

# In case you missed it: Pandemic pandemonium

As the pandemic spreads, the Fed has signalled it is prepared to go 'all in', Germany unleashes its fiscal 'bazooka', the UK has responded with fiscal and monetary action, China has cut reserve requirements and governments around the world are declaring a state of emergency. To top it all, Saudi Arabia and Russia's tussle has led to oil prices plummeting

## In this bundle



### United States

#### US: Fed steps in with US\$1.5 trillion

In response to increasingly dysfunctional markets, the Federal Reserve has stepped in with a massive liquidity injection to try and bring some calm

By James Knightley



### FX

#### EUR/USD: What's next?

With global uncertainty rising and EUR/USD volatility increasing, the game has changed for the cross. We look at various scenarios for the likely future...

By Chris Turner and Francesco Pesole



#### ECB: No 'whatever-it-takes' 2.0

The European Central Bank announces its first package to tackle the market turmoil and economic fallout from Covid-19. It's a collection of measures,...

By Carsten Brzeski



FX

### ECB & EUR: Pouring oil into the fire

The ECB didn't surprise on the dovish side today. No rate cuts and a muted QE would normally lead to higher EUR/USD. But the lack of conviction that...



### Eurozone: Bridging the economic fallout

As the economic impact of the coronavirus has become greater among eurozone economies, the focus has turned to policy makers and their responses. What are...

By Bert Colijn and Carsten Brzeski



FX | Czech Republic

### CZK meltdown: Is the past catching up?

Given the global backdrop, EUR/CZK is set to head higher, with EUR/CZK 26.50 being the next realistic target. With the koruna under heavy pressure,...



FX | United Kingdom

### UK budget: Three main takeaways for markets

The combined actions of the Bank of England and the UK Treasury will go some way to insulate firms against cashflow constraints over the coming weeks and...

By James Smith



China

### For Asia, "too low" oil prices are "a thing"

Globally, oil is not a "tax" on income, it's closer to a "transfer" from producers to consumers - but even that is a...

By Robert Carnell



Bulgaria | Croatia...

### Growth in the Balkans: From zero to hero..and back?

We review below the main changes to our macroeconomic forecasts for Romania, Bulgaria, Serbia and Croatia. While the revisions are all pointing the same...

By Valentin Tataru

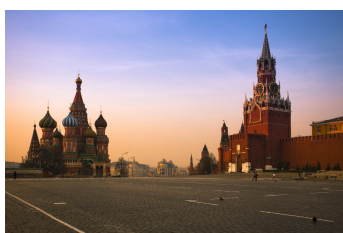


Sweden

**Why the Riksbank won't be the next central bank to cut rates**

Policymakers in Sweden are wary about taking the repurchase rate back into negative territory, having only raised it in December. But with the relatively...

By James Smith



Russia

**Russia bracing for oil shock: initial thoughts**

The Russian market is facing volatility, with large fiscal reserves and high real rates coming back into investors' focus, but only after the oil- and...

By Dmitry Dolgin



FX

**USD: The wrong kind of rally**

Thursday is turning into one of the darkest days of market dislocation since the Global Financial Crisis in 2008/09. The ECB package has failed to calm...

By Chris Turner



**Eurozone: Gauging possible supply chain disruptions from Covid-19**

As Covid-19 goes global, supply chain risks to the eurozone economy have increased materially. Our analysis finds risks to the eurozone mainly come from...

By Bert Colijn and Carsten Brzeski

## US: Fed steps in with US\$1.5 trillion

In response to increasingly dysfunctional markets, the Federal Reserve has stepped in with a massive liquidity injection to try and bring some calm



Source: Shutterstock

It has been a turbulent 36 hours for financial markets and the Federal Reserve Bank of New York. Under direction from Fed Chair Jerome Powell and the broader FOMC, it has taken the decision to step in with a US\$1.5 trillion liquidity injection and wider Treasury purchases. It increasingly looks like a confirmation that we are now in QE4 territory.

Both risk assets such as equities and safe havens, such as Treasuries and gold, have been experiencing losses as market participants scrambled for liquidity. The Fed has termed these "temporary distortions" and in response the Fed are offering a \$500bn 3M repo operation today with an additional US\$500bn 1M repo operation and another US\$500bn 3M repo operation tomorrow. This is a huge step up.

There will also be a change in the way the NY Fed manages its US\$60bn of reserve management purchases away from Treasury bills and into coupon bearing notes "across a range of maturities roughly matching the maturity composition of Treasury securities outstanding".

As we look towards next week's FOMC meeting this action signals the Fed is prepared to unleash its full armoury with a growing possibility that they could cut the Fed funds target rate a full 100bp to 0-0.25% rather than stagger its stimulus with 50bp next week and a further 50bp in April. It also

opens the door to the Fed formally announcing quantitative easing - something it has been at pains to deny with these and other recent measures that looked suspiciously like QE. With a meaningful fiscal stimulus looking some way off the markets will be looking for the Fed to deliver.

## Author

**James Knightley**

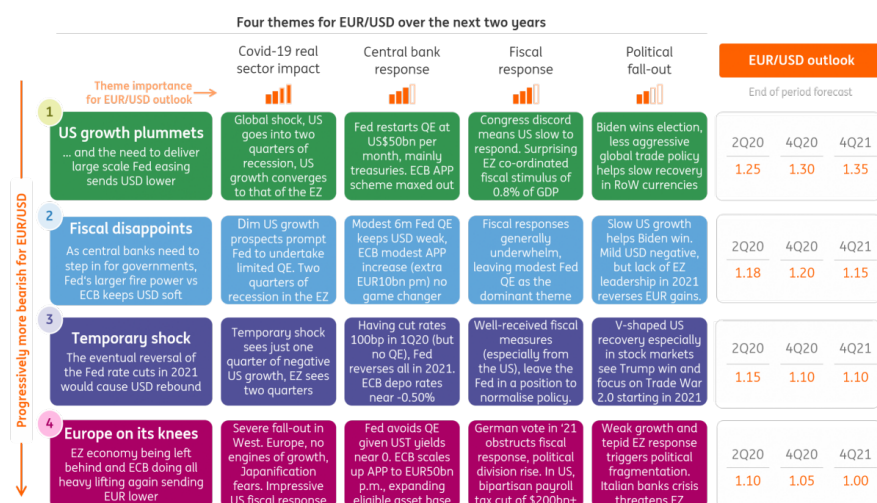
Chief International Economist, US

[james.knightley@ing.com](mailto:james.knightley@ing.com)

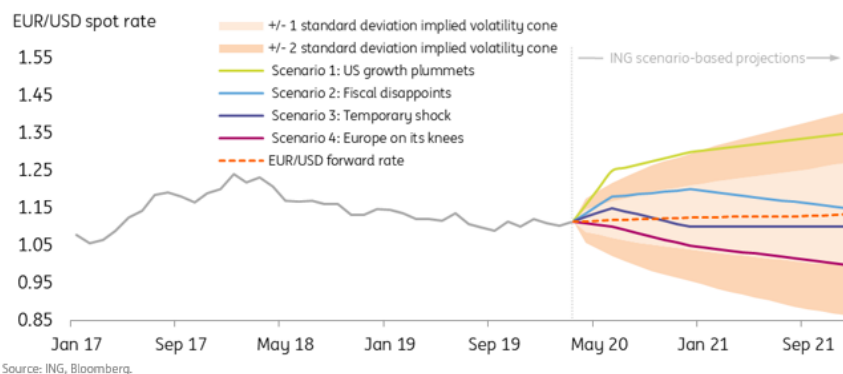


# EUR/USD: What's next?

With global uncertainty rising and EUR/USD volatility increasing, the game has changed for the cross. We look at various scenarios for the likely future...



Source: ING



## Scenario analysis based on four macro & political themes

Four factors stand out as key EUR/USD drivers over the next one to two years. These are: (i) Impact of Covid-19 on the real sector; (ii) Central banks response; (iii) Fiscal response; (iv) Politics. Above we outline our baseline and alternative assumptions for these inputs – and the corresponding EUR/USD profiles. As a base case we are now split between scenario 2 and scenario 3.

## Authors

### **Chris Turner**

Global Head of Markets and Regional Head of Research for UK & CEE

[chris.turner@ing.com](mailto:chris.turner@ing.com)

### **Francesco Pesole**

FX Strategist

[francesco.pesole@ing.com](mailto:francesco.pesole@ing.com)

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Snap | 12 March 2020

## ECB: No 'whatever-it-takes' 2.0

The European Central Bank announces its first package to tackle the market turmoil and economic fallout from Covid-19. It's a collection of measures,...



Christine Lagarde at the ECB press conference in Frankfurt

### Thursday's actions

What did the ECB decide? Firstly, all interest rates remain unchanged even though ECB President Christine Lagarde remarked, during the press conference, that the central bank had 'definitely' not yet reached the reversal rate. The ECB is mainly focussing on providing additional liquidity and stabilising markets by additional QE.

Here's the detail:

- The ECB announced additional LTROs, at the average deposit rate
- The ECB will change the conditions of the TLTROs between June 2020 and June 2021. These TLTROs will be conducted under even more favourable conditions than those previously. The TLTROs will be priced at the repo rate minus 25bp. For banks keeping their lending portfolio stable, the TLTROs will be priced at the deposit rate minus 25bp. In previous TLTROs, banks had to show an increase in their lending portfolios. While these changes were partly presented as being aimed at small and medium-sized enterprises, they are, in fact, a measure to support the entire banking sector. That suggests it was tough to come up with a pure tailor-made approach to SME lending.



- The ECB announced an additional 'envelope' of euro 120bn of net asset purchases until the end of the year. During the press conference, Lagarde said the ECB would use all flexibility when spending the euro 120bn on assets. Temporary deviations from the capital key are possible.

