

# CONJONCTURE

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## Brexit: The shape and scope of financial implications

Brexit started as a surprise, with the majority Leave vote in the UK referendum on June 23, 2016. It could turn into an accident if it takes place on April 12, 2019 without any agreement on its concrete terms. In the financial sphere, more specifically, Brexit implies a loss of European passporting rights for the UK and thus less integration between the European Union and the leading financial centre of London. The trade in financial services between the two zones will now have to meet the requirements of two separate sets of regulatory and supervisory authorities, rather than just the requirements of a single regulatory framework as at present. At the very least, this will hold operational uncertainty for some time to come. This edition of Conjoncture aims to sketch out the main lines of the changes to the regulatory framework that financial institutions will have to address because of Brexit, and to identify the main challenges.

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Laure Baquero

## India: A review of Modi's term ahead of the general election

Narendra Modi's term as India's prime minister has been broadly positive economically. In the last five years, he has pushed through some important reforms, taking advantage of his majority in the lower house of Parliament. However, to achieve a significant increase in GDP per-capita and reduce India's vulnerability to external shocks, it is necessary to carry out further reforms in order to create a more conducive environment for domestic and foreign investment. The latest polls suggest that no party could win a majority in the lower house of Parliament in the general election scheduled for April and May. Mr Modi's party still looks likely to win the most seats, but could be forced to govern alongside the Congress Party. That could make it harder to implement reform and weaken the public finances.

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Johanna Melka

ECONOMIC RESEARCH DEPARTMENT

**Eco**  
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# Brexit: The shape and scope of financial implications

Laure Baquero

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Having joined the European Union (EU) on January 1, 1973 following a vote in the House of Commons, the United Kingdom is set to leave it on April 12, 2019, in accordance with Article 50 of the Lisbon Treaty, which it triggered on March 29, 2017.

In 2015, David Cameron was re-elected as Prime Minister, with his Conservative party winning their second consecutive general election, although this time with an absolute majority. In his election manifesto Cameron had promised to hold a referendum on the UK's continued membership of the EU. This took place on June 23, 2016, with the turnout of 72.2% of the UK electorate proving, higher than in the previous general election. To widespread surprise the Leave vote was in a majority, at 51.9%, with Remain scoring 48.1%. Remain had a majority in Scotland, Northern Ireland and London, the UK's financial hub. David Cameron, who had voted in favour of remaining in the EU, resigned and was replaced by Theresa May.

*With or without a deal, the framework of the economic relationship between the EU and the UK will need to be redefined. Only the imminence of the change depends on the conclusion of a UK withdrawal agreement.*

The UK's withdrawal from the EU is currently scheduled for April 12, 2019 but was postponed for a few weeks by the Heads of State at the March 21-22, 2019 EU summit in response to Theresa May's official request, time to convince British Members of Parliament (MPs) to ratify the Brexit draft agreement. Compelled by the European legislative election of May 2019, the deadline of Article 50 has been postponed to May 22 provided that the UK Parliament ratifies the draft agreement on Brexit, but to April 12 otherwise. The objective of a large majority of politicians involved remains the conclusion of a withdrawal agreement rather than a no-deal exit, including among British MPs. If the two sides do manage to conclude a deal, Brexit will include a transition period running to 31 December 2020, or perhaps beyond.

This would imply that the UK and EU authorities had reached agreement on the terms of the UK's withdrawal, notably with regard to: the UK's financial contribution to the EU budget; the rights of EU citizens in the UK and the rights of UK citizens in the EU post-Brexit; and the issue of the border between the Republic of Ireland and Northern Ireland. Other than Gibraltar, for which arrangements were agreed in November 2018, but which could yet come back into play, the

only land border between the UK and the EU is on the island of Ireland. This raises the question of the management of the customs border and the movement of people. It also refers back to the Good Friday peace agreement signed by the UK and the Republic of Ireland, which is still comparatively recent and has shown signs of fragility.

The withdrawal agreement should in principle be accompanied by a political declaration on the future commercial, economic and financial relationships between the EU and the UK. In practice, these matters will be the subject of future talks.

For the financial sector, the challenges are substantial given the UK's position as a leading financial centre. It is likely to remain important despite the necessary adjustments and its relative shortness of breath observed for several years, regardless of Brexit (Part 1).

By leaving the EU, the UK will bring to an end (amongst other things) its access to the free movement of financial services across the European Economic Area (EEA).<sup>1</sup> It will lose the rights provided by European financial services 'passports', with the effect that its financial services firms will no longer be able to trade with the EEA nor freely establish offices there without first obtaining fresh approvals. The same will be true of EEA financial institutions operating in the UK or providing financial services to UK residents and companies (Part 2).

In practice, the new barriers to trade in financial services between the UK and the EEA that will result will be more or less restrictive according to the legal framework that governs them. The definition of this framework is therefore a major issue for financial agents in both the UK and the EU as well as for the regulatory and supervisory bodies on both sides (Part 3). Finally, clearing activities should not be interrupted, especially due to the attention given to them by the EU and UK authorities (Part 4).

<sup>1</sup>The EEA consists of the European Union, Norway, Iceland and Lichtenstein. It was created in 1994 with a view to deepening the relationship between the EU and three of the four members of the European Free Trade Association (EFTA), the fourth being Switzerland. Switzerland rejected EEA membership in a referendum.



# The UK financial sector would remain significant, but appears to have more to lose than its EU counterpart

## London's status as a leading financial centre in question

According to the 2018 overall rankings of the Global Financial Centres Index<sup>2</sup>, London was the world's second largest financial centre (all financial activities included). The EU 27 nations were represented on the list by Frankfurt in 10th, Luxembourg in 21<sup>st</sup> and Paris in 23<sup>rd</sup> place. By type of financial activity, London ranked first in banking and insurance. London's strengths lie mainly in the quality of its business environment and its human capital, the development of its financial sector, its general reputation and, to a lesser extent, its market infrastructure. Compared to 2017, London was overtaken to the top spot by New York, whilst Frankfurt moved up ten places, and Paris gained one.

London also remains by far the leading market worldwide for currency trading, which has grown 18% since June 2016<sup>3</sup>.

## The relative importance of the financial services sector is greater for the UK than for the rest of the EEA

Financial and insurance business accounted for 6.9% of added value in the UK in 2018 (against 4.4% in the EU 27) and the sector employed 3.4% of the active population (2.3% in the EU 27). These figures mean that the sector ranked 6<sup>th</sup> for added value and 9<sup>th</sup> for employment (out of 10 sectors). Having made significant productivity gains between 2000 and the financial crisis<sup>4</sup>, the UK financial services sector has nevertheless seen its relative importance decline in terms of employment since the early 2000s, and in terms of added value since 2010 (Charts 1 and 2).

### Despite 'relocations', a limited effect on total employment

The Bank of England (BoE) estimates that 5,000 to 10,000 jobs could be relocated, that is to say less than 1% of total employees in the sector. This is in line with cumulative announcements on this topic from major financial companies and with the European Banking Authority's estimate that 3,000 jobs will be transferred to Paris.

For its part the Association of Foreign Banks in Germany (VAB) expects between 3,000 and 5,000 jobs to be created in Germany. On this point, the Single Resolution Board (SRB) has warned that it will pay particularly close attention to the way in which banks relocate their activities within the EU, in order to avoid the creation of letter box designed to provide the appearance of a relocation to the EU, whilst activity and decision-making remains in the UK.

### Financial services weight in gross added value

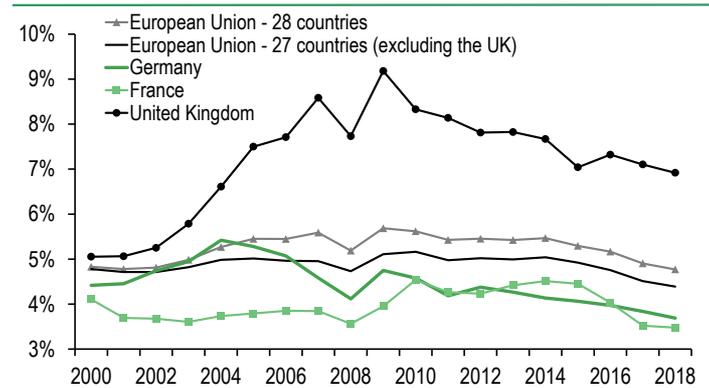


Chart 1

Source: Eurostat, BNP Paribas

### Financial services and insurance weight in total employment

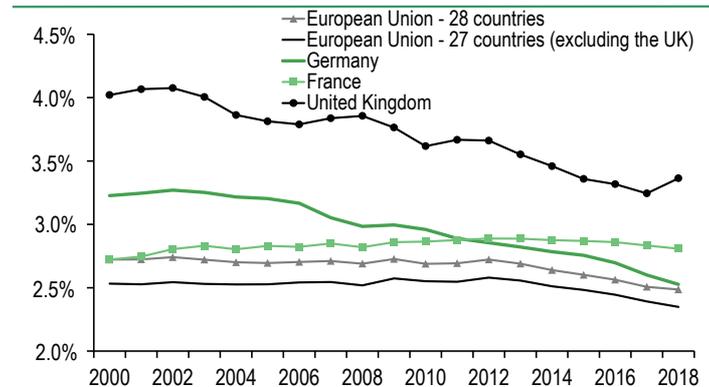


Chart 2

Source: Eurostat, BNP Paribas

At present, the financial and insurance sectors make a positive contribution to the UK's current account balance, with a surplus of nearly EUR 70 bn with the rest of the world in 2017, of which more than EUR 30 bn was with the EU 27<sup>5</sup>. The EU 27 is actually a leading client for the UK financial services industry; it is the destination for 43% of financial services exports and 38% of exports of insurance and pension fund services. In the event of a 'hard Brexit' (that is to say a departure with no deal), UK exports of financial services to the EEA could shrink to an extent determined by the scope of the equivalence regimes that are applied (see Part 3). The shock could be all the greater given that some firms from non-EEA countries use London as a bridgehead to sell financial services into the EEA.

<sup>2</sup> The GFCI is based on opinion surveys of financial services professionals together with other indices produced by the UN, World Bank etc. See: *The Global Financial Centres Index 24* (Sept. 2018)

<sup>3</sup> BoE (29/01/2019), *Results of the foreign exchange joint standing committee (FXJSC) turnover survey for October 2018*

<sup>4</sup> Insee (Dec. 2013), *À la recherche de la productivité britannique perdue (Looking for Britain's lost productivity)*

<sup>5</sup> Eurostat figures. Figures for the EEA are not available.



Against this background, the BoE and its financial regulator the Financial Conduct Authority (FCA) have encouraged banks to limit any relocation of their activities outside the UK as a result of Brexit to the strict minimum necessary.

*The UK banking system is proportionately more exposed to the EEA than EEA banks are exposed to the UK*

In the 3<sup>rd</sup> quarter of 2018, UK bank claims were USD 6,116.8 bn, 56% of which came from the rest of the world (i.e. USD 3,436.7 bn), putting the UK in 2<sup>nd</sup> place, after Japan, in the list of countries whose banks are most exposed to non-resident agents<sup>6</sup>.

UK banks are exposed first to the USA (25%) then the EEA<sup>7</sup> (22%) where their assets are mainly with private sector non-bank counterparties (38%), immediately followed by the public sector (38%) and then the banking sector (24%, see Chart 1a and Map below).

Meanwhile, the total assets held by EEA banks<sup>8</sup> are naturally larger (at USD 28,627 bn in the 3<sup>rd</sup> quarter of 2018), but also have a greater weight of EEA-resident counterparties (63%, see Chart 1b below). EEA banks' exposure to the rest of the world was thus USD 10,572 bn (37% of the total), with 15% for the USA and 12% for the UK. EEA banks' exposure to the UK is mainly in the private non-banking sector (59%), followed by banks (23%) and the public sector (9%).

