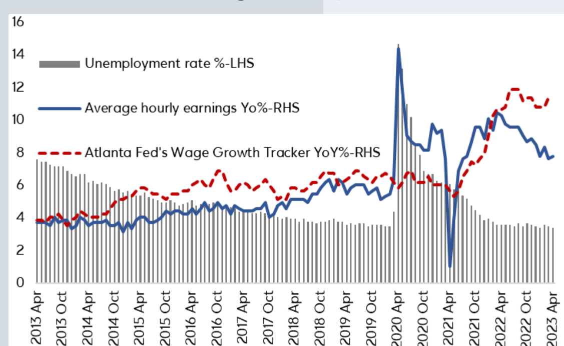
The Fed delivered a broadly anticipated 25bps rate hike at the May policy meeting, but the forward guidance in the policy statement was altered, hinting that this rate move may be the last of its current tightening cycle before pausing for an extended period. Worryingly, in the aftermath of the recent banking sector turmoil, bank lending conditions have tightened materially, as suggested by the Q1 2023 Senior Loan Officer Opinion Survey (SLOOS) amid increased uncertainty and liquidity concerns, with Chair Jerome Powell underlying at the post-meeting press conference the importance of the impact of credit standards on the evolution of the US economic outlook. Meanwhile, the March CPI report showed that the disinflationary process is progressing. Headline CPI inflation dropped by 0.1ppt to 5.0%YoY and core CPI accelerated from 5.5%YoY to 5.6%YoY, but more importantly, core services fell by 0.2ppt to 7.1%YoY and core services excluding shelter— the category the Fed Chair considers as “the most important” for determining whether the disinflationary process is on the right track — dropped to 6.4%YoY from 6.5%YoY, suggesting that, though still at elevated levels, it has likely passed its peak. Nevertheless, the Fed left an implied tightening bias in place, with Powell leaving the door ajar to further tightening if data warrant so, barring additional disruptions from the banking sector. Indeed, in spite of the March easing, it may be too early to conclude that core services excluding shelter has already embarked on a sustained downward trend, taking into account that it is closely linked to the labor market, which though has eased latterly, remains tight. The unemployment rate unexpectedly fell by 0.1ppt in April, returning to January’s 54-year low of 3.4%, while average hourly earnings rose to 4.4% from 4.3% in March, above the 3-3.5% range that historically has been consistent with the Fed’s inflation target (assuming labor productivity growth at around 1-1.5%), and the Atlanta Fed’s Wage Growth Tracker unexpectedly accelerated in March to 6.4%YoY from 6.1%YoY in the prior month. Meanwhile, US real GDP grew by a lower-than-expected annualized rate of 1.1% in Q1, less than half the prior quarter’s 2.6% pace, entirely driven by inventories. Turning into Q2, economic data for April show a mixed picture of activity, suggesting that growth is likely weakening further, reinforcing fears of recession in H2, as banking stress will likely accelerate the pass-through from tighter monetary policy to the real economy.

Figure 9: Credit conditions have tightened materially after the recent banking sector turmoil