At the same time, the ECB also used its other role, that of bank supervisor, to bring some relief to the banking sector, deciding on some temporary relief in capital requirements. There's more on that [here](#).

## No 'whatever-it-takes', but targeted measures

The brief time ECB watchers were able to discuss the motive of Christine Lagarde's brooch is over. The 'wise owl' is all of a sudden confronted with a multi-layered shock: an unprecedented combination of supply-side and demand-side shock, together with financial market turmoil and the increased risk of a negative feedback loop into the real economy. At the same time, however, the ECB is also well aware of negative side-effects of its monetary policy stance and, more generally, the fact that it has almost run out of ammunition.

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*The wise owl is all of a sudden confronted with a multi-layered shock*

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All of this explains why the ECB took today's decisions without taking out the big bazooka. As Christine Lagarde said, she had no intention of having her own 'whatever-it-takes' moment. This is a package aimed at supporting the banks and preventing the sort of credit crunch that we saw in 2008. In fact, it is highly questionable whether any big bazooka would help, at least not right now. The only thing which could really stop fear, uncertainty and turmoil would be a vaccine and certainly not monetary policy easing.

Today's measures are an attempt to tackle market turmoil and support the economy in a targeted manner. Judging from initial reactions, it wasn't enough to tackle the first. Whether it will be sufficient to support the real economy we'll only find out in a couple of months. And that will also highly depend on fiscal policies.

Christine Lagarde did not have her whatever-it-takes-moment today. Let's hope governments will have theirs soon.

### Author

**Carsten Brzeski**

Global Head of Macro

[carsten.brzeski@ing.de](mailto:carsten.brzeski@ing.de)

## ECB & EUR: Pouring oil into the fire

The ECB didn't surprise on the dovish side today. No rate cuts and a muted QE would normally lead to higher EUR/USD. But the lack of conviction that...



Source: Shutterstock

As we wrote earlier, [the European central bank announced a series of measures](#), hoping the several, targeted but smaller measures can make a difference.

On first glance, it's nothing overwhelming and underscoring the view that the ECB's usual unconditional toolkit (for cutting rates further into the negative territory and increasing QE meaningfully) is largely exhausted and government actions on the fiscal side must be taken to make a difference to the economy.

Under normal circumstances, the apparent lack of dovishness from the ECB would lead to a stronger EUR and higher EUR/USD, particularly if the Federal Reserve is likely to cut interest rates aggressively and speculation about the Fed's QE plans continue to rise. Yet, two factors lead to the weakening, rather than strengthening of the cross:

1. The clear break down in markets, where funding issues in the cross-currency basis swaps market and the sharp decline in equity markets pushed USD higher across the board (even against the safe-haven yen). See [USD: The wrong kind of rally](#) for more
2. The lack of perceived conviction from ECB President Christine Lagarde that the central

bank is willing to do whatever it takes to help euro asset markets. The remarks “we are not here to close spreads” do risk re-introducing a risk/credit premium into EUR assets and are reminiscent of pouring oil into the fire. The widening of the BTP-bund spread, as shown below in the figure provides the case in point.

[Read about ECB's smaller but targeted measures](#)

## 10Y BTP-Bund Spread



Source: ING, Bloomberg

Looking beyond the very short term, we still see scope for higher EUR/USD and the cross to return to 1.15 should the Fed deliver aggressive rate cuts and move towards QE. Moreover, any signs of a possible road to the coordinated eurozone fiscal easing in the European group meeting taking place next week could also help to the euro.

But with no ‘whatever-it-takes’ moments today, the euro has the renewed potential issue to face – the risk premium issue – particularly if eurozone states fail to deliver credible fiscal stimulus.

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Article | 13 March 2020

## Eurozone: Bridging the economic fallout

As the economic impact of the coronavirus has become greater among eurozone economies, the focus has turned to policy makers and their responses. What are...



ECB headquarters, Frankfurt

The economic consequences of Covid-19 manifest themselves as both supply and demand shocks, now aggravated through a negative feedback loop from the latest market turmoil. This makes it an unprecedented and very tough to respond to situation. Currently Covid-19 affects the economy through five broad channels:

- Direct economic impact of prevention measures
- Indirect effect through supply chains
- Economic impact of change in behavior of consumers and businesses
- Indirect effect through sick leave, remote working and downsizing of operations
- Financial market effects

Policy makers have to respond. There is not all that much that can be done to adequately counter the short-term effects of supply and demand loss. Incentivizing people and businesses to spend and invest more is very difficult when the main goal of policy, businesses and people is to curtail or avoid the virus. Even though there are no guarantees about the period of time over which the virus will negatively impact the economy expectations are that this will be limited, after which growth

will resume. Policy measures taken will therefore mainly concern bridging the period of output loss so that an otherwise healthy economy will not experience more lasting effects.

## What can be done?

Both fiscal and monetary policy can help bridge the economic fallout, but the menu of options for fiscal policy seems somewhat broader. First of all, governments can help by reducing labour costs for businesses when output is temporarily reduced. *Kurzarbeit* measures, which countries like Germany successfully employed in the aftermath of the 2008 crisis, reduce the amount of working hours with subsidized pay to make up for workers' lost income. Another way of helping businesses through a sudden period of economic fallout is through state guarantees for businesses to help combat liquidity problems that arise from sudden loss of revenue and could otherwise lead to bankruptcy. In the current crisis, the sectors to be hit first are tourism, leisure and (sport) event organisers.

Stimulating demand in times of an external shock is tough and will likely mainly help the recovery after the main economic fallout has ended. It can nevertheless be useful to help create a v-shaped return to growth. Also, think of employees working in service industries who will not be (fully) paid due to a sudden fall in their employer's revenues. Here, any demand-side support would be more than welcome. These might include government investments or more targeted measures such as temporary VAT decreases. These measures are sometimes difficult to decide on politically and there is also a time lag for the stimulus to materialize. If indeed the idea is to counter a short-lived shock this will mainly help in the aftermath. This is not unimportant: it also serves as an important sign of confidence for financial markets.

From a monetary perspective, a conventional rate cut would help lower financing costs somewhat. The conventional stimulus expected from lower rates is unlikely to materialize as the problem lies outside the economic realm. Monetary policy can also help bridge the period of output loss, though, as it can stimulate banks to provide bridge loans to businesses. More QE on the corporate sector side would also make loans for large corporates cheaper and on the public sector side it would keep borrowing affordable for sovereigns. Lower rates for TLTROs would help the banking sector to continue to provide enough liquidity. In addition, and in order to avoid a market meltdown which eventually could turn into a credit crunch, clear communication, determination and commitment can confirm the central bank's role as lender of last resort.

## What has been done so far?

On the monetary side, the ECB has decided on a range of options as their initial crisis-fighting measures. The option of a deposit rate cut has been left out and measures have been more targeted and small - aiming at specific economic fallout. These measures include LTROs aimed at providing liquidity to SMEs, a dual-rate with TLTROs available at a lower rate than the deposit rate for banks that keep their lending portfolios stable and making another 120 billion euro available for asset purchases. It has also decided on temporarily lower capital requirements for banks. This is a package that is mainly aimed at supporting the banking sector to keep a credit crunch scenario at bay. However, market reaction during and after the ECB's press conference shows how important good communication and demonstrated a willingness to act can be.

No coordinated fiscal measures for the eurozone have been announced just yet. On Monday the Eurogroup will come together to further discuss the eurozone's fiscal approach to the economic fallout from the coronavirus, something that ECB president Lagarde considered to have utmost

priority in the current situation: “it’s fiscal first and foremost”. Individual countries have already taken that to heart and have implemented a range of measures.

The largest package that has been announced so far has been – as is to be expected – by Italy. Italy will make up to 25 billion euro available as an emergency fund, with around 12 billion expected to be used for immediate healthcare spending, bridge loans for SMEs, postponement of tax duties and broader job protection. In Germany, investments will be increased by 3.1bn euro per year, something which has a negligible macroeconomic impact given that this is less than 0.1% of GDP. Most other countries haven’t announced spending plans yet, although Ireland has a one-time package of 3.1bn euro announced, a more sizable economic injection per capita than in Germany and Italy.

In France, Spain, Netherlands and Belgium no spending plans have been announced so far. Measures taken mainly focus on tax relief in countries like France. The Netherlands and Germany have employed *Kurzarbeit* measures. Most countries are providing some form of liquidity support for companies that help bridge the period of output loss. As this is a fast-moving environment many governments have already suggested that more measures will come.

This means that the measures taken so far in the eurozone have been mainly targeted at the specific issue at hand, both by the ECB and by governments. If indeed more blanket measures like a deposit rate cut and broader fiscal spending are to be employed likely depends on how the virus develops and how deep the economic fallout will be.

## Authors

### **Bert Colijn**

Chief Economist, Netherlands

[bert.colijn@ing.com](mailto:bert.colijn@ing.com)

### **Carsten Brzeski**

Global Head of Macro

[carsten.brzeski@ing.de](mailto:carsten.brzeski@ing.de)



## CZK meltdown: Is the past catching up?

Given the global backdrop, EUR/CZK is set to head higher, with EUR/CZK 26.50 being the next realistic target. With the koruna under heavy pressure,...



Source: Shutterstock

### CZK under pressure

The Czech koruna is sharply down and EUR/CZK is above 26.00. What used to be the safe harbour in times of stress within the CEE region has turned into an underperformer.

The problem for the koruna is that positioning is finally catching up. Foreign holdings of Czech government bonds - behind 40% clearly shows that the koruna has been persistently and chronically overbought, making it vulnerable in times of stress. While the CZK weathered the 2019 global trade war storm relatively well (EUR/CZK did not move above the 26.00 level), current market jitters are taking a heavy toll.