**Banks exposure in 13 out of 30 EEA member states<sup>9</sup> by location of counterparty, excluding residents (USD bn)**

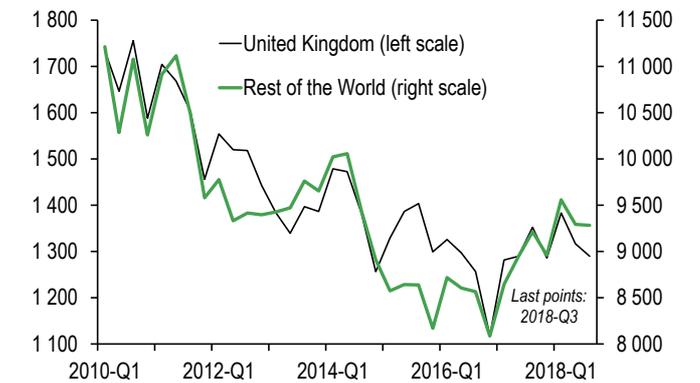


Chart 3 Source: BRI, BNP Paribas

**Exposure of UK banks by location of counterparty, excluding residents (USD bn)**

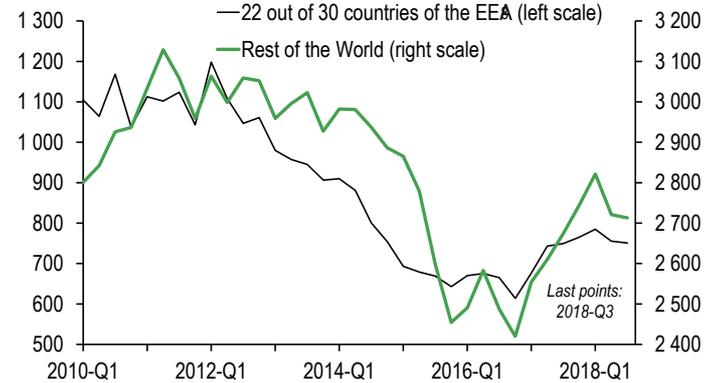


Chart 4 Source: BRI, BNP Paribas

**Breakdown of UK banks claims in 2018 Q3<sup>8</sup>**

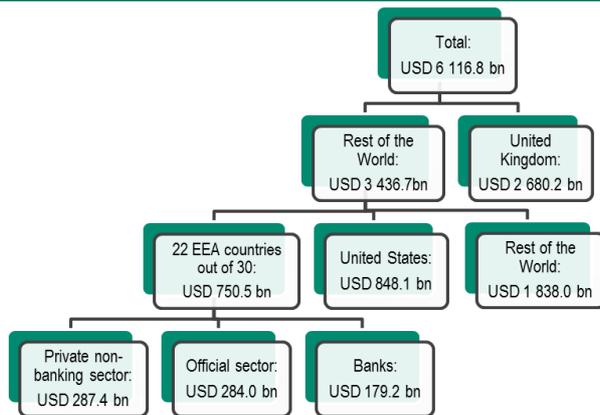


Diagram 1a Source: BIS, BNP Paribas

**Breakdown of bank claims in 13 out of the 30 EEA member states in 2018 Q3<sup>9</sup>**

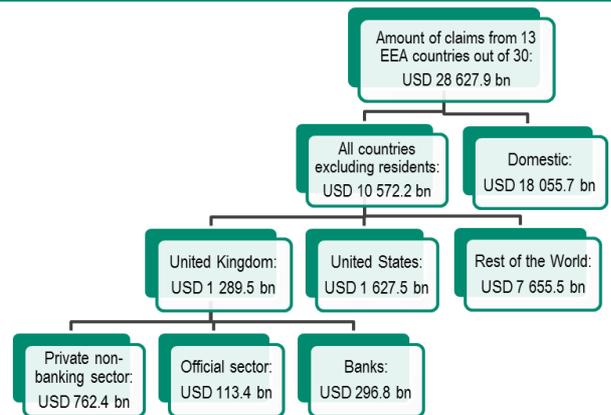


Diagram 1b Source: BIS, BNP Paribas

<sup>6</sup> Consolidated BIS data, on the basis of ultimate risk and excluding domestic positions. France, Germany, Spain, the Netherlands and Italy were in 4<sup>th</sup>, 5<sup>th</sup>, 6<sup>th</sup>, 8<sup>th</sup> and 10<sup>th</sup> places respectively.

<sup>7</sup> Calculated on the basis of consolidated banking data and using the notion of ultimate risk. In the absence of data for all countries, figures for the EEA are approximated excluding the following countries: Bulgaria, Croatia, Hungary, Latvia, Poland, Romania and Czech Republic.

<sup>8</sup> Calculated on the basis of consolidated banking data and using the notion of ultimate risk. In the absence of data for all countries, figures for the EEA are approximated as the sum of the corresponding data for the following countries: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Norway, Portugal, Spain and Sweden.

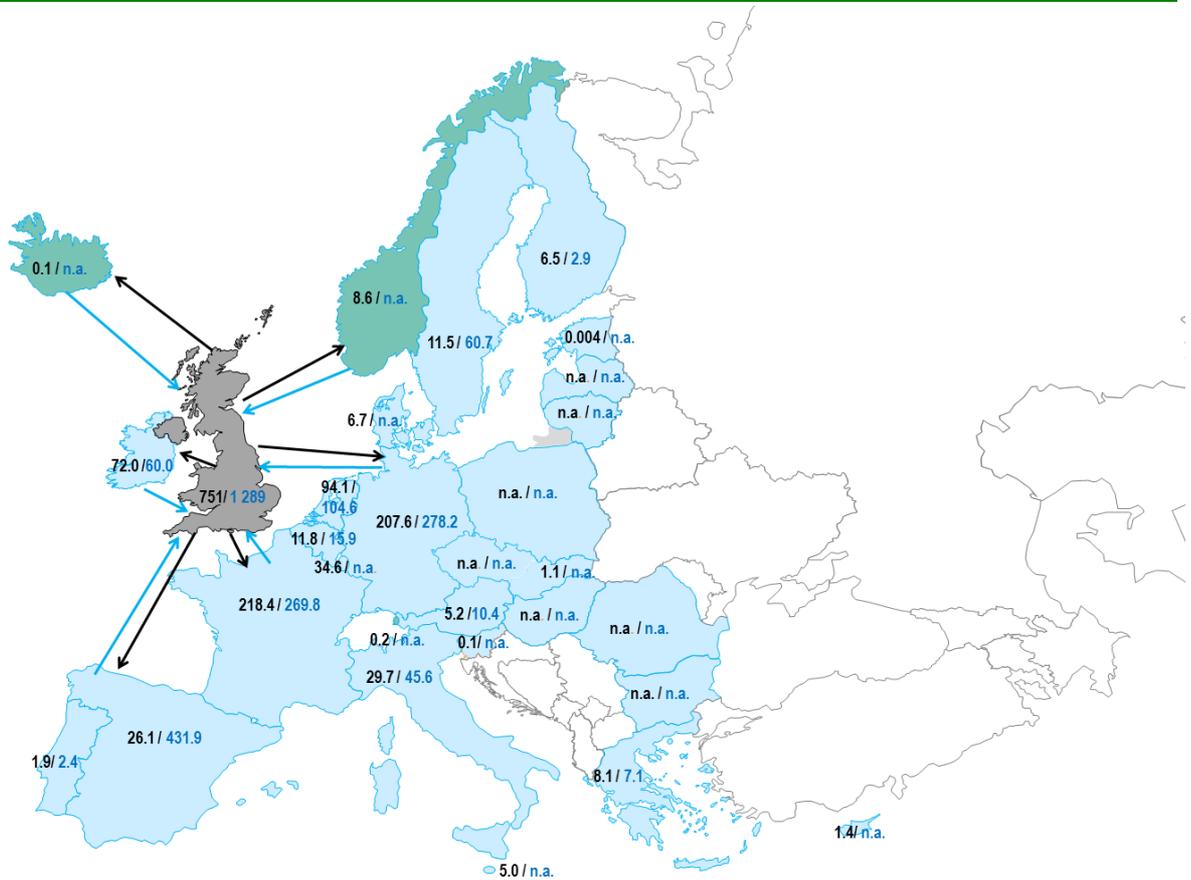
For the moment, the data does not allow us to identify any 'Brexit effect' in terms of the reciprocal exposure of banks between the UK and EEA via their bank assets. EEA bank exposure to the UK and to the rest of the world has maintained a fairly steady profile. The same is true of UK bank exposure to the EEA and the rest of the world (see Charts 3 and 4).

*UK banks are sufficiently robust to withstand a disorderly Brexit*

Royal Bank of Scotland (RBS), Barclays and HSBC have set aside provisions of GBP 100 million, GBP 150 million and GBP 165 million respectively to cover possible pressures from Brexit. This climate of uncertainty led Fitch to place 19 UK bank groups (including RBS, Barclays, HSBC, Santander UK and Lloyds) on a negative outlook, whilst Standard & Poor's has warned of the consequences of a hard Brexit for the UK banking system, explaining that possible developments related to the outlook for bank ratings rather than to a downgrading of the ratings themselves.

This said, the analysis of stress tests carried out by the BoE in 2018 suggests that the UK's biggest banks (RBS, Barclays, HSBC, Lloyds, Standard Chartered and Santander UK) are sufficiently solid to withstand a substantial shock from a disorderly Brexit<sup>9</sup>. This opinion is also supported by the Article IV Consultation by the International Monetary Fund (IMF) on the United Kingdom in 2018. However, the Governor of the BoE fears that a lack of agreement between the UK and the EU would generate financial turmoil that a reduction in interest rates by the BoE might contain. He noted that the UK's current account deficit remains substantial (at 3.8% of GDP in 2017), due notably to repeated year-on-year negative contributions from financial firms. He added that the current account deficit has largely been financed by non-resident investors buying speculative assets, making the UK economy vulnerable during a phase of uncertainty.

**Mutual exposure of UK and EEA banking systems in Q3 2018<sup>10</sup>**



Map

Source: BIS, BNP Paribas

<sup>9</sup> BNP Paribas (Dec. 2018), EcoFlash *United Kingdom: Large UK banks could withstand a major shock under certain conditions.*

<sup>10</sup> Calculated on the basis of consolidated banking data and using the notion of ultimate risk.



*The BoE will adjust its response to Brexit*

For the time being the BoE Monetary Policy Committee has left itself some room for manoeuvre by agreeing (unanimously) not to change monetary policy at its meeting in March. This decision came despite the fact that there were signs of a slowdown in late 2018 and early 2019 due to softer global growth and the effects of Brexit uncertainty in the domestic economy. The BoE is prepared to move its monetary policy in either direction according to whether there is a hard or a soft Brexit and as a function of developments in terms of supply, demand and exchange rates<sup>11</sup>. As an additional precaution to ensure the proper functioning of financial markets in the months following Brexit, the BoE and ECB have activated the special monetary agreement that they put in place following the 2008 financial crisis. This will ensure that they can provide liquidity to the markets through swap lines.

## The consequences of losing European passports

All financial agents established in the EEA have access to the European passport, which forbids any restriction on the provision of services within the EEA<sup>12</sup>. It embodies single market principles in the area of financial services, allowing passport holders freely to trade in financial products and services within the 31 EEA member states and to set up branches in these countries with only a limited number of additional authorisations compared to those required for firms from countries in the rest of the world.

The loss of this passport by the United Kingdom should result in the reorganization of financial activities in Europe with the creation of new legal entities in the rest of the EEA by UK and other third countries. Capital market movements from London to other European financial centres are also underway.