Source: Fed, Eurobank Research

Figure 10: The labor market is slowing, but only gradually



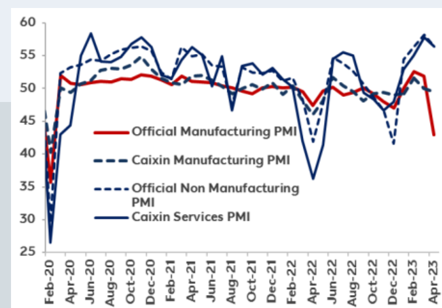
Source: BLS, Eurobank Research

China

Q1 GDP growth above expectations but risks persist

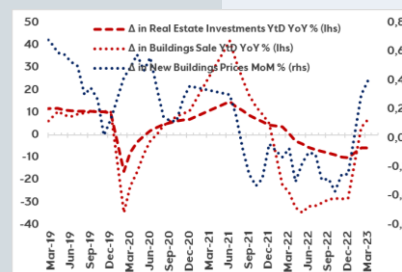
Q1-2023 GDP growth rate came in at 4.5%YoY, above the 4.0%YoY market consensus and the 2.9% growth rate of the previous quarter, while on a quarterly basis GDP expanded by 2.2%. The key contributor on the annual growth figure was the services sector which rose by a hefty 5.4%YoY, driven by the segment of restaurant and accommodation with a 13.6%YoY growth rate. The said rebound of the services sector along with the brisky 10.6%YoY retail sales growth in March, which translates into a 5.8%YoY year-to-March growth rate, underline the consumption-led character of the recovery, reiterating discussions over the resurfacing gap between the supply and the demand side of the economy. That said, industrial production may have held firm, growing by 3.0%YoY between January and March from 2.4%YoY year-to-February but came in below the 3.5%YoY market consensus while, industrial profits kept shrinking in March by 19.2%YoY from 22.9%YoY in February. March's surprising jump in exports by 14.8%YoY, when the market foresaw a -7.1%YoY contraction, could soothe worries over the uneven profile of the recovery, also given the fact that the biggest jump was in electronic parts and impacts. However, prospects over their longevity are rendered limited given the fragile global demand. April's forward-looking indicators capture the uncertainty from the aforementioned mixed data; all April's PMIs retreated compared to March and beat market expectations to the downside while both, the official and the Caixin manufacturing PMI dipped to below 50 contracting levels. All in all, the Chinese economy may have passed the easy phase where GDP growth has been boosted by the pent-up demand and looking ahead, Q2-2023 could prove the inflection point where improved consumer confidence over the income prospects will be needed to fuel further demand. For this to happen, among other factors, the course of the real estate sector is considered crucial and while improvement has been marked up to February, data released in April and referring to March shed light on its vulnerabilities; fixed property investments kept shrinking by -5.8%YoY in Q1-2023 with markets expecting a milder contraction of -4.7%YoY, and construction starts retreated by 19.2%YoY in January-March, after a 9.4%YoY drop year-to-February but new home prices inched up by 0.5%MoM in March after a 0.3%MoM rise in February, marking the fastest pace since June 2021 and the third consecutive monthly rise. In a nutshell, the standing of the economy in Q1-2023 sums up to the communique of the spokesman of the National Bureau of Statistics, Fu Linghui, upon the Q1 GDP data release, according to which the rebound is "not yet solid".

Figure 11: Inclusive dip in all PMIs in April..



Source: Bloomberg, Eurobank Research

Figure 12: ..while the prospects of the real estate sector are not yet solid



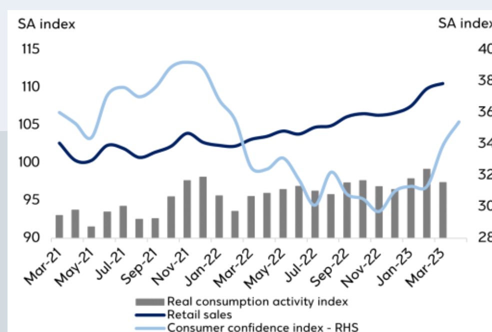
Source: Bloomberg, Eurobank Research

Japan

Modest GDP growth expected for Q2 driven by consumption and exports

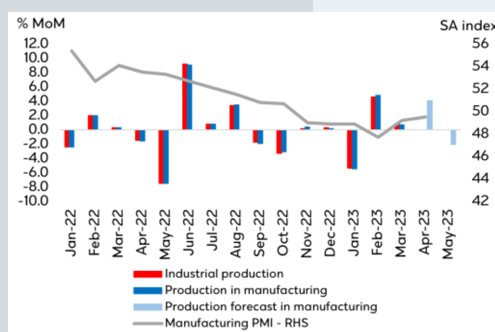
Activity indicators suggest a moderate recovery in Q1 2023. Retail sales rose by 2.6% QoQ in Q1 2023, up from 1.2% QoQ in Q4 2022, and the real consumption activity index rose by 1.2% QoQ in Q1 2023 from 0.5% QoQ in Q4 2022. On the trade of goods front, over the first 3 months of 2023, there was an average quarterly decline in real exports by 3.3% but also a sharper drop in real imports by 5.4%, with the average trade surplus standing at 0.5% of GDP comparing to 0.3% in Q4 2022. Industrial production declined by 1.8% QoQ in Q1 2023, albeit slower than in Q4 2022 (-3.0% QoQ). Q2 started with positive expectations for consumption. Consumer sentiment improved further, with the April consumer confidence index rising by 1.5 pts MoM to 35.4, possibly reflecting (i) expectations for higher wages supported by labor market tightness and encouraging outcomes of this year's "Shunto" wage negotiations, and (ii) the de-escalation of headline inflation after January. Prospects for the manufacturing sector appear rather favorable, as production is expected to increase by 4.1% MoM in April, according to the Survey of Production Forecast in Manufacturing, before declining by 2.0% MoM in May, pointing to an overall improvement for the first two months of Q2 2023. Additionally, the April headline manufacturing PMI index reached the highest level over the last six months, standing at 49.5 from 49.2 in March, suggesting a slower pace of contraction at the start of Q2. The anticipated improvements in manufacturing production and a likely increase in inbound tourism, especially after the abolishment of all major Covid-19 travel restrictions on April 29, are expected to strengthen exports of goods and services respectively. According to the updated BoJ outlook released in April, forecasts for the CPI ex. fresh food and CPI ex. fresh food and energy for the fiscal year 2023 were revised upwards from 1.6% to 1.8% and from 1.8% to 2.5% respectively, while projections for fiscal 2023 real GDP growth were revised downwards from 1.7% to 1.4%. Overall, the economy is expected to grow modestly in Q2 partially driven by consumption and exports. However, the persistently high core inflation (April Tokyo CPI ex. fresh food and energy +3.8% YoY from +3.4% YoY in March) and economic uncertainty after the recent banking turmoil, are expected to mitigate Q2 GDP growth.