This is due to:

- (a) Across the board deleveraging, which has made overbought currencies particularly vulnerable (CZK in the CEE, RUB in the wider EMEA space or MXN in the LatAm region),
- (b) Markets aggressively pricing in Czech central bank rate cuts, with the central bank being one of the few with ample room to ease monetary policy.

## Potential rate cuts will affect CZK

While there isn't much the Czech authorities can do about the positioning, they have power over rate cuts. Although from a bird's eye view, the case for central bank rate cuts is rising, from an idiosyncratic point of view, any larger scale easing cycle would in our view lead to a CZK meltdown.

The currency is already very vulnerable due to the positioning and should the central bank take away the key anchor behind CZK (the yield advantage), the exodus from Czech asset markets could be rather pronounced. Indeed, based on our conversation with investors last year, the yield advantage was the key reason why investors remained invested in CZK during the 2019 global trade war.

## Signalling CNB cut more likely

Bar the implications for the currency, we also don't see rate cuts as the best remedy for the current Czech economic situation.

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*A more effective measure would be a lower counter-cyclical capital buffer to support credit availability*

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As Governor Jiří Rusnok mentioned this week, rate cuts might not help the economy much as a small deceleration in lending costs won't be a game-changer for companies, which mainly need to have access to credit. Credit availability will be considered as more crucial than lending costs itself.

A small rate cut would aim to signal coordination between the central bank and the government (as was the case in the UK), but a more effective measure would be a lower counter-cyclical capital buffer to support credit availability.

Hence, we are biased not to call for aggressive easing from the central bank given the currency consideration. Of course, with the central bank having ample FX reserves (60% of GDP), it is well equipped to deal with the currency free-falling, if the situation were to arise and defend the koruna.

*We think FX interventions below EUR/CZK 27.00 are unlikely*

But we think FX interventions below EUR/CZK 27.00 are unlikely. To be clear, the current CZK fall is primarily a function of the global environment and pressure on risk assets (including EM FX) and the central bank cannot do much about it, but there are idiosyncratic reasons why the CZK declining more than its CEE peers and here the CNB has the power to influence the scale of the koruna downside.

It's worth noting that the CZK weakness has already delivered three implicit rate cuts, while the koruna is still not undervalued after the recent fall.



# UK budget: Three main takeaways for markets

The combined actions of the Bank of England and the UK Treasury will go some way to insulate firms against cashflow constraints over the coming weeks and...



Source: Shutterstock

There's little doubt that today marks a big sea change in UK fiscal policy. The government has unveiled a £30bn stimulus package, with pledges to significantly increase both current and capital spending over the next five years.

But the details matter, and for markets, there were really three key questions going into the budget.

## 1 How far does the budget go in tackling Covid-19 impact? (Pretty far)

This is probably the most pressing issue, and the concerns are primarily focussed on firms' cashflows, particularly those in travel, hospitality and leisure industries who may suffer from lower demand and staffing disruptions.

The [targeted actions from the Bank of England announced earlier in the day](#) go some way to

helping this, by encouraging banks to continue extending credit lines to affected firms. But ultimately the Bank's measures can only incentivise the banks to increase lending, and fiscal policy is arguably better placed to offer more precise options to help mitigate cash flow issues.

On this, the Chancellor, Rishi Sunak has announced a fairly sizeable £12bn package, which is perhaps more than most had expected. Probably the most important element of this is a state-guarantee scheme for small businesses, to ensure affected firms retain access to their day-to-day financing needs. The government has also taken the fairly large step of removing business rates for various companies, meaning these firms won't be taxed on the premises they occupy.

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*Ultimately the Bank's measures can only incentivise the banks to increase lending, and fiscal policy is arguably better placed to offer more precise options to help mitigate cash flow issues*

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There are also tweaks surrounding statutory sick pay, an amount that firms are required to pay workers for time off. The government will reduce the burden on small firms by taking on the cost of sick-pay for up to two weeks of a worker's illness. However, one often-cited criticism surrounding UK sick pay more generally is that it is lower than those in other European countries - around 20% of average weekly earnings - potentially leaving individuals more exposed relative to some other developed countries.

## 2 Have the fiscal rules changed amid all this extra spending? (A: Not yet...)

In effect, the answer is "yes". The formal forecasts still assume some wriggle-room under the manifesto pledge to balance current spending by 2022/23, but those projections don't include these new policy measures nor arguably the full effect the virus will have on GDP.

The Treasury has therefore been able to avoid making formal changes to the fiscal rules on this occasion, but the Chancellor has said they will be reviewed, making future changes likely. However in reality markets are unlikely to be fazed by any prospect of reduced fiscal discipline, given how low borrowing costs are and given the economic circumstances.

## 3 How quickly will public investment rise? (A: It depends)

Finally, markets were on the lookout for signs of the government's public investment plans. We know from the election manifesto that the government was planning to raise the level of investment to 3% of GDP, from a little over 2% currently. The budget contains the first concrete signs of this, although the details are yet to be thrashed out.

These moves will be growth positive, although as always, it often takes longer than planned for higher capital spending to feed through - there are only so many 'shovel ready' projects available.

One of the key constraints will be labour. Staff shortages tend to be more prevalent in the construction industry, given the tight jobs market and amplified perhaps by reduced levels of net migration from the EU.

We also know that a large chunk of money will be spent on research and development over the next few years, although again the devil will be in the detail. To boost productivity, this will need to be channelled into applied research - development within specific industries to help more targeted innovation, something that is often easier said than done.

All of this means it could be a few years before that 3% level of public investment is reached.

## **GBP: Coordinated stimulus helps sterling's short-term prospects**

With both the Bank of England and the UK government delivering targeted stimulus in a coordinated fashion, GBP finds itself in a rather unique position within G10 FX space, where authorities are pulling in the same direction. This is why the GBP response to the unexpected 50 basis points rate cut (under a normal scenario a clear negative for the currency) was fairly muted today and GBP is in fact up both against EUR and USD.

In our view, the GBP downside vs EUR should be limited for now due to two mitigating factors: (1) general sterling factor: the UK government and central bank targeted measures are a partial mitigating factor for downside risks to the UK economy; and (2) a EUR/GBP near-term specific factor - the surprise rate cut today will raise expectations for more meaningful ECB easing tomorrow, thus limiting near-term EUR/GBP upside.

While the proactive measures by the central bank and the UK government are a short term positive for GBP, one shouldn't get carried away given the upcoming UK-EU trade negotiations (which we see as a negative) are likely to weigh on the GBP around the middle of the year.

### **Author**

**James Smith**

Developed Markets Economist, UK

[james.smith@ing.com](mailto:james.smith@ing.com)



## For Asia, “too low” oil prices are “a thing”

Globally, oil is not a "tax" on income, it's closer to a "transfer" from producers to consumers - but even that is a...



### What is the "indifference" range for oil?

When I was a much younger economist, you would respond to swings in the price of oil by consulting one of the OECD "ready reckoners" printed in the back of the World Economic Outlook. This would tell you what a \$5/bbl increase/decrease in the price of a barrel of oil would mean for your GDP and inflation forecasts.

Back then, when the DM world dominated the global economy and most of them were both oil-intensive in production and typically net-oil consumers, it sort of made sense. But even then, it required you not to care what was happening to producer nations. A more sophisticated view of oil prices emerged as the world changed and EM economies started to dominate global GDP. This required you to think of oil as a zero-sum game, where oil producers benefited from a rise in the price of oil, and consumers form a fall and vice versa.

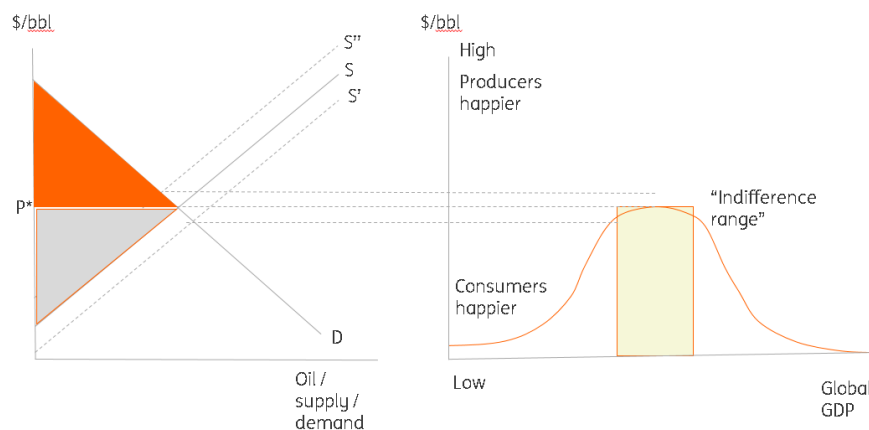
This sort of thinking still prevails in many forecasting circles, but even this is a gross simplification.

Let me explain with a simple 2-country model of the world. Here there are just two economies, and one produces and sells only oil, and the other produces and sells only chocolate. When the price of oil is very high, the chocolate producers can't afford to buy very much, and producers lose out, and when the price is very low, the chocolate producers can buy loads, but it doesn't earn enough for the producers, who then can't buy chocolate. There is a price of oil at which producers can buy

quite a lot of chocolate, and consumers can buy quite a lot of oil, both probably still grumble, which is why I refer to this as the "indifference range" for oil. Just by observation, and limited empirical analysis, I have viewed this range as about \$10/bbl either side of \$65/bbl.

Following the breakdown in OPEC+ negotiations at the end of last week, [which Warren Patterson has highlighted in this note](#), crude oil prices are down around \$36, and will almost certainly head lower in the days ahead unless someone changes their mind.