### Nine passports for nine types of financial activity

In reality, the European passport available within the 31 EEA member states is in fact several different passports. Each gives specific rights to its holders who, in general, hold a number of different passports in order to meet the needs of their clients. This is why there are more passports issued than passport-holding establishments. In 2016, some 360,000 passports were issued to nearly 13,500 companies. Although 60% of these companies were British, they held only a small share (7%) of the passports issued. Conversely, there are fewer financial firms from the rest of the EEA on the list of holders, but on average they hold a larger number of passports. The insurance and financial instruments segments are those with the largest number of companies operating under a passport, whether in the UK or the rest of the EEA (Chart 6). However, although the number of passports for each type of business provides some pointers to the number of potential legal obstacles to

<sup>11</sup> BoE (February 2019), *Inflation report*

<sup>12</sup> In accordance with Articles 56 to 62 of the Treaty on the Functioning of the European Union.

cross-border business post-Brexit, it does not indicate the size or type of financial movements, nor the number of jobs affected by the loss of a European passport.

### Companies from the UK and the rest of the EEA holding at least one financial services passport in July 2016

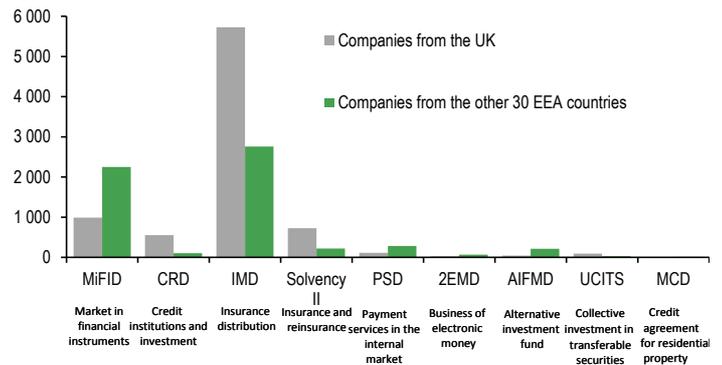


Chart 5

Source: FCA, august 2017, BNP Paribas

### The need for a new legal framework

The EU is firmly opposed to replicating the European passport, on the ground that this would offer the UK financial services sector the benefits of single market membership without the costs. Unless the UK joins the EEA as soon as it leaves the EU – a scenario envisaged by a number of Europhiles but rejected by Brexiters as limiting the UK's independence – Brexit will strip 8,008<sup>13</sup> British companies that currently hold at least one European passport of their ability to trade freely in financial services with the 30 other EEA member states and to set up offices in those countries. Reciprocally, 5,476 companies in the EEA will also face significant losses given the importance of the UK in the field of financial services. Thus, bankers from the rest of the EEA will have to repatriate their sellers. Banks originating from the UK and third countries that have previously used London as a bridgehead to trade with the EEA will have to go through subsidiaries in the other 30 EEA members.

### The continuity of contract should be ensured

Immediately following Brexit, most of the contracts existing pre-Brexit between the UK and the EEA will remain valid for their remaining term. This will be true even in the event of a hard Brexit, as indicated by the Legal High Committee for Financial Markets of Paris (*Haut Comité Juridique de la place financière de Paris* - HCJP), the European Insurance and Occupational Pensions Authority (EIOPA) and the Autorité de Contrôle Prudentiel et de Régulation (ACPR).

The European and British authorities already have taken initiatives in this sense for clearing and insurance activities. In order to ensure financial stability, the European Commission (EC) has granted a 12-months reprieve to clearing houses established in the UK continue to serve their EEA customers in the event of a no-deal Brexit. The BoE also estimates that the GBP 55 bn in insurance contracts between the

<sup>13</sup> FCA figures from July 2016.



UK and the rest of the EEA parties have essentially been transferred to the EU (most often by subrogating to the UK part one of its subsidiaries established in the EU) to ensure their viability. In any case, they will be covered by two Memorandum of Understanding (MoU) signed by UK supervisors and those from the rest of EEA. They aim to foster supervisory cooperation, enforcement an information exchange in the insurance sector. They will only come into force in case of hard Brexit.

The same is true for the three MoUs concluded between the European Securities and Markets Authority (ESMA) and the FCA:

- The first relates to the supervision of ratings agencies and trade repositories and will allow ESMA to continue its work.
- The second concerns the sharing of information between the FCA and national regulators in the EU on subjects such as market supervision and asset management. It will allow continued delegated fund management, for EEA clients, by entities established in the UK.
- Lastly, a third MoU relates to the recognition of clearing houses and central depositories installed in the UK, in order to minimise the shock for markets of a possible hard Brexit on April 12, 2019. It also allows UK central depositories to continue to handle Irish securities.

## With or without a withdrawal deal, the United Kingdom will become a third country

In leaving the EU, the UK will become a third country and will face significant barriers to trade in financial services. UK companies, having lost their European passports, will have to submit to the equivalence regimes already in place in certain market segments, if they wish to continue to trade with the EEA or conduct business there directly without establishing a subsidiary. For the other businesses, relationships between the UK and the EEA would primarily be governed by World Trade Organisation (WTO) rules, unless a bilateral agreement is concluded covering the sector.

For several months, the City of London has argued that trade in financial services after Brexit should follow the principle of mutual recognition<sup>14</sup>, which it believes is an intermediate solution between the European passport and the equivalence regime. However, Theresa May chose not to include this option in her White Paper of 12 July 2018, preferring an enlarged system of equivalence on the basis that this would be consistent with the legal independence of both the UK and the EU and that it would be easily achievable and would help reassure markets. This proposal has not so far received EU support and nothing has been revealed relating to the operational scope of the proposed enlargements.

<sup>14</sup> Mutual recognition would consist of UK and EEA authorities recognising the rules of the other party with regard to the operation of their financial sectors, which would more or less replicate the conditions of European passports.

In November 2018, a political declaration from UK and EU heads of state on the future relationship between the EU and the UK was published alongside the draft withdrawal agreement. The financial sector is evoked through four of its principles:

- Preservation of financial stability and market integrity, the protection of investors and consumers and of fair competition.
- Respect for the respective regulatory and decision-making autonomy of the parties and of equivalence decisions being made as a function of their interests.
- Commitment of the parties to close cooperation in the regulation and supervision of international agents.
- Consideration of equivalence decisions from the date of the UK's withdrawal with the aim of these being concluded by June 2020, bearing in mind that removal of equivalence must be transparent.

*The principle of equivalence is particular to each legislative act and must be appropriate to the market concerned<sup>15</sup>*

Where they exist, equivalence regimes are drawn up by the European Commission with contributions from the EBA, EIOPA and ESMA<sup>16</sup> depending on the business segment concerned. The Commission's approach in deciding whether or not to award equivalence is based on a comparison between the spirit and effects of the legal framework in the EU, on the one hand, and in the third country on the other. In theory, even an exact transposition of European legislation into the law of a third country does not guarantee that an equivalence regime will be granted. Thus, decisions on the award of equivalence are not limited to mechanical criteria alone. In granting equivalence, the European Commission seeks, in effect, to evaluate the risk its economic agents will be exposed to in trading with financial agents from third countries. Therefore it consider it can be particularly strict in equivalence decisions with regard to the UK, given the weight of the British finance sector and the exposure to risk that this implies for EEA agents.

*The equivalence regimes are based on the different types of European passport and presuppose a relative concordance of prudential requirements and supervision between the EU and the third country considered.*

Equivalence regimes are very different from each other and do not exist at all for certain areas of financial services (such as retail banking or investment services). In practice, UK firms would have to complete processes with European and/or national authorities depending on the type of activities that they want to conduct (see Table 1). Equivalence regimes applicable to a third country are partial in that they do not necessarily give the same rights as a European passport, and may be geographically limited depending on whether they are awarded by the European Commission or a member state. Lastly, equivalence can be

<sup>15</sup> European Commission (27/02/2017) *EU equivalence decisions in financial services policy: an assessment*

<sup>16</sup> Regulations (EU) N° 1093/2010, 1094/2010 and 1095/2010 of the European Parliament and of the Council.

withdrawn at any time – at 30 days’ notice – if the granting authority considers that the beneficiary country has diverged from European regulation. The European legislator has recently highlighted the need to move towards a harmonisation of practice within the member states given the already high, and growing, interconnection between financial markets.

Insurance activities (under IMD and Solvency passports) on the one hand, and securities businesses (under the MiFID passport) on the other, have the largest number of businesses operating under passports that could benefit from a partial equivalence regime granted by the European Commission following Brexit. A section of business dependent on IMD and MiFID passports could continue across the EEA (on condition that they are accepted by the relevant European authorities) but it is likely that numerous insurance policies would have to be relocated to the client’s country of residence. Meanwhile, certain banking activities, such as retail banking, are not covered by an equivalence regime<sup>17</sup>.

The principle of equivalence regimes assumes a base of common rules that contributes to the smooth functioning of the financial markets. It therefore asks for a matching of the prudential requirements and the supervision of a country with that of the country in which it seeks equivalences. In practice, this assumes that the prudential requirements and banking and financial supervision applied by the UK do not differ significantly from those of the EU. This is a sticking point between the Treasury and the BoE, with the former wishing to converge with the European spirit in this area in order to increase the probability of receiving equivalence and the latter seeking to defend its prerogatives. This is also the reason for the EU’s rejection of Theresa May’s enlarged equivalence proposals, arguing that they would link EEA and UK regulation too tightly.

*The UK would keep a regulatory framework close to that of the EU*

The Treasury plans to draw on a major survey it has carried out amongst sector stakeholders to determine whether it would be acceptable to continue to conform to the EU regulatory framework for financial services or rather to diverge from it. For the time being, the UK’s plan seems to be moving towards continued convergence with the EU framework, if only to guarantee the continuity of operations. Thus, the Treasury uses Statutory Instruments (SIs) to remove from British law reference to the texts and supervisors of the EU.

In addition, a law has been adopted in the UK in favour of a temporary authorization and recognition scheme whereby EEA markets agents will be able to practice in the UK for three years, provided they obtain the renewal of the authorization each year. The PRA has also reformed its approach to the supervision and accreditation of banks, insurance companies and clearing houses from the EEA such that non-systemically important branches (those with assets, including intra-

group assets, of less than GBP 15 bn) must declare their activities in order to continue to conduct them.

## Concern removed for clearing businesses

In September 2009, G20 heads of state expressed their desire that all transactions in standardised derivatives should be handled by a clearing house, as was already the case for transactions made on organised markets. In the European Union this resulted in the EMIR regulation (see Table 1) and the encouragement of the development of clearing houses.

## The United Kingdom: the world’s largest OTC derivatives market

The derivatives market has been examined in a number of surveys by the Bank for International Settlements (BIS). Its triennial surveys are the biggest, covering 54 countries around the world. In 2016 the survey estimated that the notional value of daily OTC transactions for forex and interest rate derivatives alone was USD 9,553 bn (see Chart 6).