Figure 13: Signs of stronger consumption demand in Q1, improved sentiment at the start of Q2



Source: METI Japan, Cabinet Office Japan, Bank of Japan, Eurobank Research

Figure 14: Prospects for the manufacturing sector appear rather favorable in Q2



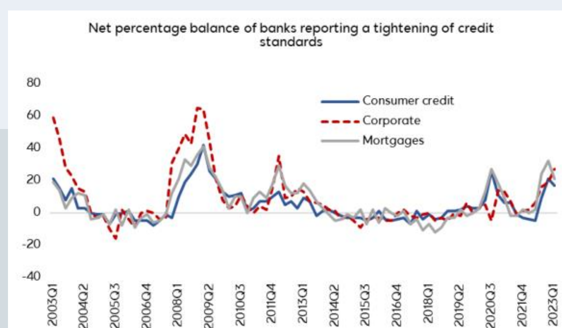
Source: METI Japan, Refinitiv Eikon, Eurobank Research

Euro area

Recession avoided, but tighter credit conditions may weigh on future growth

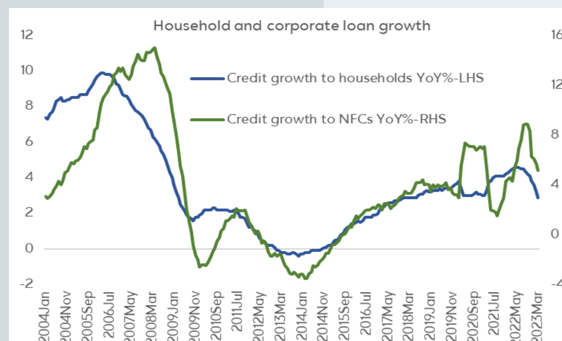
In spite of significant headwinds (rising interest rates, still elevated inflation, the cost-of-living squeeze), Eurozone GDP growth returned in expansionary territory in Q1 — though slightly — rising by a meagre 0.1%QoQ, according to the flash estimate, following a downward revision in the prior quarter at -0.1%QoQ (from 0.0%QoQ), refuting earlier expectations of a technical recession around the turn of this year. Data from a number of individual countries suggest that the Q1 gain seems to have been driven by exports, likely thanks to the easing of pandemic-related restrictions in China, while domestic final sales were weak amid persistently high price pressures and tighter credit conditions (a breakdown of Eurozone Q1 GDP growth is due on 16 May). Looking ahead, sentiment indicators suggest that positive growth momentum, though feeble, may continue in Q2. The composite PMI improved further in April (+0.4 to 54.1), again entirely driven by the services sector, while economic sentiment edged up by 0.1pt to 99.3, albeit still below its long-term average, consistent with only modest growth. The fading energy crisis, China's reopening, the continued resilience of the labor market (the unemployment rate resumed its downtrend in March falling to a new record low of 6.6%) and accelerating nominal wage growth across a number of countries, also bode well for the near-term growth outlook. However, as evident in the Q1 2023 ECB Banking Lending Survey (conducted from 22 March, i.e., 3 days after the USB-Credit Suisse deal, to 6 April), ECB monetary tightening is transmitting forcefully to financing and monetary conditions, pointing to risks of a sharp slowdown in future growth. Credit standards continued to tighten, especially for loans to NFCs, leading to a strong drop in demand, while according to the latest credit data, banking lending to households (+2.9%YoY) and non-financials (+5.2%YoY) remained in a decelerating trend in March for the seventh and fifth consecutive month, respectively. The above, combined with tentative signs that core CPI may have peaked (from March's 5.7%YoY record high down to 5.6%YoY in April, the first decline in ten months), led the ECB the slow the pace of tightening to 25bps at the May policy meeting, and though the rate forward guidance appeared fairly vague, it seemed to leave the door open for further rate hikes aiming "a timely return of inflation to the 2% medium-term inflation target".

Figure 15: Credit standards continued to tighten in Q1 2023



Source: ECB, Eurobank Research

Figure 16: Loan growth to both households and corporates is moderating, but still in positive territory