## The "indifference range" for oil



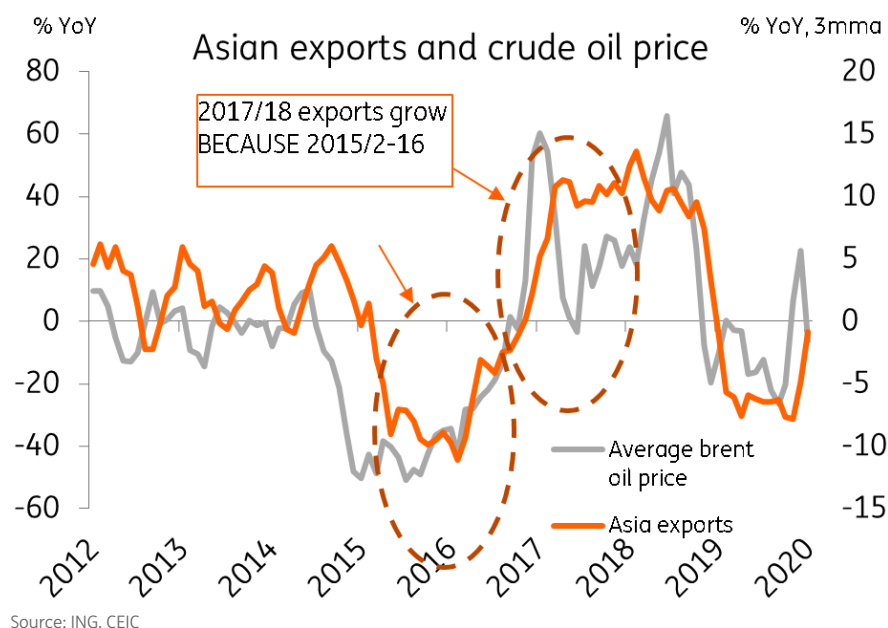
Source: ING

## Crude oil price and Asian exports in practice

Well, that is so much for the theory, how about the practice? The chart below shows how swings in crude oil prices have preceded swings in Asian export growth, with the most notable plunge in recent history being 2015/16, which led to a big fall in Asian export growth, and then as oil firmed through 2017/18, helped their recovery. The chart is specified in terms of year-on-year changes, but it also works in levels (\$/bbl) against the percentage change in exports. Oil prices are now plunging, following the breakdown of OPEC+ talks.

It is hard to see how this sort of shock could have come at a worse time for Asia. Even India, where we would normally expect an oil price decline to provide some support to the rupee, is unlikely to see much benefit, as it is embroiled in its own financial sector problems, with the collapse of a private bank at the end of last week. The MYR stands to lose too as the region's most notable oil exporter.

## Oil swings and Asian exports ("indifference range" in practice)



## Don't write off China's GDP after this quarter

Iris Pang provides some hope for Chinese GDP after what looks like it will be a horrific 1Q20 [judging by the trade data released over the weekend](#).

Iris writes, "China has issued more than CNY 1 trillion of local government special bonds recently to finance infrastructure investment. The "new infrastructure investment" mentioned by the media, includes 5G investment, electric car charging facilities, electricity infrastructure. These are all planned infrastructure. The name "new infrastructure" highlights that this investment will not include property, which is in trouble from high leverage. We believe front-loading of planned "new investment" will support the recovery of the economy from 2Q20".

### Author

**Robert Carnell**

Regional Head of Research, Asia-Pacific

[robert.carnell@asia.ing.com](mailto:robert.carnell@asia.ing.com)

# Growth in the Balkans: From zero to hero..and back?

We review below the main changes to our macroeconomic forecasts for Romania, Bulgaria, Serbia and Croatia. While the revisions are all pointing the same...



Source: Shutterstock

## Main changes to our 2020 forecasts (2021 forecasts are left unchanged):

We believe that Serbia will be least affected due to its strong investment-driven cycle. Bulgaria and Croatia, which are more tourism dependant will fall inbetween, while Romania, due to its pro-cyclical past policies, will suffer the most. All this assumes that the disruptions caused by the Covid-19 pandemic will start to dissipate towards the end of the second quarter of 2020.

- Croatia: GDP growth is revised downwards by 1 percentage point, from 2.2% to 1.2%, inflation from 1.6% to 1.0% and the year-end EUR/HRK from 7.45 to 7.55
- Bulgaria: growth revised from 3.0% to 2.1%, annual inflation from 3.4% to 2.7%
- Serbia: GDP growth revised from 4.7% to 3.9%, annual inflation from 2.3% to 1.8%, year-end EUR/RSD to 118.00 from 117.2
- Romania: growth is revised from 3.6% to 2.1% and annual inflation from 3.0% to 2.8%. We leave the EUR/RON forecast unchanged at 4.8500 year-end.

After the economic crisis of 2008-2009, the Balkan region experienced a prolonged economic slump, with anaemic growth rates by regional standards. However, with the help of the IMF, growth resumed in most cases by 2011-2012 and gradually picked up pace (with a few hiccups for Serbia and Croatia), pushing GDP growth to, or even above, potential in recent years. In the same vein, 2020 was shaping up to be another robust catch-up year for the Balkan economies. In 2019, Romania and Serbia exceeded expectations on GDP growth, advancing 4.1% and 4.2%, respectively, while Bulgaria's 3.7% rate and Croatia's 2.9% pace were broadly in line with our view and the consensus. And with the exception of Serbia, which we expected to accelerate this year, the growth prospects for 2020 were looking only a touch more modest compared to 2019, with Romania at 3.6%, Bulgaria towards 3.0% and Croatia at 2.2% - more in line with their long-term potential.

However, as the best laid plans of mice and men often go astray, the outbreak of Covid-19 has rapidly changed the picture, leading us to a point where the term 'recession' does not seem inappropriate. That's not to say we are there yet and - with a bit of luck and policy wisdom - we see a good chance for the four Balkan countries to avoid such a scenario.

## Croatia: Beyond the sun and the sea

In our view, Croatia is very exposed to an economic slowdown, mainly due to the very high share of tourism in the country's GDP (close to 20% of GDP judging by travel-related revenues), but also to the weak industrial sector (quasi-flat in 2019) and the consumption-dependent growth model. Last year, out of the total 2.9% GDP growth, c.2.1ppt came from private consumption. We therefore fail to identify any catalysts that could drive the growth story further into 2020. The fixed investments advance from the first two quarters was reversed in the following two quarters, hence it's all on the consumer to drive growth in 2020 as well.

It's worth noting that our revised 1.2% GDP growth forecast still incorporates quarterly sequential growth in three out of four quarters in 2020, with a stagnation seen in 2Q20.

On the inflation front, the lower oil price (see [here](#) the latest ING forecasts) and softer demand will undoubtedly push inflation lower. In our view, the weaker kuna will offset these developments to a very limited extent as we consider the FX passthrough to be insignificant in Croatia. Hence, our 1.0% inflation forecast for 2020 is mainly a result of incorporating the new oil price in our projection, ignoring the FX component.

Speaking of FX, the kuna looks set to be among the worst performers in our group, as the other currency which in theory could take a strong hit - the Bulgarian Lev, is under a solid peg regime. Our 7.55 year-end forecast is - we believe - relatively optimistic judging strictly from a supply/demand perspective (given that Croatia has a structural trade deficit and, starting this year, a current account deficit due to the likely fall in the export of services). However, the ample FX reserves of the Croatian National Bank (EUR19 billion as of Jan-2020) makes the case for a depreciation spiral to occur a very weak one right now.

## Bulgaria: Muddling through

2020 was supposed to be the year of ERM II (Exchange Rate Mechanism) entry for Bulgaria, an important milestone and a challenge for the country. Things have slowly started to fall apart however, with Prime Minister Boyko Borisov calling for a "national consensus" before this takes place. The root cause however seems to lie with the European Central Bank's assessment of the



Bulgarian banking sector, which found capital shortfalls at two banks.

Although there is no clear connection between recent Covid-19 related developments and the ERM topic, the prospect of an economic slowdown and all the implications that come with that (inclusively for the banking sector) are definitely not helping. It could also shift the attention and resources from taking the measures needed to comply with EC/ECB requirements to tackling the economic effects of the Covid-19 spread. Hence, although there is no straightforward link, we believe that the prospects of joining ERM-II in the forthcoming months look more distant now.

Turning to the growth story, the Bulgarian economy is not as reliant on the tourism sector as Croatia is - we estimate the travel-related revenues to be around 10% of GDP for Bulgaria. Moreover, the growth structure leaves some room for positive future developments, considering the relatively robust gross fixed capital formation dynamics: +2.0% in 2019 with a clear acceleration trend in the last few quarters. Having said that, there are downsides as well: the currency peg doesn't offer any space for short-term competitiveness gains, the country needs to run balanced budgets (which is already happening, hence little room for fiscal impulses), tourism represents an important source of revenues and already sluggish consumer sentiment is likely to be hit in the short term by the recent developments. This will filter through to consumption behaviour and in the end, cause more prudent spending. All things considered, we see the risks to our new 2.1% GDP growth forecast this year as being broadly balanced.

With the FX-passthrough topic not an issue in Bulgaria's case, we expect the lower oil prices and the (forecast) change in consumer sentiment to lower the annual inflation rate to 2.7%, from our initial 3.4% estimate which was, admittedly, at the top of consensus.

## Serbia: The new Balkan tiger?

The Serbian economy continues to enjoy the benefits of past and ongoing reforms, with investments boosting growth, capital inflows supporting the Serbian dinar and a benign inflation backdrop, which allowed the central bank to lower borrowing costs. In 2019, the GDP advance came in above consensus at 4.2%. The growth structure paints an optimistic picture, as investments continued to be the main growth driver, advancing by 15.6% (after 18.6% in 2018) and contributing 3.2ppt to overall growth. Bordering on double-digit territory, wage advances will keep consumption levels on the rise as we move ahead into this electoral year.