**OTC derivatives market by type of risks and instruments in 2016 (USD bn/day, notional values)**

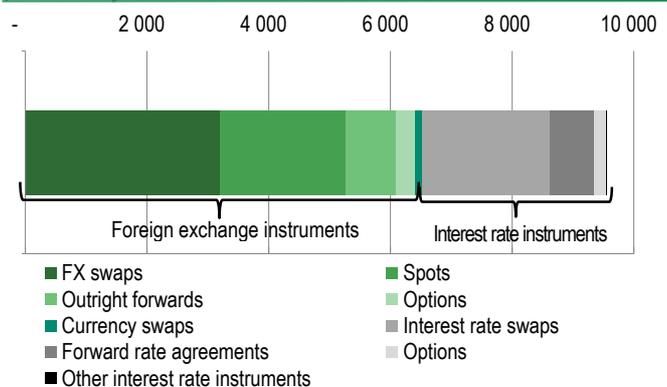


Chart 6

Source: BIS triennial survey, BNP Paribas

**OTC derivatives market by type of risks in 2016 (USD tn, market value)**

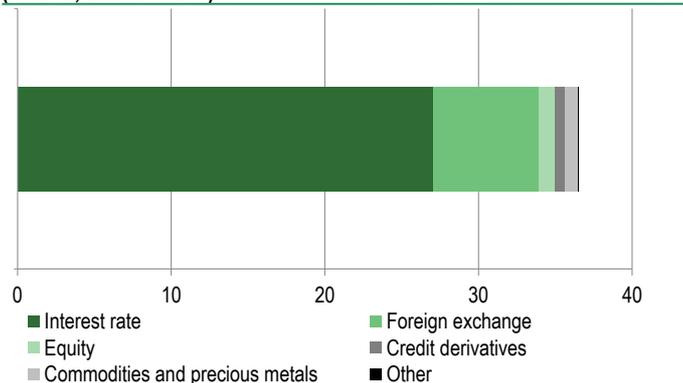


Chart 7

Source: BIS semiannual survey, BNP Paribas

<sup>17</sup> European Parliament (2017), *Implications of Brexit on EU financial services*



**Scope and granting terms equivalence associated with various European passports**

Common name and legal statute	Activities covered	Equivalence regime for companies from third countries
<p><b>MiFID II / MiFIR</b> Directive 2014/65/EU and Regulation (EU) n°600/2014</p>	<p><b>MiFID II:</b> investment services, regulated securities, data supply services, certain lending establishment activities approved under CRD IV.</p> <p><b>MiFIR:</b> trading in derivative instruments on organised platforms, clearing, trading of reference indices, investment services and activities.</p>	<p>Equivalence decision → Awarded, <u>on condition of reciprocity</u></p> <p>→ Refused. Companies may seek approval directly from the member states in which they wish to operate or with which they wish to trade within the framework of <b>MiFID II</b>. This approval is limited to the member states granting it.</p> <p><b>MiFIR:</b></p> <p><b>MiFID II:</b> Certain provisions of MiFID II apply to investment companies as well as lending establishments approved under <b>CRD IV</b> where they market <u>structured deposits or provide advice on such deposits</u>. → <b>MiFID II / MiFIR</b> may therefore apply</p>
<p><b>CRD IV / CRR</b> Directive 2013/36/EU Regulation (EU) 575/2013</p>	<p>Lending establishments and investment companies</p>	<p>No equivalence regime planned.</p> <p>Lending establishments from third countries seeking to supply retail banking services within the EEA may <u>request approval from each country concerned unless this is subject to negotiation with the European Commission</u>.</p>
<p><b>IMD</b> Directive (EU) 2016/97</p>	<p>Insurance distribution</p>	<p>Approval must be sought <u>directly from the member state</u> in which the financial firm wishes to operate.</p>
<p><b>Solvency II</b> Directive 2009/138/EC</p>	<p>Insurance and reinsurance</p>	<p><u>Insurance:</u> no equivalence regime but arrangements are possible, particularly via subsidiaries.</p> <p><u>Reinsurance:</u> equivalence granted by the EC and the Council</p>
<p><b>PSD / PSD 2</b> Directive (EU) 2015/2366</p>	<p>Payment services</p>	<p>Approval granted by the relevant authorities and valid in all member states.</p>
<p><b>2EMD</b> Directive 2009/110/CE</p>	<p>Electronic money establishments</p>	<p>Equivalence <u>granted by the European Commission</u> but with geographical coverage limited to the member state for which equivalence has been sought.</p>
<p><b>AIFMD</b> Directive 2011/61/EU</p>	<p>Alternative investment funds</p>	<p>Authorisation <u>granted by the competent authorities of the member state in which a firm from a third country wishes to operate, uniquely for the territory of that member state or for the whole European Economic Area, depending on the authorisation sought</u> (and the conditions to be met).</p> <p>In all events, <u>the authorisation</u> only concerns AIF activity and the European Commission must adopt these authorisations by subjecting them to the view of the ESMA.</p>
<p><b>UCITS</b> Directive 2014/91/EU</p>	<p>Undertakings for collective investment in transferable securities (UCITS)</p>	<p>No equivalence regime planned.</p>
<p><b>MCD</b> Directive 2014/17/EU</p>	<p>Mortgage lending to consumers for residential property</p>	<p>No equivalence regime planned.</p>
<p><b>EMIR</b> Regulation (EU) 648/2012</p>	<p>OTC derivative products, central counterparties and trade repositories</p>	<p><u>Equivalence granted by the European Commission to firms recognised by ESMA</u> (clearing houses, trade repositories and central banks).</p>

Table 1

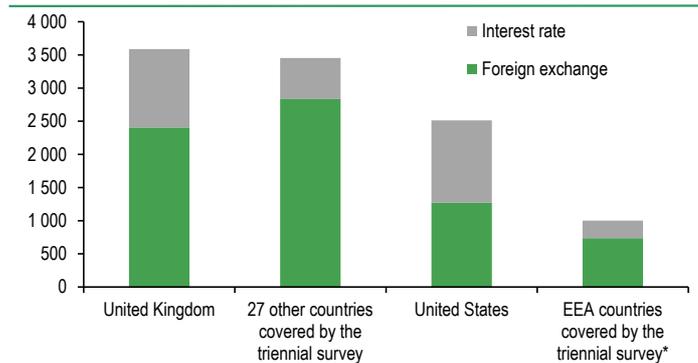
Source: European Parliament (2017), Implications of Brexit on EU Financial Services Eur-Lex, BNP Paribas



BIS's more frequent half-yearly surveys cover 13 countries and in 2016 suggested that global outstanding OTC derivatives had a market value of USD 36.1 trillion. At the time, clearing houses covered 39% of the market (or 62% in terms of notional values, see Chart 7).

In 2016, UK financial companies declared USD 3,587 bn in daily transactions on the OTC market (notional values) according to the BIS three-yearly survey, making it the global leader (Chart 8).

**Size of OTC derivatives markets in 2016 (USD bn/jour, notional values)**



\* Missing countries are : Croatia, Cyprus, Iceland, Liechtenstein and Malta.  
Chart 8 Source: BIS, triennial survey, BNP Paribas

In addition, UK-based clearing houses handle 40% of euro-denominated credit default swaps and 90% of euro-denominated interest rate swap of euro area banks.

*The European clearing market is therefore being reorganized*

Clearing has a low labour intensity. The three main clearing houses in London with authorisation to trade in the EU employ around 1,400 people (713 at Ice Clear, 641 at LCH and 45 at LME), compared to 220 at the German company Eurex Clearing. This latter company hopes to benefit from Brexit by increasing market share. It has already seen a significant upturn in business levels over recent months.

At the same time, LCH relocates part of its business to its Paris-based subsidiary – with the exception of euro-denominated interest rate contracts – and LME's application for a licence to operate in Germany and the Netherlands. Lastly, the British CME group announced in early November 2018 that it was relocating its BrokerTec Europe Ltd subsidiary, a leader in repo trading, from London to Amsterdam. This subsidiary handles EUR 210 bn in trades each day, and 90 employees will be affected.

The European clearing market is therefore being reorganized. This process is expected to result in a rebalancing of volumes between London market and the continental European markets, an ultimately lead to a multipolar distribution, called for by the EU supervisors. The adaptation shown by the agents in this market should allow the continuation of clearing activities, including in case of a no-deal Brexit.

**Clearing of derivative products within a clearing house: definitions and orders of magnitude**

Clearing is a mechanism that enables financial establishments that are members of a clearing house to pay the amounts due and receive the corresponding assets for transactions they have made on the markets. Clearing takes the form of an aggregation of all positions (buy and sell) by type of product/asset held by each account holder, and results in a net balance due to be received and the net transfer of securities to be delivered or received relative to the clearing house. Thus, financial agents exchange cash and securities only with the clearing house (for trades cleared through it) rather than with their initial market counterparties. Counterparty risk is thus assumed by the clearing house, which settles the contract and acts as an intermediary between seller and buyer. Clearing houses therefore play a central role in the financial system. This is why the legal framework for clearing businesses attracts so much interest in the financial sphere.

Some of the contracts handled through clearing houses take the form of derivative products. Their initial purpose is to allow parties to the contract to protect themselves against the risk relating to a financial transaction. There are therefore several different types of contract and types of associated risk, resulting in a range of types of derivative product (interest rate, credit, commodities, exchange rates, etc.). They can be broken down into two main categories: over-the-counter (OTC) contracts and exchange traded derivatives (ETD), with the latter being traded on regulated markets in the EU or a third country considered equivalent. OTC derivatives make up the bulk of the market, accounting for 83% of the total in the EU in 2017 according to ESMA.

However the EC has taken an additional precaution to avoid any risk of interruption in this market by providing a temporary scheme allowing UK clearing houses to continue serving their EEA customers in the event of a hard Brexit. Currently planned to run for one year, it is reasonable to think that the EC would extend the measure in necessary.

Although independent of Brexit, the EU's review of its regulatory framework for clearing activities – EMIR – will influence the location of clearing activities. In its current form, EMIR is criticised because of advantage that it offers clearing houses located in third countries, to the detriment of those in EU member states. A rebalancing of this potential distortion of competition will be the primary objective of EMIR II which could, at best, come into force by the end of 2019<sup>18</sup>.

In the meantime, and by virtue of the principle of equivalence, clearing houses in third countries will continue to be supervised by their local

<sup>18</sup> See European Parliament (2018), Brexit, Financial stability and the supervision of clearing systems.

supervisory authority. In contrast, under EMIR II the location and supervision of clearing houses will depend on their level of systemic importance. Those that are not considered systemically important will be able to continue operations in their home country, including third countries, if they have received authorisation from the European Commission. The rest will be subject to joint supervision by ESMA and the central bank of the country in question and will face additional prudential requirements as a function of their level of systemic importance. This will be determined by ESMA working with the relevant central bank. On this basis, a clearing house operating in a third country could be judged to be systemically important to the point that additional prudential requirements alone do not ensure sufficient security and it would be required to establish itself in the EU as a consequence. The IMF has offered partial support to the Commission, taking the view that control of euro clearing activities by European supervisory bodies is justified by their systemic importance. However, the Fund believes that it would be very costly to transfer these activities to the EU<sup>19</sup>. Clearing is an activity whose efficiency depends in part on the quantity and diversity of currencies processed.

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With or without an agreement on the UK's withdrawal from the EU, its trade in financial services with the rest of the EEA will be subject to a new legal framework. In all likelihood, this should be the equivalence regime, unless the UK joins the EEA after leaving the EU or the UK and the European authorities agree a more favourable framework. For, notwithstanding its advantages, the equivalence system remains more restrictive than the European passport. This said, its mere existence contributes to making the financial sector one of the best prepared at Brexit. In the meantime, the joint efforts of professionals and their supervisory authorities ensure business continuity the day after Brexit, even if it were to intervene without deal.

In the end, the City could see its position as a world-leading financial centre dented or worse. The EU plans to benefit from these changes to increase the attractiveness and scale of its own financial sector, whilst at the same time rethinking its structure on a multi-hub model. This long term process has already resulted in national initiatives complementary to those carried by the EC in its scope of competence. Thus France has prepared for Brexit through a series of decrees from Foreign Minister Jean-Yves Le Drian, seeking to address the risk of a disorderly Brexit (see box below), or by taking care of the attractiveness of the Paris market.

Finally, beyond direct consequences of Brexit on the financial sector, the Brexit is likely to have far wider implications for trade between the United Kingdom and its European partners, notably through the increase in customs duties. The impact will depend in particular on the geographical distribution of value chains, which in a number of sectors has seen growing globalisation.