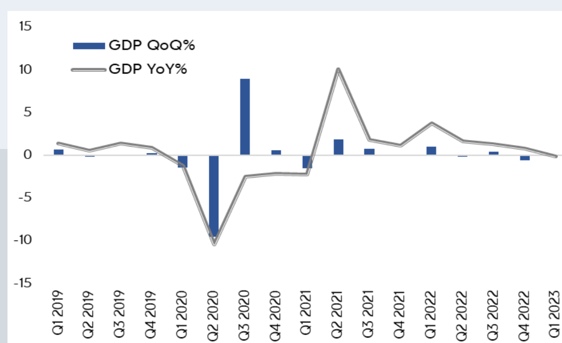
Source: ECB, Eurobank Research

Germany

Germany narrowly avoided a technical recession, but is not out of the woods

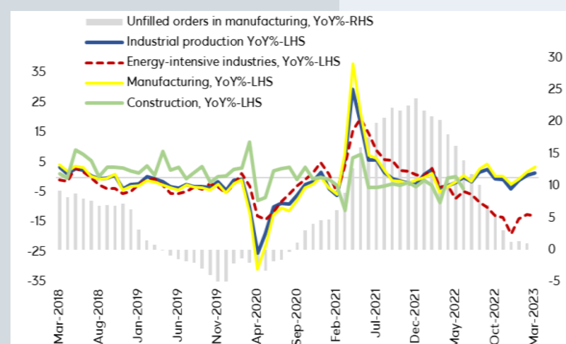
According to the flash estimate, the economy stagnated in Q1 2023 on a quarterly basis following a downward revised -0.5%QoQ contraction (from -0.4%QoQ previously) in the prior quarter, suggesting that a technical recession has been narrowly avoided (the annual rate declined from 0.8% to -0.1% due to adverse base effects). As suggested by the Federal Statistical Office, private consumption acted as a drag on GDP growth, likely reflecting the erosion of purchasing power amid persistently elevated price pressures (according to revised data, real earnings dropped by a higher than earlier estimated 4.0% in 2022, while nominal earnings grew by only 2.6%). Positive contributions to Q1 GDP growth, though, came from investment and exports (the detailed GDP report is scheduled for release on May 25). Indeed, supported by the substantial easing of supply shortages and lower wholesale energy prices, industrial activity recovered more than expected early this year. Industrial production rose by 2.0%MoM in February after a 1½ year high of 3.5%MoM in January, before unexpectedly falling by 3.4%MoM in March, but on a quarterly basis increased by 2.4% in Q1, mainly helped by a weather-related boost in construction. China's fast reopening — one of Germany's major trading partners — was also a driver behind the economy's improved performance in Q1. Looking into Q2, the economy is likely to continue picking up steam. The latest wage agreements could help to provide some support to private consumption even in the very short term (including the public sector wage deal of a €1,249 net one off payment in June 2023), industrial production will likely improve further given the significant order backlog, especially in the automotive and machinery sector (according to the April IFO survey, order backlog among manufacturers remains considerable), while a flurry of high frequency indicators (composite PMI, Ifo business climate for April) also point to some improvement in near-term growth momentum. However, the H1 2023 rebound will likely run out of steam in the remainder of the year and the economy may face again the risk of a modest technical recission, as the lag effect of the ECB's monetary policy tightening will be increasingly felt and the expected slowdown in the US economy will likely hit exports. Overall, we stick to our 0.0% forecast for the full year 2023.

Figure 17: Germany narrowly avoided a technical recession in Q1 2023



Source: German Federal Statistical Office, Eurobank Research

Figure 18: Industrial production has recovered more than expected in Q1 2023



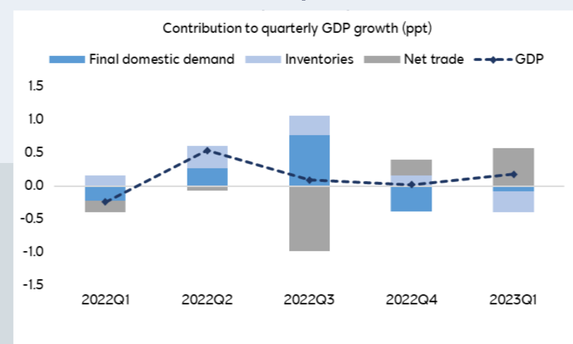
Source: German Federal Statistical Office, Eurobank Research