In a surprise move, on 11 March the National Bank of Serbia (NBS), lowered the key rate by 50bp to 1.75%, while narrowing the corridor of its main interest rates from  $\pm 1.25$  pp to  $\pm 1$  pp relative to the key policy rate. The move came explicitly as a response "to heightened uncertainty in the international environment triggered by the spread of the coronavirus (Covid-19)". The possibility of additional easing has been also mentioned, depending on the global and domestic conditions.

However, we believe that the Serbian economy has enough momentum to move forward at a decent growth pace this year. Strong domestic demand should be able to absorb the external shocks coming from Serbia's main trading partners - with Italy and Germany each accounting for some 12% of Serbian exports. Although not negligible, the share of tourism in GDP is not a game changer either - we estimate that travel-related revenues account for c.6.7% of GDP. Our previous 4.7% GDP growth forecast was among the highest in the market and we believe that after a fresh wave of forecast revisions, which are bound to appear, our new 3.9% GDP advance will remain one of the highest.



The already relatively low inflationary pressures will further moderate amid the impact of falling oil prices and softer demand. We see average annual inflation at 1.8% and expect headline inflation to fall below the 1.5% lower bound of the inflation target range in the coming months.

## Romania: Growth resilience story to be seriously tested

We had started the year with a long-standing 2.7% GDP growth forecast, which was among the lowest in the market, but after a stellar 1.5% advance in the fourth quarter versus the previous quarter, we have revised our forecast to 3.6% for 2020 mainly due to the carry-over effect of the strong fourth quarter. However, looking at the growth structure and in view of the recent pandemic, we believe that Romania will experience a serious growth slowdown.

An unprecedented fiscal impulse in the fourth quarter (when the government spent around 2ppt of GDP in less than two months) led to an unusually large contribution from public consumption to 4Q GDP growth. At 2.6ppt, it is the highest number since the third quarter of 2008. This pace is very unlikely to be maintained and we would expect public consumption to have a neutral effect on growth in 2020. It is already well known that Romania burned through its fiscal buffers during very good economic times, which leaves the economy exposed to a downturn. Although we can hardly expect any meaningful fiscal consolidation to occur this year (due both to the Covid-19 impact and to the electoral context), there is no room for fiscal expansion either, as the -4.64% of GDP fiscal gap in 2019 has already got the attention of the European Commission (which will activate the Excessive Deficit Procedure) and the markets.

On the monetary policy front, we believe that there is some room for easing, but any serious action needs to be done in sync with credible fiscal measures. To the extent the National Bank of Romania will be comfortable with the fiscal backdrop, we can envisage the central bank doing a little bit of everything: leaving the EUR/RON to shift higher earlier in the year rather than later (we maintain our 4.85 year-end forecast), leaving some carefully monitored surplus liquidity in the market, further cuts in minimum reserve requirements and even one or two 25bp key rate cut(s) if the economic downturn deepens. As [previously mentioned](#), we think that the central bank would initially prefer a targeted lending programme to assist businesses in need, which however requires cooperation between the NBR and political actors in order to pass the “adequate legislation”. Given the political backdrop, we think that it could take at least a couple of months for such a programme to become operational.

### Author

#### Valentin Tataru

Chief Economist, Romania

[valentin.tataru@ing.com](mailto:valentin.tataru@ing.com)

## Why the Riksbank won't be the next central bank to cut rates

Policymakers in Sweden are wary about taking the repurchase rate back into negative territory, having only raised it in December. But with the relatively...



Source: Shutterstock

The Governor of the central bank of Sweden, Stefan Ingves

### The open economy is at risk

Who will be the next central bank to cut interest rates? That's the question markets are focused on, but the [latest comments](#) from Riksbank Governor Stefan Ingves and Deputy Governor Anna Breman suggest it won't be them.

The duo has said that it is 'too early to determine' the impact coronavirus will have on the economy. But being a small, open economy, policy easing in Sweden is nevertheless fairly likely.

That poses increased risks for core inflation. January's numbers have been dismissed as displaying temporary drags, but the virus is likely to hit the numbers through the first half of this year. As consumption dips, airfare prices will be first to take the hit, probably closely followed by leisure and entertainment.

This will lower core inflation, and [plunging oil prices](#) will be a further drag on the consumer price index with a fixed interest rate or CPIF. This also poses a risk given the ongoing wage negotiations

due to be wrapped up in Spring. The labour market already appears to be weakening and inflation expectations among employee/employer organisations are muted.

## Rate cuts aren't the priority

But having only increased the repurchase rate back in December, officials are clearly wary about lowering it again so soon. Don't forget that December's decision was motivated more by a desire to prevent negative rates becoming a permanent state of affairs than it was due to any economic strength.

That suggests any initial action is likely to be focussed on other tools. One of the key concerns globally is the impact the virus will have on small businesses and their cashflows. A rate cut is unlikely to do too much in that regard, which is why the Riksbank has hinted that it is looking at other measures to ensure that credit continues to flow to affected companies. As a result, the Bank might end up using some of the policies it used back in the crisis, including loan facilities.

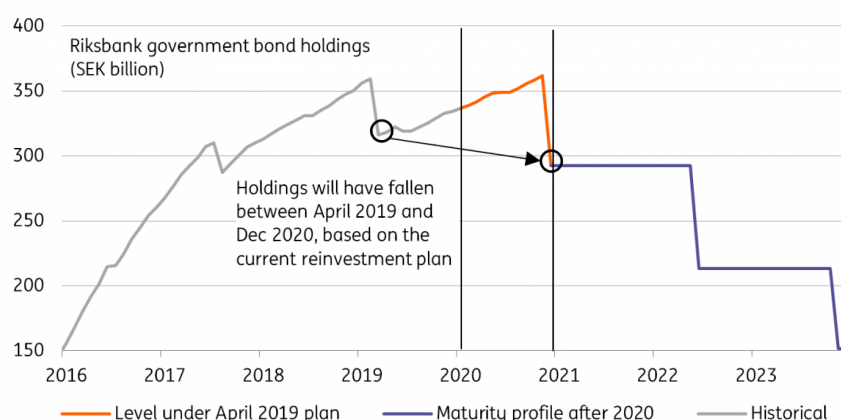
## A faster pace of bond-buying?

Quantitative easing also appears to be fairly high up the list of tools. That might include an increased rate of government bond purchases. Currently, policymakers are reinvesting roughly 50% of what will (or has) matured between April 2019 and December 2020 (most of this is centred on one large maturity towards the end of this year).

This policy means that the size of the bank's government bond holdings will fall by the end of the year, relative to where they were in April 2019. However, [policymakers said on Tuesday](#) that the balance sheet shouldn't reduce this year, which potentially opens the door to increase that rate of reinvestment of government bonds.

Policymakers are also hinting that the purchase programme could be expanded to include other assets, including corporate bonds.

## Riksbank government bond holdings



Source: Riksbank

## Riksbank outlook

Some kind of easing looks fairly likely, but the real question is when will this take place.

The next Riksbank meeting isn't until the end of April, by which time the epidemic is likely to have spread further. So while policymakers have hinted easing measures are not imminent, we can't rule out some action before the formal meeting. Either way, rate cuts are unlikely to be the first line of defence.

## SEK: Downside risks vs EUR but outperforming its G10 cyclical peers

The Swedish krona (SEK) currently screens well compared to its G10 commodity peers. The room for the Riksbank to ease policy is much more limited than the ample easing space available to the likes of the Federal Reserve or the Norges Bank, while the country has limited exposure to oil/commodity prices.

Indeed, within our G10 vulnerability score-card (which considers the impact of low oil prices and the risk-off environment) SEK looks like the best of the worst G10 cyclical bunch in the current challenging market environment. See [The FX winners and losers from the oil price collapse](#) for details.

If the Riksbank feels the need to ease monetary policy via unconventional measures rather than targeted measures, its likely preference for a modest QE rather than rate cuts should be less negative for the currency. The SEK should suffer less from a flatter curve (a result of QE) than compression in the front end interest rate differential and implied yield vs its peers (which would be a result of bringing the depo rate back into negative territory).

In the current environment of falling markets, the near-term EUR/SEK bias is clearly higher, yet SEK should continue outperforming its G10 cyclical peers (which are formed of high beta commodity currencies). Whether EUR/SEK converges to, and tests, the psychological 11.00 level is currently purely a function of the Covid-19 related dent to risk sentiment, rather than Riksbank's monetary policy set up.

Compared to 2018 and 2019 (the period of persistent pressure on SEK), the Riksbank currently does not necessarily stand out on the dovish side compared to other G10 central banks. As for NOK/SEK, we look for a further near-term downtrend.

[The FX winners and losers from the oil price collapse](#)

### Author

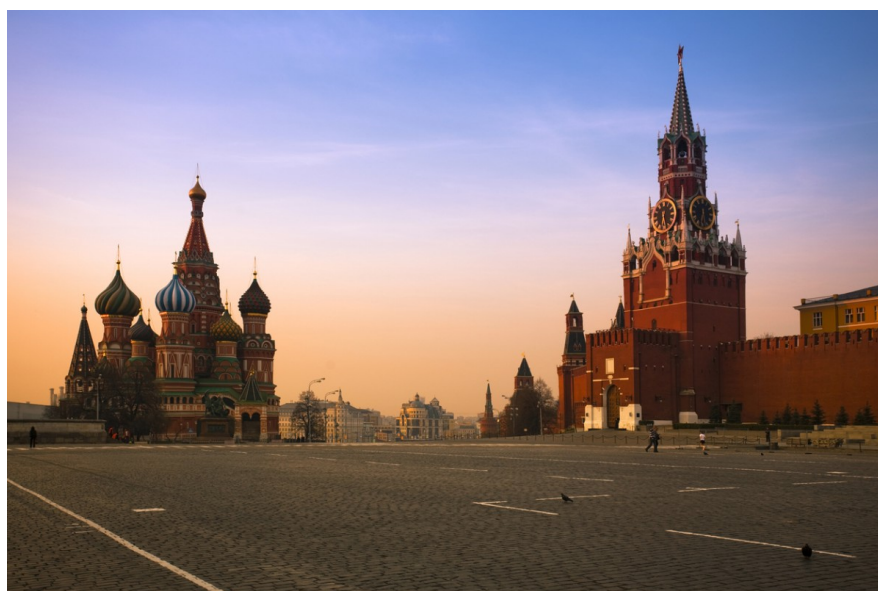
#### James Smith

Developed Markets Economist, UK

[james.smith@ing.com](mailto:james.smith@ing.com)

# Russia bracing for oil shock: initial thoughts

The Russian market is facing volatility, with large fiscal reserves and high real rates coming back into investors' focus, but only after the oil-and...