*Completed on 29 March 2019*

laure.baquero@bnpparibas.com

<sup>19</sup> IMF (July 2018) Euro area policies – 2018 Article IV



## **Summary of the draft act enabling the government to take measures to prepare for the withdrawal of the United Kingdom from the European Union with regard to the financial sector by decree (so-called Le Drian decrees):**

In the event of a no-deal Brexit, the French government is authorised to issue decrees, for a period of 12 months following the publication of the act in question, relating to certain measures in French law. The draft act enabling this is ready. It was presented to the Senate on 3 October 2018, and some of the measures included relate to the financial sector.

Access of French entities to interbank settlement and clearing systems in third countries including the United Kingdom. The French entities concerned are clearing houses, payment systems providing interbank settlement of retail payments or high-value payments between financial institutions, and settlement and delivery systems clearing transactions in financial securities and central repositories.

At present, French law does not recognise the applicability of the provisions of Directive 98/26/EC to participants in systems governed by the law of a country that is not an EEA member, such that after Brexit this directive will no longer apply to these systems in the event of the collapse or insolvency of a French participant. This could result in the system refusing French participants for reasons of the significant legal uncertainties that they would create for the system.

The measures planned by the French government seek to allow French entities to continue to operate in the foreign exchange market and the UK market after Brexit so as not to weaken their current position in these markets. This would mean extending to certain specific UK payment systems the protections provided by Directive 98/26/EC concerning the definitive nature of settlement in payment systems and the clearing of securities transactions.

Continuity of use of framework agreements on financial services and securing the conditions for execution of contracts after Brexit.

Three situations in which there remain uncertainties over the proper execution of contracts have been identified in the following areas:

insurance, because it covers long-term risks that could give rise to the provision of services or payments of premiums after Brexit even though the contract was entered into before the withdrawal date;

investment services, for instance if a UK establishment decided to modify an essential obligation of a transaction concluded before Brexit;

asset management, which requires the taking of decisions and the making of trades in financial securities throughout the life of the mandate.

For insurance and asset management, it will be necessary to transfer the contracts affected to an approved entity within the EEA. Regarding investment services, it will be necessary to set limits to modifications affecting the parties' essential obligations.

In response, the French government plans to define a regime of management to expiry of current contracts (for those which create uncertainties for the contracting parties) such that the service providers will execute their obligations by effecting the operations strictly necessary for the elimination of existing positions to the best interest of their clients.

Lastly, French law will need to be modified in two areas to allow the development of the International Swaps and Derivatives Association's standard contract. These are:

Expanding the scope of transactions eligible for clearing-cancellation in order to cover spot FX deals and the sale, purchase and delivery of precious metals, as well as trades on CO<sub>2</sub> quotas, since not all of these transactions are currently covered by French law.

To create the possibility for two parties to a derivatives contract to invoice for capitalised arrears in the event of payment default, including where the arrears are for less than one year, in contrast to the current situation. This implies providing for capitalisation of interest due for a period of less than a whole year but solely for ISDA-type financial contracts (that is to say excluding contracts relating in particular to consumer credit).



# India: A review of Modi's term ahead of the general election

**Johanna Melka**

*Narendra Modi's term as India's prime minister has been broadly positive economically. In the last five years, he has pushed through some important reforms, taking advantage of his majority in the lower house of Parliament. However, to achieve a significant increase in GDP per-capita and reduce India's vulnerability to external shocks, it is necessary to carry out further reforms in order to create a more conducive environment for domestic and foreign investment. The latest polls suggest that no party could win a majority in the lower house of Parliament in the general election scheduled for April and May. Mr Modi's party still looks likely to win the most seats, but could be forced to govern alongside the Congress Party. That could make it harder to implement reform and weaken the public finances.*

Five years after Narendra Modi came to power and ahead of the general election due to take place on 11 April and 19 May, India is in a better place economically than it was in 2014.

Economic growth has remained robust in the last five years. It has been accompanied by rising real incomes, which has reduced poverty although it still remains prevalent.

The government's finances have strengthened because of efforts to streamline public spending and the 2017 introduction of a Goods and Services Tax (GST) common to all states. In the medium term, the GST should broaden the tax base and make India more competitive, even though it has fallen short of its targets so far.

The restructuring of the banking sector, although incomplete, has been helped by the introduction of the Insolvency and Bankruptcy Code in 2016. In addition, loan growth has accelerated significantly after slowing for two years, although public-sector banks remain fragile.

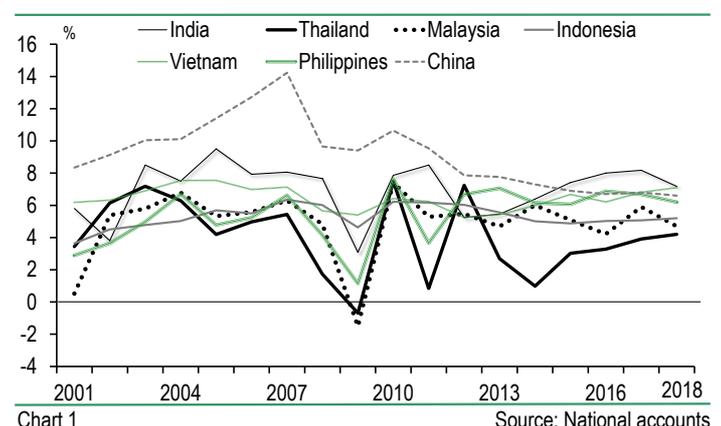
Finally, India has shored up its external position compared with 2013. However, despite a substantial improvement in the business environment, foreign direct investment inflows are still not strong enough to make India less vulnerable to external shocks and to support its potential growth.

The new government's main challenge will be to boost growth in ways that are more beneficial to the whole population. Although the poverty rate has fallen, India's GDP per capita remains much lower than that of other Asian countries. The next government must create an economic, financial, tax and institutional environment that is more conducive to domestic and foreign investment. To achieve that, it will have to continue reforms to further improve the business environment, particularly in terms of governance, education, labour market deregulation and land acquisition. The lack of investment is dragging down growth and job creation and making the country more vulnerable to external shocks. India will also need to shore up its public finances further to free up enough budget resources to allow increased government investment.

## Growth is still concentrated in the service sector

India's economy has grown at an average rate of 7.5% per year in the last five years, the highest of any Asian country. However, not all of the population is seeing enough benefit from that growth. GDP per capita has risen at an annual rate of 6.2% in real terms in the last five years but remains low (USD 2,011 in 2018), and India is much less developed than other Asian countries. By comparison, China's per-capita real GDP growth averaged 9.7% between 2000 and 2010, before gradually slowing to 6.1% in 2018. In 2017, China's GDP per capita at purchasing power parity was 2.4 times higher than India's, Indonesia's 1.7 times higher and that of the Philippines 1.2 times higher. India's figure is slightly higher than Vietnam's, however. According to the UN's latest Human Development Report, India ranked 130<sup>th</sup> out of 188 countries in 2017, 14 places lower than Vietnam. The poverty rate remained high at 28% – equating to 364 million people below the poverty line – although it had fallen sharply in the previous 10 years.

Asia: real GDP growth



## Asia: GDP per capita at purchasing power parity (PPP)

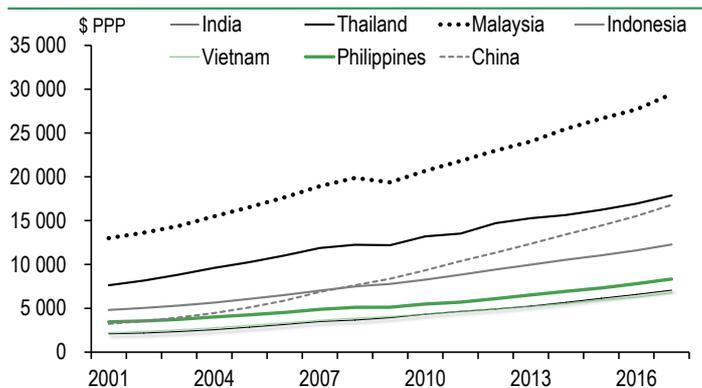


Chart 2

Source: IMF

When the Modi government came to power in 2014, on a platform of achieving growth of 10% per year, it intended to use the Chinese economic model, attracting foreign investment in order to develop its manufacturing sector. To date, however, the results have been mixed. Although India has increased its share of export markets, its manufacturing sector is still not sufficiently well developed to create jobs on a massive scale and thus increase Indians' living standards.

## Structure of Indian growth

To increase its growth potential, a country can take action in three areas: capital, labour and technical progress. In its most recent report, the World Bank estimated India's potential growth rate at 7% and took the view that, to achieve growth of 8%, the country needed to increase both private- and public-sector investment.

### Insufficient investment

Investment in India is insufficient. Investment as a proportion of GDP has been 32% in the last five years versus 45% in China. This lack of investment is due to three factors:

- The business environment which, although it has improved significantly, remains a brake on investment decisions.
- The debt reduction efforts made by Indian companies between 2014 and 2017.
- The fiscal base, which is too small for the government to have the resources to finance investments. In the last five years, government investment has remained very modest, averaging 1.7% of GDP per year, 0.1 points lower than in the 2008-2012 period.
- Foreign investment remains insufficient. Despite the improvement in the business environment and the fact that the Indian market has been more open to foreign investment since Mr Modi came to power, the stock of FDI in India to-GDP-ratio rose only 0.8 points in five years, reaching 14.3% in 2018. India's FDI inflows averaged 2% of GDP per year between 2007 and 2017, just over half the level achieved by China between 2000 and 2010 (3.8% of GDP).

### Job creation insufficient and concentrated in low-productivity sectors

Although labour is abundant in India, the pace of job creation remains far too slow compared with the growth in the labour force: it is estimated that 6 million jobs were created per year in Mr Modi's term of office as opposed to his promise of 10 million. The situation in the labour market appears to have deteriorated in the last 10 years. According to the International Labour Organisation (ILO), the unemployment rate was 3.5% in 2017, an increase of 1.4 points over the previous 10 years. Among young people, unemployment was even above 10%. According to the highly controversial report published by India's National Sample Survey Office, the unemployment rate hit a new high of 6.5% in 2017/18. Finally, the Centre for Monitoring Indian Economic (CMIE) calculated an unemployment rate of 7.2% and a participation rate of 42.7% in February 2019.

Although India's education rate is rising, it remains lower than that of other Asian countries, including Vietnam. Informal employment accounts for most jobs (81% according to the ILO). One of Mr Modi's aims, before taking office in 2014, was to deregulate the labour market, making it easier for companies to fire workers and thus reduce informal employment. However no such reforms have been adopted during his term.

Employment remains concentrated in low-productivity sectors. In 2016, 46.6%<sup>1</sup> of jobs were in the primary sector, which generated only 17.2% of the country's GDP in fiscal year (FY)<sup>2</sup> 2017/18. The proportion of jobs in the service sector, although steadily rising, remains low (30.3% in 2016), whereas services generated 53.5% of India's GDP in FY2017/18. Despite the government's goal to develop industry and particularly manufacturing ("Made in India"), that sector's share of GDP has remained relative stable in the last five years (16.4% in FY2017/18) and has even fallen by 2 points compared with 2007/08. The manufacturing sector's share of employment, despite rising since 2010, was still low at 12.8% in 2016 according to the Asian Productivity Organisation.

### The manufacturing sector is struggling to grow

Overall, in the last 10 years, growth in the manufacturing sector has remained weak, averaging 1.3% per year. Services, meanwhile, have seen a sharp acceleration, with average growth of 4.1% per year. Manufacturing's share of GDP has fallen by 3.3 points to 29.3%, although the government expects that to recover to 29.8% in FY2018/19. Nevertheless, we can see that the trend turned after Mr Modi came to power. Since FY2014/15, activity in the manufacturing sector has strengthened a little. Analysing the breakdown of value added in the manufacturing sector, we see that the proportion of activity in the machinery and capital goods industries has remained stable at 3.8%, the same as the textile industry.