France

GDP accelerated in Q1, but the outlook remains bleak for the rest of the year

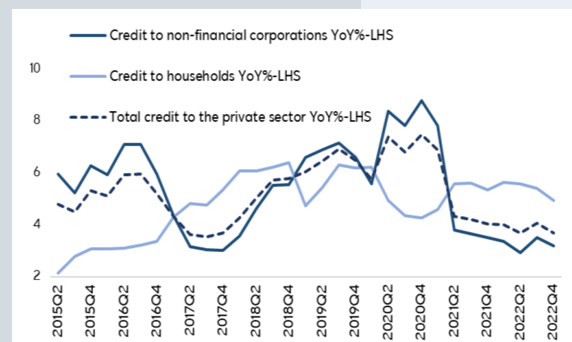
France's GDP rose by 0.2%QoQ in Q1 2023, accelerating from a downward revised 0.0% (0.1%QoQ initially) in Q4 2022, despite strikes and social protests against the pension reform. Growth acceleration was entirely driven by net exports (+0.6ppt) on strong exports growth (1.1%QoQ) following a rebound in transport equipment, while weak imports (-0.6%QoQ) was also a driver. On the flipside, the contribution of inventories to GDP growth was negative (-0.3ppt vs. +0.2ppt in Q4), while domestic demand was also a drag for the second consecutive quarter (-0.1ppt). Consumer spending stagnated amid persistently elevated price pressures (April's HICP up by 0.2ppts to 6.9%YoY on energy base effects), and gross fixed investment dropped for the first time since Q4 2021 (-0.2%QoQ), as business investment continued to decline (0.1%QoQ) and household investment fell for the fourth consecutive quarter (-1.4%QoQ). Looking ahead, the latest business surveys suggest that the economy retained a positive growth momentum at the start of Q2. Solely driven by services, the composite PMI rose to a near one-year high of 53.8 in April, consumer confidence improved from 82 to 83 and, in a gloomier note, INSEE business confidence dropped by 1ppt to 102, though still remained above its long-term average. However, activity is expected to remain subdued throughout year-end, with annual GDP growth easing to 0.6% in 2023 from 2.6% in 2022, as persistently high inflation should continue to hinder household purchasing power, higher ECB interest rates should continue to weigh on domestic demand, and banking concerns might lead to a further tightening in credit conditions. On the political front, labour unions have yet to call a halt to the protests, as President Emmanuel Macron signed the pension reform bill into law in mid-April, shortly after the Constitutional Council ruled in favor of the key provisions of the reform. Against this backdrop, Fitch surprisingly downgraded France's sovereign credit rating by one notch to AA- with a stable outlook, the first downgrade from a major agency since 2015, citing that, besides the lack of a major improvement in various fiscal metrics, the political landscape and high social unrest could create pressures for a more expansionary fiscal policy and could pose a risk to the President's reform agenda.

Figure 19: Q1 GDP growth was entirely driven by



Source: INSEE, Eurobank Research

Figure 20: Signs of softening credit growth



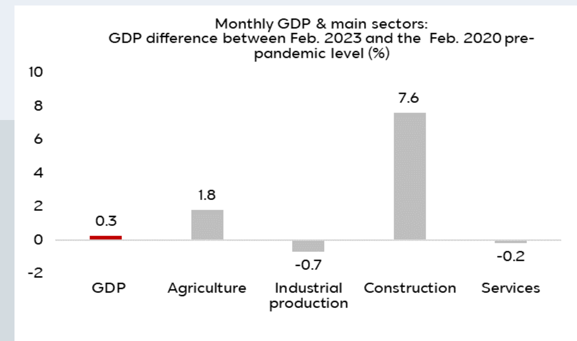
Source: INSEE, Eurobank Research

UK

Improving near-term growth momentum, but challenges prevail

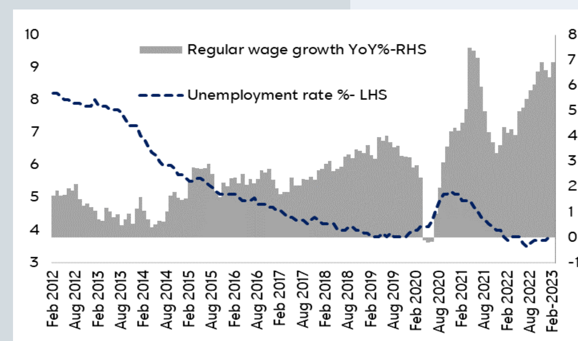
February GDP came in weaker than expected printing at 0.0%MoM, led by the service sector (-0.11%pts) owning to public-sector strike actions. Industrial production also weighed on overall growth (-0.03pts) mainly due to reduced energy demand amid unusually warm February temperatures, while a weather-related 2.4%MoM bounce in construction (+0.15pts) prevented a growth contraction. However, the February GDP downside surprise was offset by a 0.1ppt upward revision in January's GDP at 0.4%MoM. Against this backdrop, UK GDP is now above pre-pandemic levels (by 0.3%MoM), with the flat February print translating into a carry-over effect of 0.1%QoQ into Q1 2023. That said, risks seem skewed for stronger growth than the BoE's projection of a -0.1%QoQ contraction in Q1. Barring downward revisions, reaching the BoE's projection would require a 0.6%QoQ contraction in March, which, while it cannot be ruled out completely as strike action continued through March and the February's bounce in construction may prove temporary, it is not the signal coming from tendency and activity indicators. Turning into Q2, available data is also largely encouraging for a positive, though modestly, print, taking also into account that an extra bank holiday in May (King's coronation) will temporarily weigh on growth. Indicatively, the flash PMI for April accelerated more than expected (+1.7ppts to a one-year high of 53.9) entirely driven by services, and the Gfk measure of consumer confidence rose in April for the third consecutive month (+6ppts to -30, the highest since February 2022) supported by decelerating headline CPI inflation (at 10.1%YoY in March from April's 10.4%YoY, though sticky core remained flat at 6.2%YoY). Meanwhile, the labor market remains tight (regular wage growth at 6.9%YoY in February), fiscal policy turns more supportive from April, as the government delivered in the Spring Budget additional fiscal support worth £21.6bn (0.8% of GDP) for FY 2023-24 (by also canceling the planned 20% increase in energy bills for another three months). But though there are some reasons for cautious optimism over the UK's near-term outlook, further out, the economy still faces steep challenges. Notably, the 425bps of BoE rate tightening has yet to fully feed through to the real economy, and persistently high price pressures should continue to erode consumer purchasing power. Overall, we continue to expect the economy to contract this year, but only modestly, by -0.2%.