Source: istock

## Oil shock incoming

The Russian market is exiting the long weekend (9 March was a day-off related to a public holiday) with the Brent oil price at US\$35/bbl, which is US\$10-15/bbl lower than last Thursday-Friday, due to the collapse of the OPEC+ deal, which had been limiting global oil supply since 2018. The breakup of the deal was a surprise: even though Russia's reluctance to support OPEC's call to deepen production cuts by 1.5 MMbpd had been consistently articulated since the beginning of Coronavirus outbreak, a number of market participants have still be hoping for an eleventh hour agreement.

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*The breakup of the OPEC+ deal was a surprise*

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Moreover, OPEC's reaction to completely abandon the earlier agreements and threaten a ramp-up of production were unexpected. The only possible rationale for the reversal in the OPEC+ approach

is to avoid losing market share to the shale oil producers. Based on the OPEC+ outcome, ING has [slashed average quarterly Brent forecasts](#) from US\$56-65/bbl for 2-4Q20 to US\$33-45/bbl.

The market has yet to react to the drop in the oil price, however the preliminary OTC trading indicates USD/RUB depreciated to 75.0 (see Figure 1), suggesting an almost 9% depreciation over the weekend and 17% year to date. The Central Bank reacted on Monday by announcing that it will suspend all fiscal-rule related FX purchases for at least 30 days (initially it was supposed to purchase around US\$3 bn in March), while the Finance Ministry reminded that at Urals below US\$42.4/bbl the fiscal rule dictates FX sales from the sovereign wealth fund. If the oil price settles close to current levels, the Finance Ministry can announce FX sales in the beginning of April, however we would not exclude that the Central Bank could front run the FX sales on the market if conditions deteriorate.

It is obvious that the Russian market is facing a great deal of uncertainty related to future oil prices (the range of market forecasts is wide and includes numbers like US\$20/bbl in the worst case) and EM risk volatility related to the still ongoing coronavirus outbreak (virus is spreading globally, EM assets are under continued pressure).

*The Russian market is facing a great deal of uncertainty*

The spreading of Covid-19, however, seems to be slowing down in China, and fiscal and monetary stimulus worldwide combined with lower oil prices could somewhat mitigate the negative impact on the economy - all of which is clouding our forecasts. In this report we present our initial considerations relevant to the Russian FX and rates market in the near- and medium-term.

**Figure 1. USDRUB of 75 under Brent of US\$35/bbl is a 4-year low**



Source: Bloomberg, ING

**FX: watch out for interventions and OFZ flows**

**It remains unclear at this point whether the drop of USDRUB to 75.0 is justified under a Brent price of US\$35/bbl.** The last time that combination occurred was 4 years ago, in February 2016, and since then:



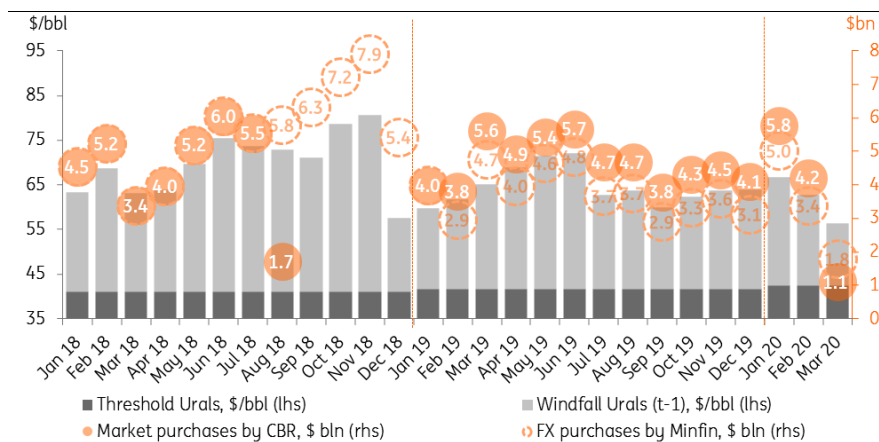
- Russia introduced the fiscal rule, which was supposed to lower RUB's sensitivity to oil price fluctuations through FX purchases/sales under Urals exceeding/underperforming US\$40/bbl (2017) and US\$42.4 (2020) (see Figure 2).
- Foreign policy environment for Russia improved, as sanction risks were lowered, prompting a Russia-specific discount in USD/RUB relative to EM peers shrinking from 25% four years ago to around 10% ahead of the breakup of the OPEC+ deal (see Figure 3). After Monday's RUB collapse this discount recovered to 14%.
- Lower foreign policy risks combined with a high real rate environment made Russia more attractive to portfolio investors, which increased their holdings in local state bonds (OFZ) from RUB1.1 tr (US\$14.4 bn under USD/RUB 75.0) in February 2016 to RUB3.0 tr (US\$40.2 bn under USD/RUB 75.0) in the beginning of February 2020, with their share on the total market increasing from 21.5% to 34.1% respectively (see Figure 4).

**Meanwhile, in the near-term, this does not protect RUB from volatility or guarantee immediate USD/RUB appreciation from the current weak range of RUB70-75 for the following reasons:**

- The Central Bank of Russia's decision to suspend FX purchases seems adequate and resembles the action it took in April-December 2018, however now the effect of that move should be smaller due to the oil price differential: in August-December 2018 the average oil price was around US\$70/bbl, and the CBR suspended FX purchases of US\$5-8 bn per month (see Figure 2); with the current oil price FX purchases should be zero to slightly negative effective in April. **Basically by suspending FX purchases the CBR is front running something that should have happened anyway in a month's time, unless oil prices recover.** Based on the Finance Ministry's [statement](#), **if oil prices stabilize at current levels, the fiscal rule would prescribe FX sales of around US\$1bn per month (each further US\$5/bbl drop would require an extra US\$0.7 bn),** which is not a large volume.
- The current USD/RUB level is not weak enough to trigger emergency FX interventions by the CBR (unrelated to the fiscal rule), as a) the current oil price is within the CBR's risk scenario assuming average US\$25/bbl Urals for 2020, b) the market USDRUB has not deviated materially from the fair value range of 60-70 (historically a deviation of around USDRUB 15 was required), c) **attempts to actively prevent USD/RUB depreciation amid the current oil price could result in RUB oil price dropping below RUB2.6k/bbl, which would be the lowest level since 2010 (the 2018-19 level was RUB4.2-4.4k/bbl), being negative for the budget.** Under the current oil price, we would not expect emergency FX interventions at levels stronger than USD/RUB 80-85.
- The downgrade of the oil price suggests that our expectations of a US\$45bn current account surplus for 2020 (made under a US\$65/bbl Urals assumption) is too optimistic: each US\$1/bbl of oil price assures around US\$3 bn of fuel exports, and the drop in exports will only partially be offset by lower imports, as around 50% of total imports reflect investment imports, and those are likely to be needed in order to assure investment growth the government is targeting. As a result, **we would not exclude a zero to negative CA balance at least in 1H20,** leaving RUB exposed to capital account volatility.
- With little involvement from the CBR on the FX market, the USDRUB sensitivity to oil price moves should now be higher - closer to values seen **before the introduction of the fiscal rule, when a US\$2/bbl move in the oil price was enough to ensure a 1.0**

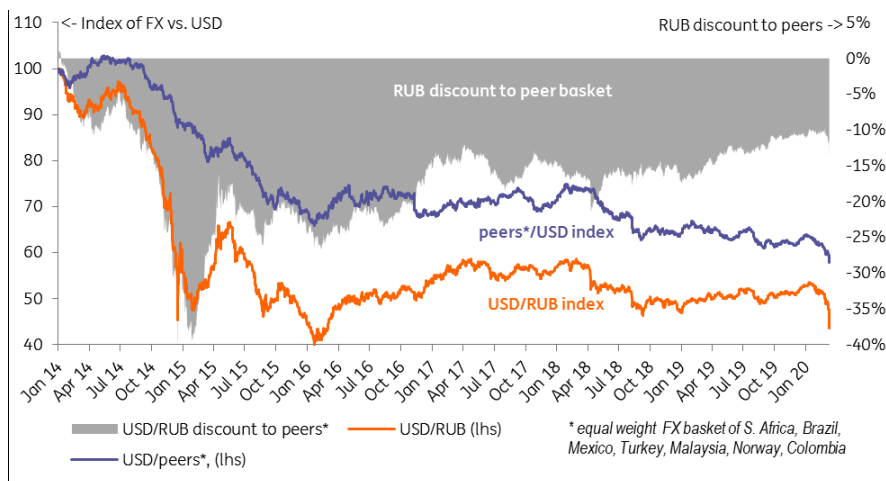
**change in the USD/RUB exchange rate.** Meanwhile, portfolio flows related to OFZ are unlikely to provide support to RUB in the near term: historical analysis of previous risk-off episodes (2014, 2018) suggest a likelihood of 4-9 months of flat to negative flows.