However, India shows limited integration within the global trade system. Its goods exports accounted for less than 19% of its GDP in 2018, a figure that has fallen constantly since 2013/14, as opposed to 97% in Vietnam. India's global value chain participation rate is one of the lowest

<sup>1</sup> Employment figures published by the Asian Productivity Organisation (APO) in September 2018.

<sup>2</sup> Fiscal year from April 1<sup>st</sup> to March 31<sup>st</sup>.



in Asia, estimated by UNCTAD to be at 42% in 2017 as opposed to 50% in Indonesia, 51% in Vietnam, 62% in China and 64% in Malaysia.

**India: growth in value added by sector**

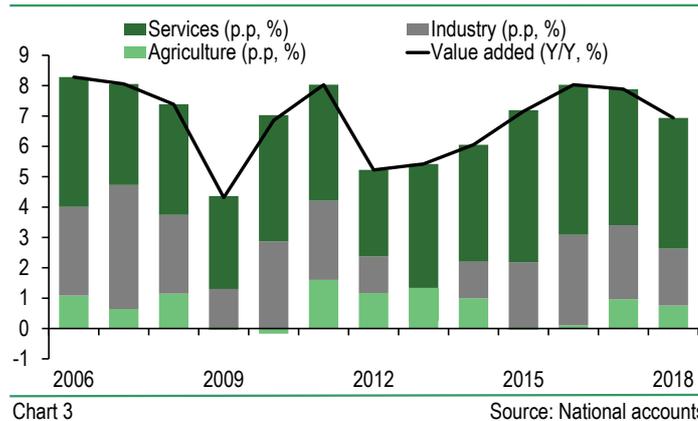


Chart 3 Source: National accounts

India has managed to grow its share of export markets, accounting for 1.7% of global trade in 2017 versus 1% in 2007. That increase reflects higher prices of primary and processed products, but also a slightly higher market share in unprocessed manufactured products.

Excluding manufactured products made by processing basic commodities, India's share of global manufactured product exports rose 0.6 points to 1.4% in 2017 as opposed to 0.8% ten years earlier. The areas in which India's export market share has increased the most in the last 10 years have been textiles, automobiles and to a lesser extent mechanical intermediate goods. However, most of the improvement took place between 2007 and 2013. India's export market shares have risen only very slightly since then, and has even fallen in the textile industry in the face of competition from other Asian countries.

*Foreign direct investment remains insufficient in the manufacturing sector*

Countries need foreign direct investment (FDI) to develop their manufacturing sectors. In the last five years, however, despite substantial improvements in the business environment and the Modi government's move to lift all constraints on foreign investment, foreign investment has remained modest in India and concentrated in services. According to the Reserve Bank of India's annual report, FDI in the manufacturing sector has averaged less than USD 9 bn per year in the last five years, equal to 30% of total investment and only 0.3% of GDP. By comparison, in 1995-2000 China attracted more than USD 31 bn of FDI per year on average in its secondary sector alone, equal to almost 2.5% of GDP.

**Growth components**

The Conference Board's analysis of growth components is instructive, although it does not take account of the most recent revisions of the national accounts carried out by India's national statistics office in late 2018. It shows in particular that the main drivers of Indian growth in 2013-2017 were capital and total factor productivity (TFP). Job creation accounted for only 13.5% of growth. The growth contribution of labour quality fell substantially between 2008-12 and 2013-17, to only 5.8%. India's low education levels are still a major problem.

Capital's contribution to Indian growth is substantial, but still insufficient. It also fell between 2008-12 and 2013-17 in tandem with debt reduction among Indian companies and efforts to clean up the public finances.

The increase in the TFP contribution reflects transfers of jobs from the least productive sectors to more productive ones. In the last five years, the proportion of jobs in the primary sector has fallen by around 5 percentage points, although it still remains too large given the sector's share of GDP.

INDIA	2008-2012	2013-2017
<b>Growth (%)</b>	<b>6.7</b>	<b>6.8</b>
<b>Contribution of labour quantity</b>	0.6	0.9
<b>Contribution of labour quality</b>	0.7	0.4
<b>Total capital contribution</b>	4.6	3.4
ICT capital contribution	1.0	0.5
Non-ICT capital contribution	3.6	2.9
<b>Total factor productivity</b>	0.8	2.0

CHINA	2001-2010
<b>Growth (%)</b>	<b>9.5</b>
<b>Contribution of labour quantity</b>	<b>0.4</b>
<b>Contribution of labour quality</b>	<b>0.3</b>
<b>Total capital contribution</b>	<b>4.9</b>
ICT capital contribution	0.5
Non-ICT capital contribution	4.4
<b>Total factor productivity</b>	<b>4.0</b>

Source: Conference Board, November 2018

**Business environment considerably improved**

India's business environment has improved in the last five years in terms of governance, ease of doing business, openness to foreigners and corruption. However, India remains less competitive than the ASEAN countries (excluding Vietnam).

According to the latest international "Ease of Doing Business" league table, India ranked 77<sup>th</sup> out of 188 countries – a rise of 55 places in five years – and was ahead of the Philippines but behind Indonesia and Vietnam.



- According to the latest World Economic Forum competitiveness league table, India ranks 58<sup>th</sup> out of 140 countries, two places higher than five years ago. However, because the methodology was different, the rise in India's ranking was too small to suggest any real improvement, except as regards infrastructure quality. Trade barriers, the lack of efficiency in the labour market and low education levels are the main constraints. India ranks lower than Indonesia and the Philippines, but higher than Vietnam (77<sup>th</sup>).
- The quality of governance has improved, but remains limited. India ranked 107<sup>th</sup> out of 211 countries on this criterion in 2017, 24 places higher than five years previously.
- Corruption has fallen in the last five years due to the Modi government's adoption of measures to make the economy more digital. India ranked 78<sup>th</sup> out of 180 countries in 2018 (ahead of Indonesia, the Philippines, Thailand and Vietnam), six places better than in 2014.

To attract more foreign investment and support domestic investment, India therefore needs to continue improving its business environment, focusing on the factors stopping the labour market from operating efficiently, along with education, female access to education and work, and reductions in tariff barriers. The next government will also have to move forward with the land acquisition reform that the Modi government put on hold in 2015.

## Shoring up the public finances: the fiscal base remains too small

India's public finances still do not provide the government with enough resources to finance public investment, although they have improved significantly.

In the last few years, the central government has reduced its deficit, particularly by trimming expenditure. However, the fiscal base remains small. The adoption of the Goods and Services Tax (GST) in July 2017 should broaden the tax base and indirectly make India more competitive, even though it has fallen short of its targets so far.

At the same time, the fiscal position of India's states has worsened. That is partly because some states have taken on debts owed by the poorest farmers through the "loan waiver scheme", and partly because debts owed by public electricity companies have been restructured through the "Uday scheme".

While central government debt has fallen, debt owed by India's states has risen, causing public-sector debt as a whole to rise slightly to 67.6% of GDP in FY2017/18<sup>3</sup> as opposed to 67.1% of GDP in FY2013/14.

Currently, refinancing risk is moderate since public debt is almost exclusively held by domestic agents, is denominated in local currency and has a long maturity. However, interest expenses remain high and severely constrain India's investment capability.

<sup>3</sup> Calculations based on new GDP series.

### Asia: governance indicators range from -2.5 (weak) to +2.5 (strong)

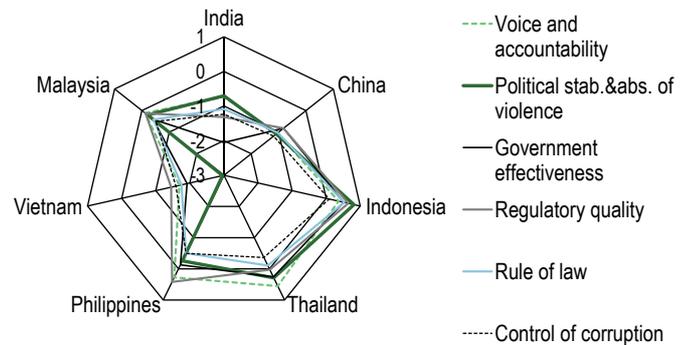


Chart 4A

Source: World Bank

### Asia: ease of doing business ranking among 188 countries

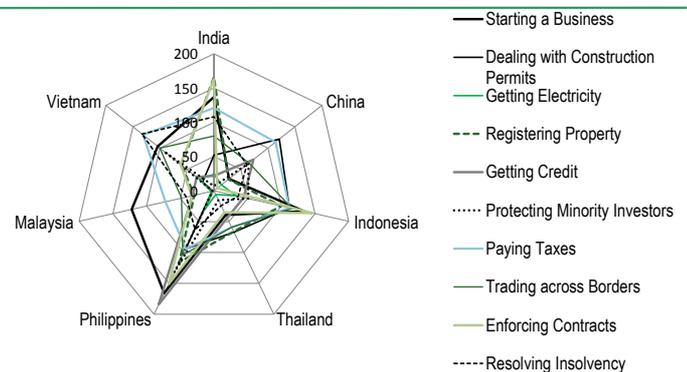


Chart 4B

Source: World Bank

## Lower spending behind the improvement in public finances

The central government deficit was 3.5% of GDP in FY2017/18, and the MoF expects that to fall to 3.4% in FY2018/19 (year ended 31 March 2019), from 4.5% in FY2013/14.

Until last year, the reduction in the central government deficit was mainly due to falling public spending, while the revenue-to-GDP ratio remained relatively stable. However, in FY2018/19, ahead of the general election, the government increased some types of spending to help India's poorest citizens, against a background of slightly rising government revenue caused by higher income from the Goods and Services Tax.

In the last five years, India's government spending as a proportion of GDP has fallen by 1 point, coming in at 12.9% in FY2018/19.

- The decline in public spending was due in particular to lower subsidies, which fell by 0.7 points to 1.6% of GDP in FY2018/19.



- The sharpest drop was in fuel subsidies (down 0.6 points). Continuing the previous government's policy, the MoF gradually deregulated petrol and fuel oil prices until mid-2018<sup>4</sup>.
- Subsidies remain focused on food products, rising 0.3 points to 0.9% of GDP in FY2018/19.

The reduction in overall subsidies has reduced some of India's core expenditure. However, subsidies make India's government less able to deal with economic shocks and invest in infrastructure. Interest expenses amounted to 3.1% of GDP in FY2018/19, equal to 32% of government revenue according to MoF estimates.

## The fiscal base remains small

In the last five years, India's fiscal base has remained very small. According to initial government estimates, central government revenue amounted to 9.1% of GDP in FY2018/19, only 0.1 point higher than five years previously. By comparison, government revenue in Indonesia (among the lowest in Asia) was 13.1% of GDP in 2018, and in Vietnam it was around 23% of GDP according to the IMF.

However, India's disappointing figure hides a slightly more nuanced picture. Gross tax revenue equalled 11.9% of GDP in FY2018/19, up from 10.1% five years previously. GST revenue, which has risen to 3.4% of GDP, equals 0.8 points of GDP. Direct taxes levied on businesses remained stable at 3.5% of GDP, those on households rose by 0.7 points to 2.8% of GDP<sup>5</sup>, while revenue from customs tariffs fell 0.8 points.

Since its introduction in July 2017, GST receipts have remained lower than the MoF's targets, and the shortfall was 0.6 points of GDP in FY2018/19. Since July 2017, the list of GST exemptions has grown ever longer. Exemptions relate to the type of goods and services subject to the tax, but also the companies that have to pay it. In particular, currently, they concern small and medium-sized companies with annual revenue of less than INR 4 m.