Figure 21: UK GDP growth is back above pre-pandemic levels



Source: ONS, Eurobank Research

Figure 22: The labor market remains tight



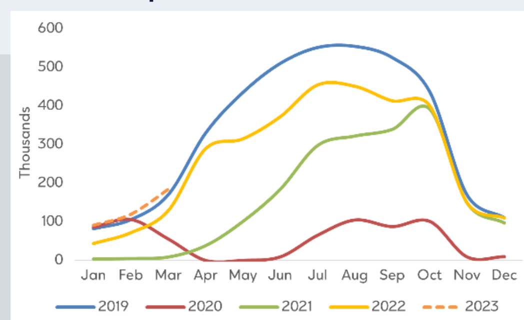
Source: ONS, Eurobank Research

Cyprus

Tourism growth remains on the fast lane, real estate sector supported by reforms

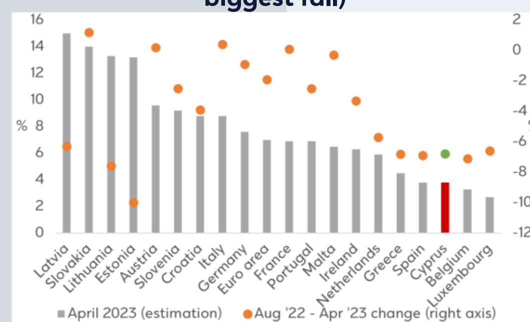
Ahead of the flash Q1 2023 GDP estimate (due on May 16) robust growth dynamics persisted in March in some of the main growth drivers in 2022. Retail trade volume expanded by 6.5%YoY, against 9.0%YoY in February, bringing the average increase in Q1 2023 to 7.3%YoY, the strongest rise since Q3 2021. The outlook for the retail sector and in general household consumption is also favorable, on the back of income rises in civil servants in January and probably shortly in the private sector (Ministry of Labour proposal for partial wage indexation by 66.7%), tighter labour market conditions, as well as continuous easing in inflation. On the latter issue, the CPI increase eased significantly in April, to 3.7%YoY, the slowest pace since July 2021, with the recent imposition of a zero VAT rate on certain basic goods for a period of six months, starting from May, paving the way for a further deceleration. Regarding trends in exports of services, tourist arrivals remained on the fast lane in March, albeit with a slowdown (+43%YoY against +65.6%YoY in February), standing higher on average in Q1 2023 by 60.1%YoY, but more importantly, exceeding by 10.2% their respective pre-pandemic (Q1 2019) level. As analysed in previous issues, these dynamics are expected to go beyond Q1 2023, supported by much more visitors from certain European and Middle East countries. The improved services balance will likely be partially offset by a worsening in the goods balance, due to stronger demand for imported consumer goods. Recent and forthcoming reforms, such as the termination of suspension 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, especially in housing. Besides, the activity of the real estate sector spiked in Q1 2023 (ca. +30%YoY in turnover terms), with the number of house sales amounting to 42.8% of their total in 2022, reflecting increased immigration due to the war in Ukraine and the attraction of foreign ICT professionals through the digital nomad visa program. A recent development whose implications are early to assess as it may evolve in the period ahead concerns US and UK sanctions to Russia affecting Cypriot citizens. In view of the aforementioned dynamics, expected average growth in 2023 was slightly revised upwards, to around 2.5%

Figure 23: The pattern of monthly tourist arrivals in Q1 2023 is similar to the pre-pandemic one in 2019



Source: CYSTAT, Eurobank Research

Figure 24: Inflation in Cyprus in April was the 3rd lowest in the Euro area, 6.8ppts below the August 2022 all-time high (5th biggest fall)