**Figure 2. With Urals close to cut-off price, effect of suspended FX purchases is smaller than it was in 2018**



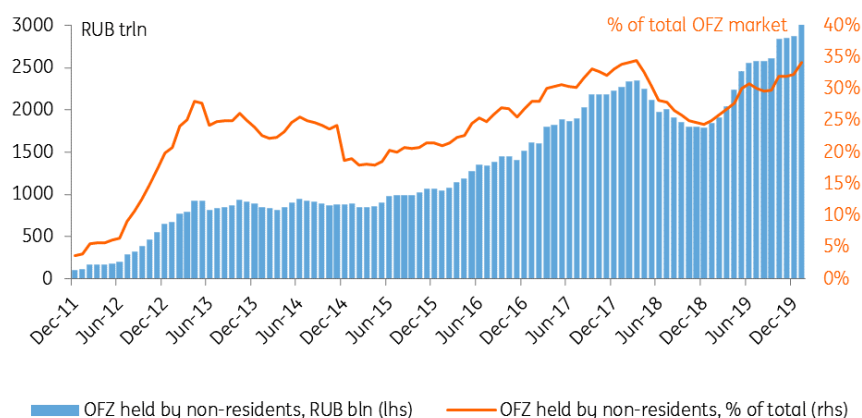
Source: Bank of Russia, Finance Ministry, ING

**Figure 3. RUB has been narrowing its discount to peers since 2016 - till the OPEC+ deal fell apart**



Source: Bloomberg, ING

**Figure 4. Russian market is now under a higher influence of foreign portfolio flows**



Source: Bank of Russia

## Rates: key rate on hold (at least), bond market to focus on fundamentals later

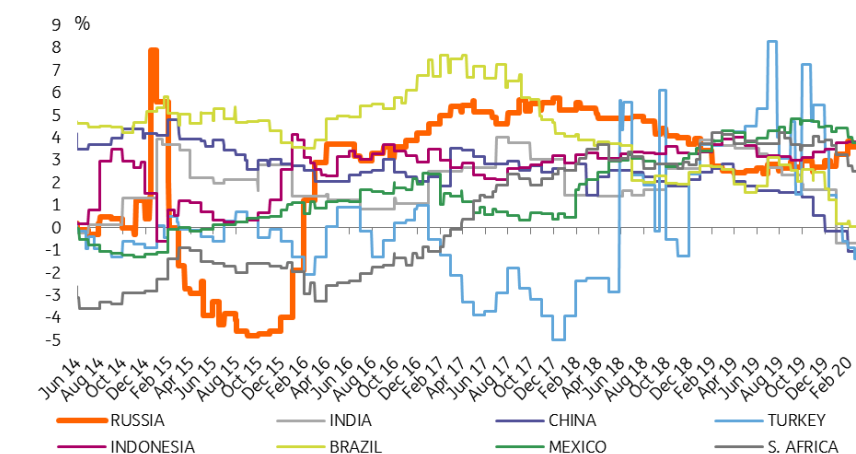
While some market participants are now expecting the CBR to hike rates, as it did in 2H18 or at the end of 2014, **we do not see the urgency in raising the key rate now.**

- The emergency rate hike at the end of 2014 (including the final mid-December hike from 9.5% to 17.0%) was the mark of a transition in the monetary policy regime from managed FX floating to inflation targeting amid a deteriorating foreign policy backdrop, 50% USD/RUB depreciation and rapidly climbing inflationary expectations.
- The episode of two 25 bp hikes in September and December 2018 is a closer analogy, however back then inflationary expectations were facing upward pressure not just because of RUB depreciation, but also amid expectations of an inflationary shock from the VAT rate hike, which materialized only partially, and the CBR had to reverse the move in the following year.
- Russia is entering the current volatility episode with CPI expected by the CBR at year-end 2020 of 3.5-4.0%, below the 4.0% target, with **estimated FX pass-through into CPI of 0.3-0.5 percentage point (pp) per each 10% FX depreciation (vs. around 1.0 pp previously)**. With 17% year-to-date depreciation, CPI expectations could deteriorate by 0.5-0.9 pp, which does not suggest a major overshoot of the CPI target. Meanwhile, further USD/RUB depreciation - to and beyond the aforementioned USD/RUB 80-85 range would mean up to 23-27% year-to-date depreciation or more, potentially creating risks to the CPI target. In that extreme case, an emergency rate hike is possible.
- Another difference of the current episode is that **global central banks are facing a downward rate cycle** in response to global growth concerns, which suggests that even at an unchanged nominal key rate Russia's real rates are to remain at a high level relative to peers. According to our observations, **Russia's real rate is competitive both in terms of current CPI (see Figure 5) and based on expected CPI at year-end 2020.**

As result, if USD/RUB stabilizes at the current 75.0 level we expect the CBR to react by keeping the key rate flat at 6.0% in March-April, which will in effect be a tightening in the stance vs. previous expectations of at least two 25 bp cuts. *More material RUB depreciation, however, could lead to a higher key rate due to a material worsening in CPI expectations.* We are planning to present our detailed considerations on the Russian CPI trend in a separate article.

As for the bond yields, while the Russian market was closed on Monday, its **EM/commodity peers saw around a 30 bp spike in 10-year local currency bond yields, and we do not exclude OFZ catching up.** Weekly OFZ placement auctions are likely to be cancelled for the second week in a row. In the near term we expect the market performance to be driven by the overall performance of oil prices and EM risk sentiment. Favourable Russia-specific considerations, including one of the lowest break-even oil prices among oil exporters (around US\$50/bbl), low state debt (around 13% GDP), liquid fiscal reserves of US\$150 bn (**each US\$1/bbl of oil price below US\$50/bbl breakeven suggests a deficit of around US\$2 bn per annum**), and one of the highest real rates will only return to investors' focus after the oil market and EM risk appetite stabilizes.

Figure 5. Russia's real rates are at the top of peers' range



Source: Bloomberg, ING

Author

Dmitry Dolgin

Chief Economist, CIS

[dmitry.dolgin@ing.de](mailto:dmitry.dolgin@ing.de)

## USD: The wrong kind of rally

Thursday is turning into one of the darkest days of market dislocation since the Global Financial Crisis in 2008/09. The ECB package has failed to calm...



### Cross currency basis swap recalls events in 2008/09

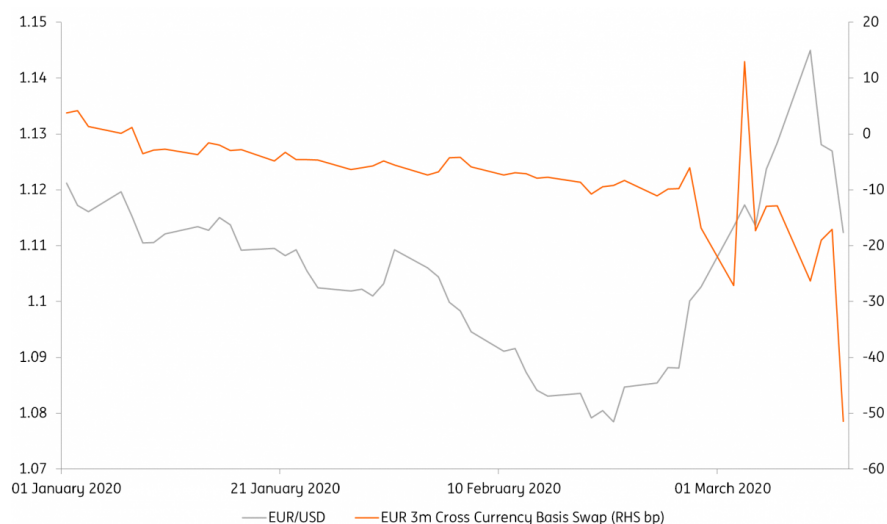
Global financial markets are reeling. One day losses in excess of 10% in some major equity benchmarks recall the dark days of October 2008. We have also been keeping a close watch on money markets. [As Padhraic Garvey noted earlier this week](#), money markets have started to show signs of stress.

What stands out for us today is the widening of the EUR cross-currency basis swap. Recall this represents (when it is negative) how much banks are prepared to lend out EUR below inter-bank Euribor rates to get hold of USD funding through the FX swap market. Back in 2008, this swap had blown out to levels in excess of -150 basis points as European banks, shut out of USD wholesale funding markets, scrambled to the FX swap market to fund their USD loan book.

Today's dramatic widening in the cross-currency swap suggests all is not well with the USD funding market. Indeed, the Federal Reserve's 14-day and 25-day repo operations were over-subscribed and represent an unfilled demand for USD funding. The Fed will be monitoring these developments carefully and will be speaking with banks as to the best measures to address it – e.g. much larger and longer-term USD repo operations. Or more likely, as the guardian of the world's financial system, the Fed will be looking at a permanent liquidity add by re-starting quantitative easing.

Here, the Fed shrank its balance sheet last year (President Trump called it 'quantitative tightening') and has plenty of room to grow it back to the peak of 25% of GDP from levels near 19% today.

## Cross currency swap blows out, representing squeeze in USD funding



Source: Bloomberg, ING

## USD: The wrong kind of rally

Today's move by the European Central Bank has not helped confidence in risk assets at all, but it would be wrong to think the dollar outperformance today represents some kind of global re-assessment of risks, favouring the US. Far from it. Typically these types of moves in money markets come during periods of extreme stress, where the unwind of a long term, benign environment for equities has painful consequences.

