Economic Analysis Division
Emerging Markets Analysis

Bi-Weekly Report
19 May - 1 June 2020

**TURKEY**

GDP growth slowed to, a still solid, 4.5% y-o-y in Q1:20, as COVID-19 took hold

GDP set to contract sharply in Q2:20, amid growing concerns over the limited policy space available to counter the COVID-19 shock and increasing global headwinds

**SERBIA**

GDP expanded by an impressive 5.0% y-o-y in Q1:20, with increasing wages outweighing the COVID-19 impact

A bold policy response to the COVID-19 shock, together with favourable base effects, should contain GDP contraction to a “shallow” 2.0% in FY:20

**CYPRUS**

High uncertainty due to COVID-19 and lockdown measures pushed down GDP growth to 0.9% y-o-y in Q1:20

Cyprus enters a severe recession in Q2:20, before slowly rebounding in H2:20

Sources: National authorities, IMF & NBG estimates
Turkey

GDP growth slowed to, a still solid, 4.5% y-o-y in Q1:20, as COVID-19 took hold. Following a strong start in the first 2 months of 2020, driven by monetary stimulus, economic activity was affected by the COVID-19 outbreak in March. Despite the relatively soft containment measures initially adopted, economic sentiment weakened, taking a toll on domestic absorption, especially private consumption (adding 3.0 pps to overall growth against 4.0 pps in Q4:19). The slowdown in the build-up of inventories (adding 5.4 pps to overall growth in Q1:20 against 6.5 pps in Q4:19) also weighed on economic activity. All said, GDP growth slowed to 4.5% y-o-y in Q1:20 -- below consensus expectation of 5.4% -- from a 7-quarter high of 6.0% in Q4:19, with the impressive growth outcome mainly attributed to the strong carry-over from Q4:19 (3.8 pps).

GDP set to contract sharply in Q2:20, amid growing concerns over the limited policy space available to counter the COVID-19 shock and increasing global headwinds. Against the backdrop of the uncertainty caused by the pandemic and the social distancing and lockdown measures, we expect domestic demand to contract sharply in Q2:20. In this context, private consumption will be hit hard, reflecting, inter alia, forced savings and a sharp deterioration in an already weak labour market (the unemployment rate was at c. 13.5% before the outbreak of COVID-19). Similarly, weaker business confidence, together with lower foreign capital inflows and the depreciation of the TRY (see below -- note that the non-financial sector’s net open FX position stands at a high of 30% of GDP), are set to take a toll on investment activity. At the same time, COVID-19 related disruptions in domestic and global supply chains, together with subdued external demand (including for tourism, which accounts for c. 13.0% of GDP), should weigh on net exports.

The authorities are relying on an already stretched fiscal space to mitigate the impact of COVID-19, having so far announced measures worth c. 4.0% of GDP. These comprise, inter alia, tax deferrals and temporary tax cuts for affected industries, wage subsidies and income support for households. The authorities also doubled the funds available under the Credit Guarantee Fund (to 1.1% of GDP) and entitled the Sovereign Wealth Fund to buy stakes in distressed firms. All said, we see the budget deficit widening to 7.8% of GDP, highlighting the relatively weak starting point from which Turkey entered the crisis (the FY:19 budget deficit stood at 2.8% of GDP or slightly less than 4.0% adjusted for one-off transfers from the CBRT).