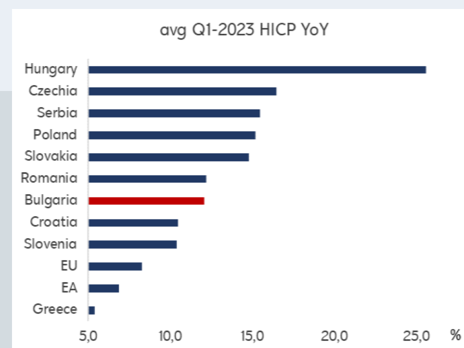
Source: Eurostat, Eurobank Research

Bulgaria

Fiscal loosening on the back of lingering political impasse

The key developments of the month come, in our view, from the fiscal front, taking into account that inflationary pressures have started to somewhat ease (CPI retreated to 14.0%YoY in March from 16.0%YoY in February) and the Q1-2023 GDP flash estimate is due in mid-May. Given the scheduled elections in Bulgaria on April 2, the economy had entered the second quarter of the year with not having a ratified fiscal budget in place for 2023 and the running's year budget being executed on the trails of the 2022 basis. Given the notification, each EU member has to report semiannually to the EC and Eurostat under the fiscal monitoring auspices, the caretaker government stated in late March that the general government budget deficit in 2023 is expected to amount to BGN5.5bn or 3.0% of GDP from 2.8% of GDP in 2022 but a month later it laid before parliament a budget with a BGN 12bn of deficit, accounting for 6.1% of GDP. The divergence between the two quoted fiscal deficit targets in such a short period of time raised concerns over the credibility of the fiscal planning and has caused extensive political criticism within the parliament. Even worse in terms of decisiveness, the caretaking cabinet shared the conviction that the budget should be limited to 3% of GDP as initially endeavored and declared to the EC, leaving, however, the gap for the Parliament to figure out how to bridge it. Regarding the key assumptions of the draft budget, the GDP growth rate is forecast at 1.8%, compared to 3.4% in 2022, rendering slightly more optimistic than recent estimates by the IMF and the WB that stand close to 1.5%. Targeted budget deficits for 2024 and 2025 remain also loose as they are set at 5.2% and 4.6% of GDP, respectively. The loosening of the budgets, if ratified and eventually executed, will consequently and reportedly not leave the levels of public debt unaffected up to 2025. Specifically, in the strategy draft for the public debt management for the period 2023-2025 released on May 5 by the Ministry of Finance, public debt is forecast to climb gradually from 21.8% in 2022 to 33.0% in 2025, making a stop somewhere in the middle at 25.3% in 2023 when the average between 2018-2022 was close to 22.5%. Doubtlessly, it is the lack of political stability in the country during the past two years that has led to such fiscal declinations which of course, in turn, undermine further the already deferred euro adoption. With the eurozone accession date pushed to 2025, targeted fiscal deficits above 3% of GDP up to the said year can only delay the once broadly accepted at national level strategic goal.

Figure 25: inflationary pressures in Q1 less severe compared to intra-CESEE



Source: Eurostat, Eurobank Research

Figure 26: ...with FY-2022 growth firm, though weaker than in other peers

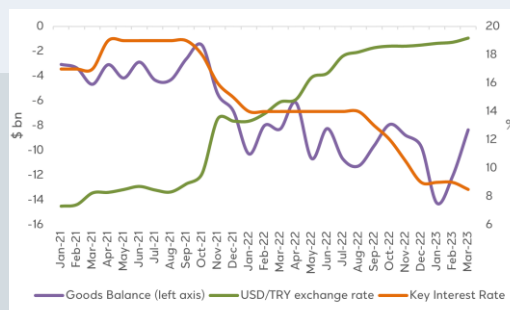
Source: Eurostat, Eurobank Research

Turkey

Uncertainty escalates due to the elections and implications of the new lira sliding

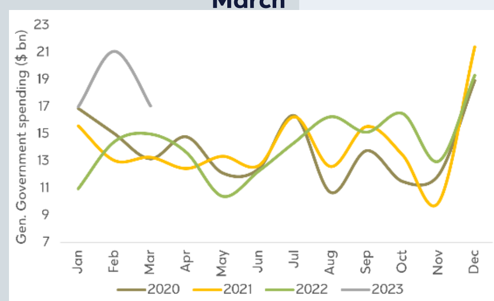
With the coming presidential elections in a few days' time, some potential trends in monetary policy for the period ahead should be considered. Indicatively, in their joint policy document (released on January 30) the opposition parties of the Nation Alliance vowed explicitly that they will gradually abolish the FX-protected lira deposit scheme, by not allowing the openings of new such accounts and not renewing the existing ones at maturity. According to the latest data (April 2023), such deposits account for 34.3% of total lira deposits. On the other hand, the export revenue conversion rule, according to which goods exporters are obliged to exchange 40% of FX revenues with lira at the Central Bank of Turkey (TCMB) will also be abolished. This measure could have further implications, as banks are required to keep lira-based securities (practically government bonds) at the TCMB relative to their FX deposits. On the part of the ruling party, it has been signaled that the low-rate policy followed since September 2021, leading to negative real interest rates and TRY devaluation, will be continued after the elections. Meanwhile, the first hard data about economic activity after the February earthquakes indicate, as expected, a weakening in former growth dynamics. That said, these figures should be interpreted cautiously, as the underlying surveys in the hit regions were based on alternative sources, providing partial field coverage. Specifically, industrial production volume fell in February by 7.6%YoY, against a 3.9%YoY increase in January. Retail trade volume expanded by 21.8%YoY in February, considerably less than in January (+33.9%YoY). A rapid deceleration of inflation could sustain an increase in household consumption, but its decline since past November is moderate, owed to base effects, with the monthly pace still highly positive (+3.1% on average in November-April). The monthly trend is in part due to the new round of lira sliding, after the last policy rate cut in February (as of May 9, TRY to USD exchange rate at 19.5, -3.8% since the cut). The implications of the new key rate cut could be moderated by an improvement in the goods balance, as the widening of its deficit narrowed in March to 0.9%YoY against +51.6%YoY in February and +38.5%YoY in January. The various above dynamics are reflected in the recent moderate downward revision of the GDP projection for 2023 by the IMF, to 2.7%, 0.3ppts below the October forecast.