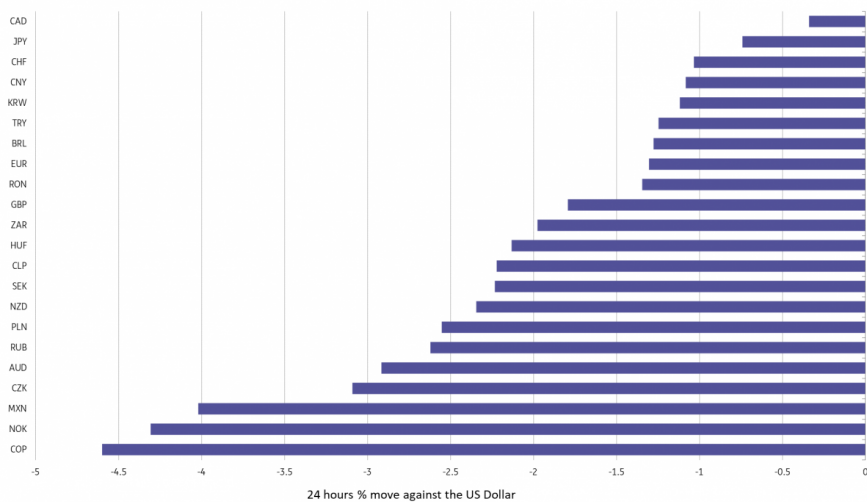
Given the piecemeal response from most (ex UK) politicians and now the ECB effectively saying 'we're done here', we expect risk assets to stay under heavy pressure and volatility levels to stay through the roof.

However, today's developments do bring a more aggressive Fed response that much nearer. Assuming the Fed finds the right tools to address current dislocation, we expect the dollar to be reversing lower ahead of next week's FOMC meeting. That means the USD/JPY rally does not look sustainable above 105 and even today's crash in EUR/USD can find some support – perhaps around the 1.1000/1050 now.

For the rest of the FX market, we are still in a massive unwind stage with very little confidence (e.g. even the Czech koruna is getting hit hard). Expect commodity and high yield FX to remain under heavy pressure, while in the emerging markets space, we are particularly worried about those twin deficit countries with large external financing needs, such as India and South Africa.



## Dollar goes bid across the board on Thursday



Source: Bloomberg, ING

### Author

**Chris Turner**

Global Head of Markets and Regional Head of Research for UK & CEE

[chris.turner@ing.com](mailto:chris.turner@ing.com)

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Article | 9 March 2020

# Eurozone: Gauging possible supply chain disruptions from Covid-19

As Covid-19 goes global, supply chain risks to the eurozone economy have increased materially. Our analysis finds risks to the eurozone mainly come from...



Source: Shutterstock

As coronavirus spreads, one big question is how much will the eurozone economy be impacted. Obviously, there are several channels through which the eurozone economy will be affected - for example, weaker demand from China and other Asian countries, the impact of preventive measures and increased uncertainty in general. But supply chain disruptions are a big one. As factories shut down, production becomes increasingly fragmented worldwide, and this can have a significant impact on eurozone production.

To gauge the eurozone's overall supply chain exposure to Covid-19, we use eurozone value chain exposure to four countries that have seen the most cases of the virus except Iran. This leaves China, Korea and Italy.

[Using the intercontinental input-output tables of the OECD](#), we estimate value-added of China, South Korea and Italy in the total output of Eurozone countries. This is the sum of intermediate inputs produced by the affected countries used in final goods produced by eurozone countries. For example, a car part from China used in German car production. Indirect inputs are also included in this estimate, think of a Korean semiconductor that is used in an electronic component imported

from the US by a eurozone producer. Sounds complicated? That's because global supply chains usually are these days.

*The countries that rely most on Chinese intermediate inputs for their production are Slovakia, Estonia and Slovenia*

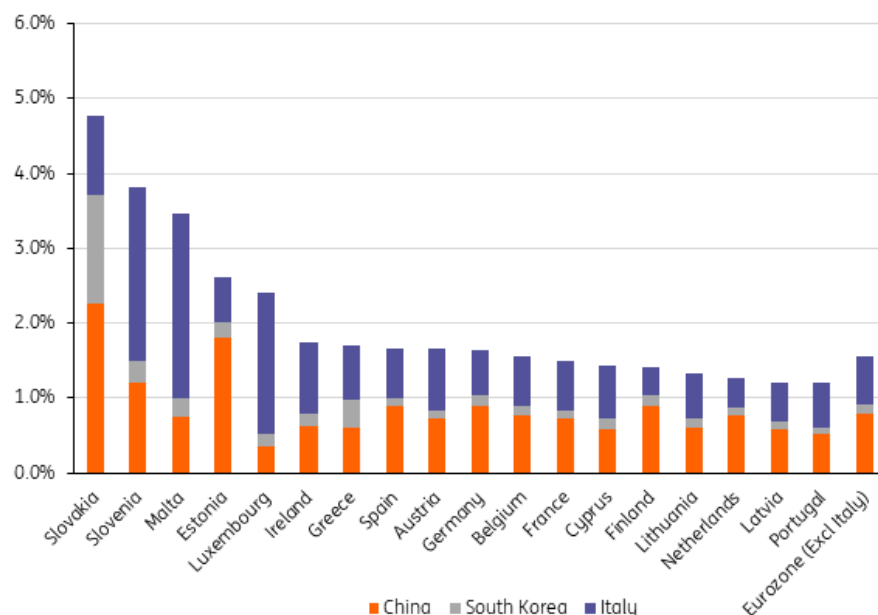
We find that the exposure of the rest of the eurozone economy to Italian intermediate inputs is not as large as one would expect. While in general, the golden rule holds that proximity increases the impact on a country's economy, this is not necessarily the case for Italy. The rest of the eurozone's exposure to Chinese production is, in fact, larger than the exposure to Italy at 0.8 and 0.6% of eurozone value-added respectively.

The Korean exposure to eurozone production is far smaller at 0.1% and therefore poses a much smaller risk. However, if inputs are essential and difficult to substitute, they may have a material impact on the supply chain when unavailable, despite the smaller contribution of Korean industries.

[OECD Inter-Country Input-Output \(ICIO\) Tables](#)

### Fig 1: Country exposure to COVID-19 affected countries

Country exposure as % value added of affected countries in country output.



### Large differences in terms of country exposure

Take countries like Slovakia, Slovenia and Malta for example as they have a relatively large exposure to Italy, bringing them to the top of the list in terms of eurozone countries overall

exposure to the three countries at 4.8%, 4% and 3% of value-added.

*Larger economies like Germany, Spain, France and the Netherlands have an exposure of around 0.8% to China*

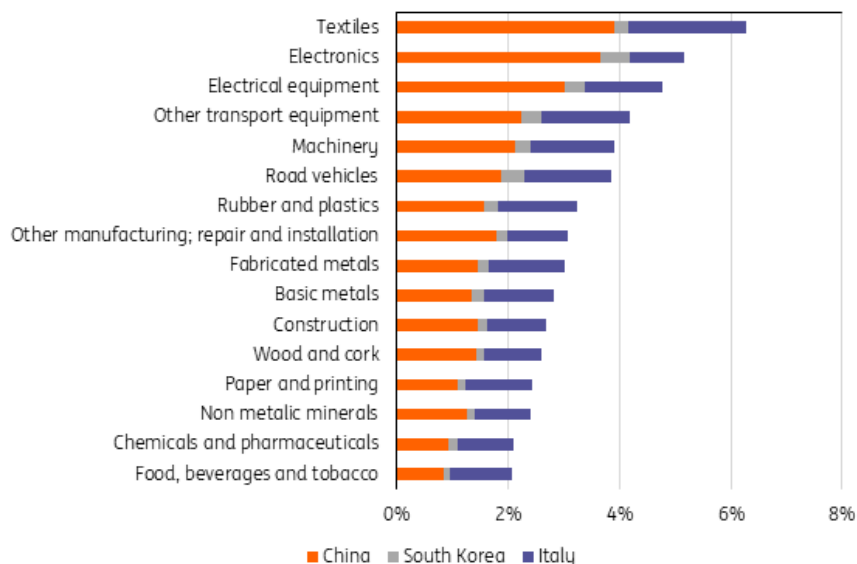
The countries that rely most on Chinese intermediate inputs for their production are Slovakia, Estonia and Slovenia at 2.3%, 1.8% and 1% of value-added. Larger economies like Germany, Spain, France and the Netherlands have an exposure of around 0.8% to China. Slovakia is the only eurozone country with material exposure to Korea at 1.5% of value-added. For Italy, neighbouring Slovenia and Malta both have sizable exposure of 2%, while Luxembourg and Slovakia also have exposure of above 1%. France, Germany and Spain all have similar exposures to Italy at 0.7, 0.7 and 0.6% of value-added.

By sector, textiles, electronics and electrical equipment rank high on the list. Thanks to exposure to both Italy and Germany, vehicle and other transport production are also high up on the list, which have already been struggling with supply-side issues after the new emission standards.

Even though Korea has an important role in the global supply of semiconductors, the exposure of eurozone electronics to Korean inputs is limited compared to Italian and Chinese exposure. But, even small disruptions can have a material impact.

## Fig 2: Eurozone sector exposure to COVID-19 affected countries

Sector exposure as % value added of affected countries in sector output.



Supply chain exposure in value terms is not linear. An essential input but low in value could still cause the shutdown of an entire supply chain if unavailable. The exposure in terms of value-added should be seen as indicative for the potential number of essential parts in a supply chain produced by the affected countries.

As the impact on total GDP seems small, one might think that the impact will be minor, but small disruptions can cause disruptions in production much larger than suggested by these numbers.

This is why it is difficult to gauge where production will be disrupted most, but differences in exposure to China, Korea and Italy show which countries and sectors on average have a higher chance of being affected.

## Authors

### **Bert Colijn**

Chief Economist, Netherlands

[bert.colijn@ing.com](mailto:bert.colijn@ing.com)

### **Carsten Brzeski**

Global Head of Macro

[carsten.brzeski@ing.de](mailto:carsten.brzeski@ing.de)

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