## Decline in central government debt

In the last five years, government debt as a proportion of GDP has fallen by 3.4 points, amounting to 49.1% in FY2017/18<sup>6</sup>. The MoF estimates that the figure fell to 47.8% at the end of FY2018/19.

The structure of India's government debt is fairly healthy. There is very little risk of the debt burden rising because of a devaluation in the rupee, because foreign-currency debt equalled less than 3% of GDP at end-2018. Refinancing risk is moderate, since the average maturity of debt is 10.4 years. Only 3% of debt securities are due to mature in the next year (the equivalent of USD 22 bn). Moreover, as 93% of debt is held by domestic agents, India is relatively well protected against increased international volatility. Commercial banks are the main holders of

<sup>4</sup> In October 2018, fuel oil prices were cut to reduce pressure on household real incomes in the pre-election period.

<sup>5</sup> A better managed tax system has substantially increased the number of people paying income tax.

<sup>6</sup> Data based on the new GDP series published by India's CSO in January 2019.

government bonds (40.5% at end-December 2018), followed by insurance companies (24.6%), the central bank (13.8%) and pension funds (5.5%). The central government's external debt (2.8% of GDP at end-2018) is on concessional terms.

### India: central government public finances

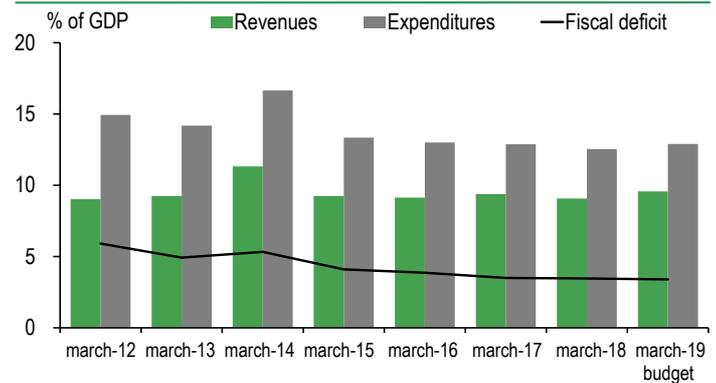


Chart 5A

Source: RBI

### India: general government deficit

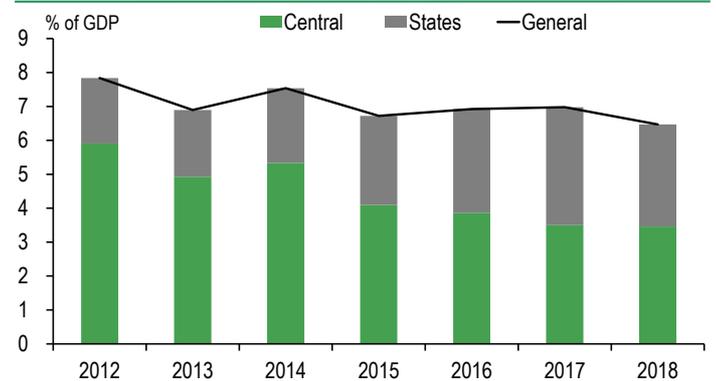


Chart 5B

Source: RBI

### India: public debt

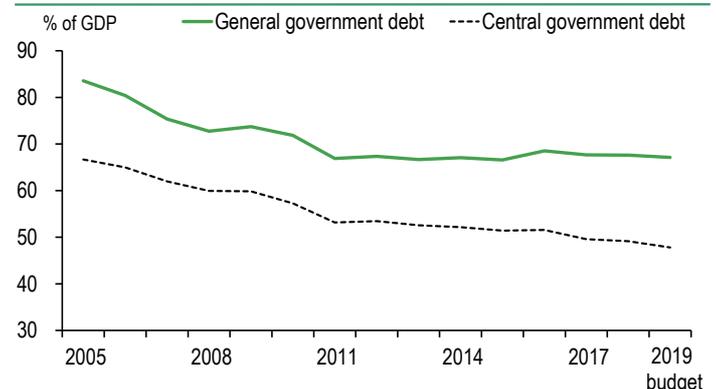


Chart 5C

Source: RBI



## Rising debts among India's states

Unlike the central government, India's states have not managed to improve their finances. Their overall deficit as a percentage of GDP doubled between FY2011/12 and FY2016/17, reaching 3.5%. That deterioration stopped last year, with the deficit falling to 3.0% of GDP in FY2017/18. However, the states' debt has continued to grow and equalled an estimated 23.8% of GDP in FY2018/19.

The deterioration in the states' finances is mainly due to higher spending, caused by:

- The decision taken by some of them to take on some debts owed by the poorest farmers<sup>7</sup> through the "loan waiver scheme", costing an estimated 0.3% of GDP in FY2017/18;
- The decision to assume some debts owed by public electricity companies as part of their financial turnaround plan ("Uday scheme") in FY2015/16 and FY2016/17, costing 0.7% of GDP per year;
- Higher spending on wages and rent allowances, which make up almost 25% of the states' expenditure, applying the recommendations of the "7th Central Pay Commission";
- An increase in interest expense to 1.7% of GDP in FY2017/18 versus 1.5% of GDP five years earlier.

## Difficulties in strengthening the banking and financial sector

The gradual deterioration in the financial position of India's public-sector banks between 2011 and 2018 has dragged down bank lending since 2016, and has also affected business investment. However, the Modi government and India's monetary authorities have introduced some major reforms to shore up the banking sector and enable it to support growth. The Insolvency and Bankruptcy Code, the recognition of non-performing loans and moves to recapitalise the weakest banks have allowed an upturn in lending since August 2018. However, the banking and financial sector remains fragile. Public-sector banks have been unable to raise the funds needed to comply with new Basel III solvency rules that came into force on 31 March 2019. As a result, although government expenditure on recapitalising public-sector banks has been modest (1% of GDP), it has been much higher than the initial targets announced in October 2017. Although India's public-sector banks are now more capable of meeting the economy's financing needs than they were three years ago, the quality of their assets remains poor and their governance is a concern. In addition, the interrelatedness between public-sector banks and non-bank financial institutions – whose share of lending has sharply increased in the last five years – is a growing source of risk.

<sup>7</sup> Andhra Pradesh and Telangana were the first states to announce partial forgiveness of farmers' debts in 2014. In 2016, they were joined by Tamil Nadu, and in 2017 by Maharashtra, Uttar Pradesh and Punjab. In 2018, first Rajasthan and Karnataka, then Assam, Chhattisgarh and Madhya Pradesh took similar measures after elections at the end of the year.

One of Narendra Modi's ambitions was to tackle India's shadow economy and clean up the banking sector. To fight the black market, in November 2016 he took the unexpected decision to withdraw all 500- and 1,000-rupee notes from circulation. Today, it appears that 86% of India's money supply has been withdrawn as a result. However, the positive impact on the shadow economy seems highly debatable, because cash remains the main payment method.

## Banking sector restructuring

In May 2016 India's parliament adopted the Insolvency and Bankruptcy Code, which is now the sole regulatory framework for resolving payment defaults, since all other procedures are no longer valid. Banks have only 180 days from the time of default to restructure bad loans of more than INR 20 bn. To speed up the resolution of bad debts, in 2018 the central bank lowered the threshold for lenders to reach agreement<sup>8</sup>. The central bank can intervene directly in the loan restructuring process, providing advice to struggling banks. Finally, to force banks to set aside more provisions to cover bad loans, since February 2018 the monetary authorities have required restructured loans and "special mention loans" to be regarded as non-performing.

### India: non-performing loans in the banking sector

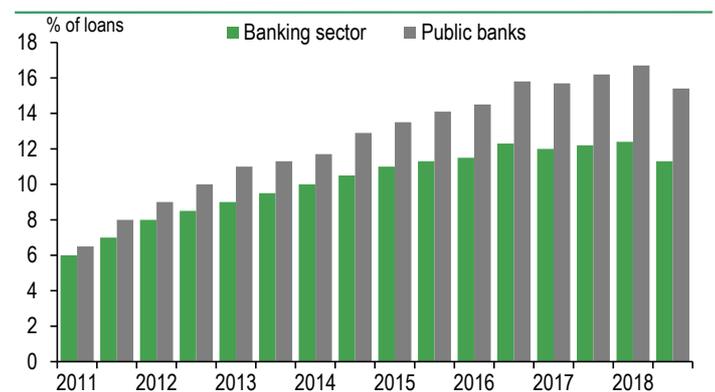


Chart 6

Source: RBI

### Public-sector banks: a more stable situation

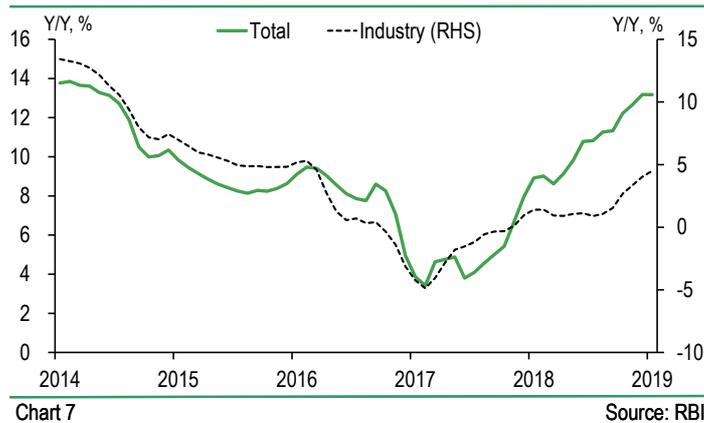
The financial position of banks, particularly public-sector banks, deteriorated sharply between 2011 and mid-2018 but has recovered since the second quarter of 2018. The NPL rate across the whole banking sector fell from 11.5% in Q2-2018 to 10.8% in Q3-2018 (14.8% for public-sector banks), and the proportion of loans deemed "risky" also fell from 12.4% in Q1-2018 to 11.3% in Q3-2018 (15.4% for public-sector banks). At the same time, the provision coverage rate rose to 52.4%, although this is still far too low. The solvency ratio across the whole banking sector was 13.7% in September 2018, falling to 11.3% for public-sector banks alone. In December 2018 the central bank took the view that nine public-sector banks would not achieve a 9% solvency ratio on 31 March 2019. The government had to inject more capital into them in early 2019. The wave of recapitalisations that have taken place

<sup>8</sup> It is now enough to obtain the agreement of 50% of creditors owed 60% of the loan.



between 2017 and 2019 is estimated to have cost the government INR 1,960bn, equal to 1% of GDP.

**India: credit growth**



*Risks arising from the growth in shadow banking*

The proportion of lending taking place through the shadow banking system has doubled in the last five years, due in particular to the problems experienced by public-sector banks. We define “shadow banking” as lending by non-bank institutions, which are mainly non banking financial companies (NBFCs) and housing finance companies<sup>9</sup> (HFCs). The proportion of commercial loans granted by NBFCs and HFCs was 18% and 8% respectively at end-September 2018, equal to 17% of GDP. In addition, 50% of lending to the real-estate sector was by NBFCs.

NBFCs are under the supervision of the monetary authorities and must comply with prudential rules regarding capital and bad loan provisions. However, they currently have no liquidity constraints.

Overall, their financial position has deteriorated since 2015, partly because their short-term debts have risen sharply, causing a major mismatch between their short-term assets and liabilities. In September 2018, this caused one of the largest NBFCs (Infrastructure Leasing & Financial Services) to default. However, for the sector as a whole and according to the latest report by India’s central bank, it appears that:

- Their assets are less risky than those of commercial banks, because the central bank estimated their bad loan ratio to be 6.1% in September 2018.
- Although their solvency ratio has fallen by more than 5 points compared with 2015, it was still 21% in September 2018, higher than the regulatory minimum of 15%.
- NBFCs’ profitability remains weak, with a RoA of 1.8% and a RoE of 4.4% at end-September 2018.