On the other hand, with real interest rates having already turned negative before the COVID-19 outbreak, the CBRT has limited scope to cut rates further (currently at 8.25%, down 250 bps since March and 1575 bps since the initiation of its easing cycle in mid-2019), in view of Turkey’s fragile external position. Indeed, external financing needs remain high (with USD 170bn of debt coming due over the next 12 months), while net FX reserves (excluding gold, the CBRT’s short-term borrowing and banks’ required reserves) have been completely depleted, leaving the economy vulnerable to adverse shifts in investor sentiment. In this context, the TRY has lost 13.0% of its value against the USD y-t-d, following losses of 40.0% in 2018-19. Assuming no second wave of the pandemic, we expect economic activity to recover, albeit from a low base, starting from Q3:20. Note that, as of mid-May, the authorities have begun to lift gradually the containment measures. Importantly, the low “openness” of the economy (exports and imports account for c. 45% of GDP) means that Turkey is well-placed for a quick rebound from the crisis. However, growing corporate balance sheet vulnerabilities and a structurally weak labour market continue to cloud the outlook. Overall, we see GDP falling by 2.4% in FY:20 against a rise of 0.9% in FY:19.
Serbia

BB+ / Ba3 / BB+ (S&P / Moody's / Fitch)

19 May-1 June 2020

GDP expanded by an impressive 5.0% y-o-y in Q1:20, with increasing wages outweighing the COVID-19 impact. GDP grew at a solid pace of 5.0% y-o-y in Q1:20 -- the highest growth rate in the region -- moderating only slightly from a post-GFC high of 6.2% in Q4:19. The strong Q1:20 performance was largely attributed to a generous income policy (including the abolishment of the (IMF-mandated) temporary wage reductions (introduced in 2014) and, on top of that, a 9.6% hike in public sector wages and a 5.0% rise in pensions). Indeed, the contribution of the public sector to overall growth increased sharply in Q1:20 (to 1.4 pps from just 0.3 pps in Q4:19), broadly offsetting the impact of the COVID-19-related containment measures on retail and wholesale trade. At the same time, the industrial sector continued to sustain economic activity (adding 1.0 pp to overall growth for a 2nd consecutive quarter), mainly reflecting a positive base effect from the interruption in production in the Pančevo oil refinery and Petrohemija chemical plant, due to factory maintenance in H1:19, and the elimination of a negative base effect from the imposition by Kosovo of a 100% tariff on imports from Serbia, effectively halting trade with Kosovo. In fact, the main factor behind the slowdown in GDP growth was construction activity, which moderated abruptly in Q1:20 (with the sector adding 0.7 pps to overall growth against 2.3 pps in Q4:19), following, inter alia, the completion of the TAP pipeline at end-2019.

A bold policy response to the COVID-19 shock, together with favourable base effects, should contain GDP contraction to a “shallow” 2.0% in FY:20. From a sectoral point of view, the services sector will be hit hardest by the pandemic. Indeed, increased uncertainty, together with the impact of containment measures, are set to suppress demand, particularly to the segments related to travel and recreational activities. Similarly, the industrial sector will be affected by disruptions in supply chains and a sharp drop in demand, although the aforementioned positive base effects should alleviate somewhat the impact of the shock. The construction sector is also set to suffer losses, albeit smaller compared with other sectors, as some large, multi-year infrastructure projects are still ongoing.

The impact of the pandemic on economic activity should be mitigated, however, by the adopted monetary and fiscal stimulus packages. Specifically, the Government announced a set of measures, worth EUR 3.1bn (6.7% of GDP), including, inter alia, increased healthcare spending, tax relief, wage subsidies, a universal payment of EUR 100 to adult citizens and an additional one-off payment to pensioners. A state guarantee scheme, worth EUR 2.0bn (4.5% of GDP), for loans to SMEs was also approved. The cost of the discretionary fiscal measures, together with the effect of automatic stabilisers, should boost the budget deficit to 7.5% of GDP in FY:20 from -0.2% in FY:19.