Figure 27: The new key interest rate cut has not been followed yet by a worsening in the goods balance, as in previous cuts



Source: Central Bank of Turkey, Eurobank Research

Figure 28: Signs of significant easing of emergency spending due to the earthquakes in March



Source: Ministry of Finance, 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	3.2	2.5	2.8	8.7	5.5	3.5									
Advanced Economies															
USA	2.1	1.1	0.8	8.0	4.2	2.5	3.6	3.9	4.6	-3.7	-3.1	-3.1	-5.3	-5.7	-5.4
Eurozone	3.5	0.6	1.0	8.4	5.6	2.5	6.7	6.9	6.9	-0.7	1.5	1.6	-3.6	-3.6	-3.0
Germany	1.8	0.0	1.0	8.6	6.2	2.7	5.3	5.5	5.3	4.2	5.0	5.1	-2.6	-2.8	-2.0
France	2.6	0.6	1.0	5.9	5.5	2.6	7.3	7.4	7.5	-2.2	-1.5	-1.3	-4.7	-5.1	-4.8
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	0.7	0.9	8.7	6.3	2.4	8.1	8.2	8.2	-1.2	0.2	0.5	-8.0	-4.8	-3.8
Portugal	6.8	1.0	1.5	8.1	5.5	2.7	6.0	6.5	6.3	-1.3	-1.0	-1.0	-0.4	-1.2	-0.9
Spain	5.5	1.4	1.5	8.3	4.1	2.6	12.9	13.0	12.7	0.6	0.9	1.1	-4.8	-4.4	-3.7
UK	4.1	-0.2	0.9	9.1	6.6	2.5	3.7	4.2	4.4	-4.9	-3.8	-3.6	-4.5	-5.3	-3.7
Japan	1.0	1.0	1.1	2.5	2.6	1.5	2.6	2.5	2.4	2.1	1.7	2.1	-6.7	-5.5	-4.0
Emerging Economies															
BRICs															
Brazil	2.9	0.9	1.7	9.3	5.3	4.2	9.5	9.1	9.5	-3.0	-2.4	-2.2	-4.6	-7.5	-7.3
China	3.0	5.6	5.0	2.0	2.1	2.3	4.9	4.1	4.1	2.2	1.4	1.1	-4.7	-5.0	-4.6
India	6.9	5.9	6.2	6.7	5.3	5.0		NA		-2.2	-1.9	-1.9	-6.4	-5.9	-5.3
Russia	-2.1	-1.7	1.5	13.8	5.8	5.0	3.9	3.8	3.7	10.2	4.9	4.3	-2.2	-3.5	-2.0
CESEE															
Bulgaria	3.4	1.3	2.5	15.3	9.5	4.1	4.3	4.5	4.7	-0.7	-0.8	-0.4	-2.8	-3.6	-3.0
Serbia	2.3	2.1	3.2	10.5	9.7	5.1	9.4	9.5	9.1	-6.9	-6.8	-5.9	-3.1	-3.3	-2.5
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%	5.00-5.25%	4.96-5.20%	4.83-5.10%	4.45-4.70%
3m SOFR	5.07%	5.16%	5.11%	4.86%	4.46%
2yr Notes	5.25%	5.25%	5.20%	5.10%	4.70%
10yr Bonds	5.00%	4.96%	4.83%	4.45%	3.75%
Eurozone					
Refi Rate	4.00%	4.10%	4.05%	4.05%	3.95%
3m Euribor	3.31%	3.45%	3.48%	3.45%	3.32%
2yr Bunds	2.60%	2.83%	2.64%	2.40%	2.25%
10yr Bunds	2.31%	2.56%	2.44%	2.31%	2.26%
UK					
Repo Rate	4.25%	4.45%	4.40%	4.30%	4.10%
3m Sonia	4.55%	4.37%	4.36%	4.18%	3.99%
10-yr Gilt	3.80%	3.53%	3.41%	3.30%	3.20%
Switzerland					
3m Saron	1.55%	1.73%	1.71%	1.71%	1.64%
10-yr Bond	1.04%	1.46%	1.44%	1.38%	1.34%

Source: Bloomberg (market implied forecasts)

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