Shadow banking’s growing market share is problematic because of its growing interrelatedness with the banking sector.

<sup>9</sup> According to the Credit Suisse report dated 12/12/2018, NBFCs and HFCs were behind almost 60% of debt financing other than bank loans (loans granted by NBFCs and HFCs and debt securities issued by companies).

Bank loans are one of the main sources of funding for NBFCs and HFCs, accounting for 47.2% and 41% of their funding respectively. However, the related systemic risk remains low because lending to NBFCs as a proportion of Indian banks’ total loans outstanding rose was only 7% in December 2018. Indeed, the Indian authorities have encouraged banks to increase lending to non-financial companies. The aim is to help them access long-term funding in order to reduce the maturity mismatch between their assets and liabilities.

**External vulnerability: lower than in 2013, but India is not attracting enough FDI**

India is now less vulnerable to external shocks than it was in 2013. However, the country is not attracting enough FDI to speed up its development and make it less vulnerable to volatility in the international financial markets. In 2018, India’s FDI stock equalled only 14.3% of GDP, versus 22.5% in Indonesia and 21.7% in China. India remains vulnerable to rises in oil prices (23% of its imports) and tensions in international capital markets. Lower FDI inflows in 2017 and 2018 compared with 2015-2016, has made India much more dependent on volatile capital flows to cover its current-account deficit, although India is less exposed to capital outflows than Indonesia or Malaysia. India has sufficient foreign exchange reserves to cover its short-term external financing needs.

**Short-lived improvement between 2014 and 2016**

Between 2014 and 2016, India’s current-account deficit fell significantly, averaging 1.1% of GDP per year, having averaged 3.6% of GDP between 2010 and 2013. The improvement stemmed from a sharp fall in the trade deficit. India is an oil importer, and benefited from the fall in international oil prices.

FDI also increased sharply in 2015 and 2016, coinciding with the Modi government’s move to lift investment constraints, averaging 2% of GDP per year as opposed to 1.6% of GDP per year between 2010 and 2013. For two consecutive years, therefore, net direct investment fully covered the current-account deficit, leading to a sharp rise in foreign exchange reserves, which equalled 1.7 times India’s short-term external financing needs in 2016.

**Weaker external accounts since 2017**

In 2018, India’s external accounts worsened again as oil prices rose and as foreign investors became more risk-averse against a background of US monetary tightening.

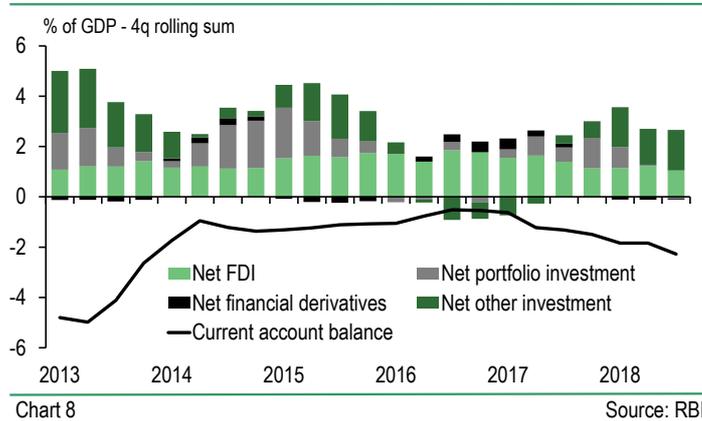
India’s FDI fell in 2017 and 2018 compared with 2015-16, and amounted to only 1.8% of GDP in 2018. It no longer covers India’s current-account deficit, which as a proportion of GDP has risen 1.7 points since 2016 to 2.4% because of higher oil prices. This makes India vulnerable to a potential shock in the international capital markets. In 2018, India, along with Indonesia, was one of the Asian countries worst affected by the loss of investor confidence in emerging markets.



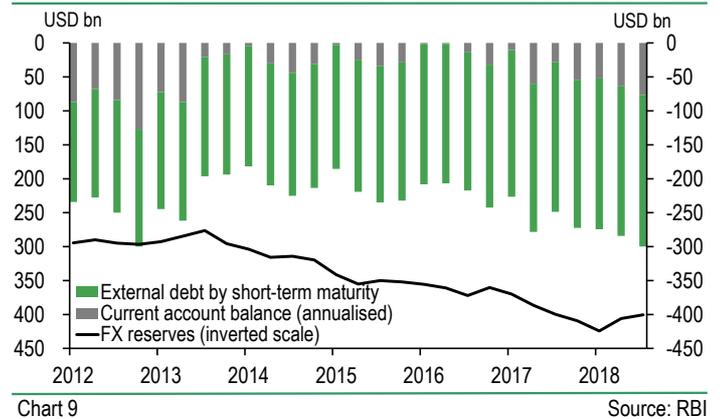
Capital has flowed out of India – with net portfolio investments falling by 1.4% of GDP in 2018 – and combined with the increase in the current-account deficit this caused a 9% fall in the rupee against the dollar and a USD 20bn fall in foreign exchange reserves. Nevertheless, foreign exchange reserves totalled more than USD 400 bn at end-March 2019 and remained comfortably enough to cover India’s short-term external financing needs (1.3 times).

To make India less vulnerable to external shocks and support its growth, the next government will have to attract more foreign direct investment. The fall in foreign investment in the last two years (compared with 2015-16) is hard to explain. According to UNCTAD’s latest report dating from mid-2018, FDI inflows into emerging Asian countries were broadly stable in 2017, and flows into Indonesia and Vietnam did not decline in 2017 and 2018<sup>10</sup>.

**India: balance of payments**



**India: short-term external financing needs**



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In the last five years, Narendra Modi’s government has pushed through some important measures – the Insolvency and Bankruptcy Code, the Goods and Services Tax and greater openness to foreign investment – taking advantage of its majority in the lower house of parliament. However, to achieve a significant increase in GDP per capita and reduce India’s vulnerability to external shocks, the new government due to be elected on 23 May 2019 will have to go even further with its reforms to create an environment that is more conducive to domestic and foreign investment.

The government’s room for manoeuvre in the next five years will depend on the result of general election.

Completed on 27 March 2019

johanna.melka@bnpparibas.com

**Structure of external debt: moderate risk**

India’s external debt is fairly low and its structure shows moderate risk. At end-December 2018, it amounted to USD 521.2 bn, equal to only 19.2% of GDP, and more than 36% of it was denominated in rupees in Q3-2018. More than 37% of external debt consisted of securities issued by Indian companies (“external commercial borrowings”) and deposits by non-residents (24% of debt). Government debt accounted for 20% of external debt.

Refinancing risks are moderate for India’s external debt. At end-December 2018, the amount of debt due for repayment by December 2019<sup>11</sup> was USD 226.6 bn (43.5% of debt), representing 55.7% of currency reserves in March 2019. However, non-resident deposits are included in the amount “due” in less than one year. As a result, debts due to be repaid in less than one year, excluding non-resident deposits, amounted to a mere USD 136.5 bn, equal to only 33.5% of foreign exchange reserves.

<sup>10</sup> For those two countries, FDI also remained stable in 2018 (figures up to the first half in Vietnam’s case).

<sup>11</sup> Short-, medium- and long-term debt repayable in less than one year.

# GROUP ECONOMIC RESEARCH

**William De Vijlder**  
Chief Economist

+33 1 55 77 47 31 [william.devijlder@bnpparibas.com](mailto:william.devijlder@bnpparibas.com)

## ADVANCED ECONOMIES AND STATISTICS

**Jean-Luc Proutat**

Head – United States, United Kingdom

+33 1 58 16 73 32 [jeanluc.proutat@bnpparibas.com](mailto:jeanluc.proutat@bnpparibas.com)

**Hélène Baudchon**

France – Labour markets

+33 1 58 16 03 63 [helene.baudchon@bnpparibas.com](mailto:helene.baudchon@bnpparibas.com)

**Louis Boisset**

European Central Bank watch, Euro area global view, Japan

+33 1 57 43 02 91 [louis.boisset@bnpparibas.com](mailto:louis.boisset@bnpparibas.com)

**Frédérique Cerisier**

Euro area (European governance and public finances), Spain, Portugal

+33 1 43 16 95 52 [frederique.cerisier@bnpparibas.com](mailto:frederique.cerisier@bnpparibas.com)

**Catherine Stephan**

Nordic countries – World trade – Education, health, social conditions

+33 1 55 77 71 89 [catherine.stephan@bnpparibas.com](mailto:catherine.stephan@bnpparibas.com)

**Raymond Van Der Putten**

Germany, Netherlands, Austria, Switzerland – Energy, climate – Long-term projections

+33 1 42 98 53 99 [raymond.vanderputten@bnpparibas.com](mailto:raymond.vanderputten@bnpparibas.com)

**Tarik Rharrab**

Statistics

+33 1 43 16 95 56 [tarik.rharrab@bnpparibas.com](mailto:tarik.rharrab@bnpparibas.com)

## BANKING ECONOMICS

**Laurent Quignon**

Head

+33 1 42 98 56 54 [laurent.quignon@bnpparibas.com](mailto:laurent.quignon@bnpparibas.com)

**Laure Baquero**

+33 1 43 16 95 50 [laure.baquero@bnpparibas.com](mailto:laure.baquero@bnpparibas.com)

**Céline Choulet**

+33 1 43 16 95 54 [celine.choulet@bnpparibas.com](mailto:celine.choulet@bnpparibas.com)

**Thomas Humblot**

+33 1 40 14 30 77 [thomas.humblot@bnpparibas.com](mailto:thomas.humblot@bnpparibas.com)

## EMERGING ECONOMIES AND COUNTRY RISK

**François Faure**

Head

+33 1 42 98 79 82 [francois.faure@bnpparibas.com](mailto:francois.faure@bnpparibas.com)

**Christine Peltier**

Deputy Head – Greater China, Vietnam, other North Asian countries, South Africa

+33 1 42 98 56 27 [christine.peltier@bnpparibas.com](mailto:christine.peltier@bnpparibas.com)

**Stéphane Alby**

Africa (French-speaking countries)

+33 1 42 98 02 04 [stephane.alby@bnpparibas.com](mailto:stephane.alby@bnpparibas.com)

**Sylvain Bellefontaine**

Turkey, Ukraine, Central European countries

+33 1 42 98 26 77 [sylvain.bellefontaine@bnpparibas.com](mailto:sylvain.bellefontaine@bnpparibas.com)

**Sara Confalonieri**

Africa (Portuguese & English-speaking countries)

+33 1 42 98 43 86 [sara.confalonieri@bnpparibas.com](mailto:sara.confalonieri@bnpparibas.com)

**Pascal Devaux**

Middle East, Balkan countries

+33 1 43 16 95 51 [pascal.devaux@bnpparibas.com](mailto:pascal.devaux@bnpparibas.com)

**Hélène Drouot**

Korea, Thailand, Philippines, Mexico, Andean countries

+33 1 42 98 33 00 [helene.drouot@bnpparibas.com](mailto:helene.drouot@bnpparibas.com)

**Salim Hammad**

Latin America

+33 1 42 98 74 26 [salim.hammad@bnpparibas.com](mailto:salim.hammad@bnpparibas.com)

**Johanna Melka**

India, South Asia, Russia, Kazakhstan, CIS

+33 1 58 16 05 84 [johanna.melka@bnpparibas.com](mailto:johanna.melka@bnpparibas.com)

## CONTACT MEDIA

**Michel Bernardini**

+33 1 42 98 05 71 [michel.bernardini@bnpparibas.com](mailto:michel.bernardini@bnpparibas.com)



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