Regarding monetary policy, the NBS cut its policy rate by 75 bps to an all-time low of 1.5%, providing, at the same time, increased liquidity to the market through repo purchases of securities and FX swap auctions. Moreover, it introduced a 3-month moratorium on all loan repayments. Assuming that the pandemic dissipates, economic activity should recover gradually in H2:20. Despite the high “openness” of the economy (exports account for c. 60% of GDP), we expect a relatively quick recovery path, reflecting, inter alia, Serbia’s low dependence on tourism and a better product and geographic diversification compared with its peers. All said, we see FY:20 GDP growth at -2.0% against an expansion of 4.2% in FY:19. Note that Parliamentary elections, initially scheduled for April, were deferred to June 21st. According to the latest polls, the ruling SNS party is set to retain an absolute majority.
High uncertainty due to COVID-19 and lockdown measures pushed down GDP growth to 0.9% y-o-y in Q1:20. Strong economic sentiment and an improving labour market, together with continuing construction activity, signalled solid economic growth in the first two months of the year. However, following the outbreak of COVID-19 and the enforcement of containment measures, economic momentum weakened sharply in March. As a result, the annual pace of economic expansion decelerated to 0.9% y-o-y in Q1:20 from 3.4% in Q4:19, still above that of the EU (estimated to have dropped 2.7% y-o-y).

A closer look at the GDP breakdown reveals that, albeit slowing, private consumption continued to sustain growth in Q1:20 (adding 1.2 pps against 1.5 pps in Q4:19). On the other hand, fixed investment (excl. special purpose entities) weakened (subtracting 0.9 pps from overall growth against a positive contribution of 0.5 pps in Q4:19), driven by the residential construction segment. Unsurprisingly, net exports deteriorated in Q1:20 (shaving 0.8 pps off overall growth following 0.5 pps in Q4:19), in line with the drop in external demand. The moderation in economic growth would have been sharper had public consumption not strengthened in Q1:20 (adding 2.5 pps to overall growth against 0.7 pps in Q4:19), mainly due to higher spending on the healthcare system. 

Cyprus enters a severe recession in Q2:20, before slowly rebounding in H2:20. Negative supply-side shocks from the lockdown and heightened uncertainty (the economic sentiment indicator fell by a sizeable 33.7 pps y-o-y to a low of 75.7 in April-May against a broadly stable Q1:20), together with the concomitant drop in demand, could deal a serious blow to economic activity in Q2:20. In this context, private consumption will be significantly affected, reflecting, *inter alia*, a sharp deterioration in the labour market. Investment is also set to drop, albeit somewhat more modestly, as several large-scale, multi-year projects (including marinas, hotels and energy-efficiency upgrades for buildings) are still ongoing.

At the same time, external demand is set to decline sharply, with tourism (accounting for 14% of GDP) feeling the impact of the pandemic the most. Indeed, the enforced travel restrictions, together with lockdown measures and weaker confidence, are set to take a high toll on tourism (arrivals were already down 67% y-o-y in March against a rise of 2.0% in January-February). Shipping activity (accounting for 5% of GDP) will also be affected, in line with weaker global trade. The impact of the sharp drop in exports should be partly offset, however, by that of weaker domestic demand on the large import base. 

The authorities’ response to the crisis includes a large relief package, worth 4.5% of GDP. The measures comprise, *inter alia*: i) increased healthcare spending; ii) targeted support to the tourism sector; iii) tax deferrals; and iv) income support to households. Overall, we see the budget turning into a deficit of 5.0% of GDP in FY:20 from a surplus of 1.7% in FY:19. Note that businesses can also benefit from financial assistance, worth up to 4.0% of GDP, from the Cyprus Entrepreneurship Fund and guarantees offered by the EIB for additional lending worth 2.0% of GDP.

Assuming that COVID-19 fades gradually, we expect economic activity to start recovering in Q3:20 onwards. The authorities have begun to ease the lockdown, as of early-May, with airports and hotels due to reopen gradually as of early-June (note that flights from Russia and the UK, together accounting for 50% of arrivals, are still banned). However, in view of Cyprus’ strong dependency on tourism (adjusted for its indirect contribution, the sector’s contribution to GDP stands at 22%), we expect the recovery to be sluggish. The large public and private sector debt burden pose additional downside risks. All said, we see GDP dropping by 6.7% in FY:20 against an increase of 3.2% in FY:19.
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