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Raymond Van der Putten

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Over the past decade, Germany has consistently been posting large current account surpluses on its balance of payments. Since 2011, the surplus has been above 6% of GDP, the threshold above which the surplus is qualified excessive by the European Union (EU).

Current account imbalances are in principle not bad. In the case of Germany, they are partly linked to the accumulation of savings by an aging population which are invested abroad in younger and more dynamic economies.

However, they also could be related to currency misalignments. For 2017, the IMF estimates that Germany's cyclically adjusted current account surplus amounted to 8.25%, which is 3.25 - 6.25 % above the interval considered to be in line with economic fundamentals.¹ According to the Fund, the real effective exchange rate is undervalued by 10-20%.

At the eurozone's inception, many thought that national current account balances would not play a role. However, the European sovereign debt crisis has revealed that national balance of payments imbalances still played an important role in the fragmented European financial markets.

In the past few years, Germany has been much criticised for its large current account surplus. International institutions, trading partners and economists have argued that it may represent a risk for macroeconomic stability. They have called on Germany to use its fiscal room to stimulate domestic demand.

These calls have largely fallen on deaf ears. The German authorities argue that the current account surplus is mainly due to structural factors such as population aging and some temporary factors such as relatively weak prices for energy and other commodities. Moreover, a stimulus package would only have a small effect on the balance of payments balances of the other EU countries and the rest of the world.

The German government recently has embarked on an investment programme, but at a modest pace. It fits nicely in the recommendations made by the European Commission to reduce the current account surpluses. Nevertheless, according to the Commission, it would only have a limited effect on the surplus. In the Commission's Autumn Forecast, the current account surplus is projected to decline only to around 7% of GDP by 2020.

¹ IMF, 2018, Germany 2018 Article IV Consultation, Country Report No. 18/208

Germany's current account

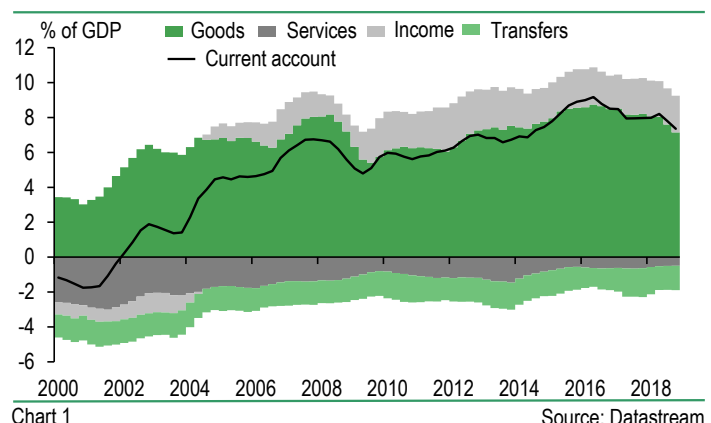


Chart 1

Source: Datastream

What is behind Germany's current account surplus?

Since the creation of the Federal Republic in 1949, the current account has been most of the time in surplus (chart 1). Until the reunification in 1990, West Germany had only two significant episodes of current account deficits, in 1965 and in 1980. This drastically changed with the reunification in 1990. The substantial fiscal stimulus for the reconstruction of the new Länder and the losses in price competitiveness through increases in payroll taxes resulted in a current account deficit that lasted for a decade.

Since the mid-2000s, the economy made a remarkable export-led recovery, only briefly interrupted by the Great Recession, thanks to the strength of the manufacturing sector. An important element was the consensus-based decision making between employers and trade-unions. This allowed firms to adapt better to the emergence of new challenges such as the entry of low-cost neighbours - including Poland, Hungary, the Czech Republic and Slovakia - to the common market and the emergence of China as a major exporter. Firms increasingly opted out of the industry-wide pay deals and concluded wage agreements at company level that suited them better. The 2003-2005 Hartz labour market reforms reinforced the willingness to moderate wages in order to save jobs. Between 2000 and 2010, German unit labour costs per hour



worked in the manufacturing sector declined by 10% compared with France, Italy and even by 22% compared with Spain. As a result German manufacturing regained competitiveness, and was able to maintain its position, whereas in other major economies experienced a drastic decline in particular after the Great Recession (chart 2).

Germany's manufacturing sector maintains its position

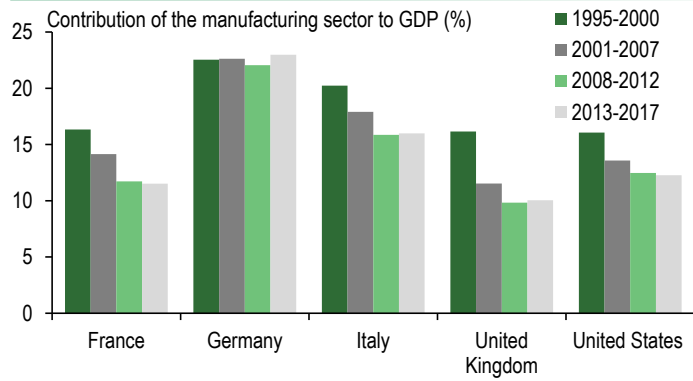


Chart 2 Source: OECD

Regional breakdown of Germany's current account

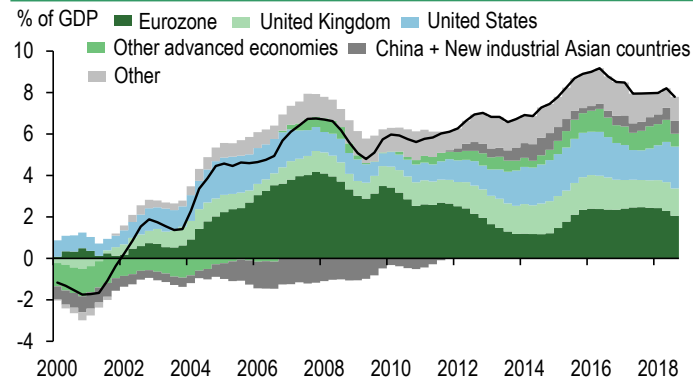


Chart 3 Source: Deutsche Bundesbank

Investment rate in major countries

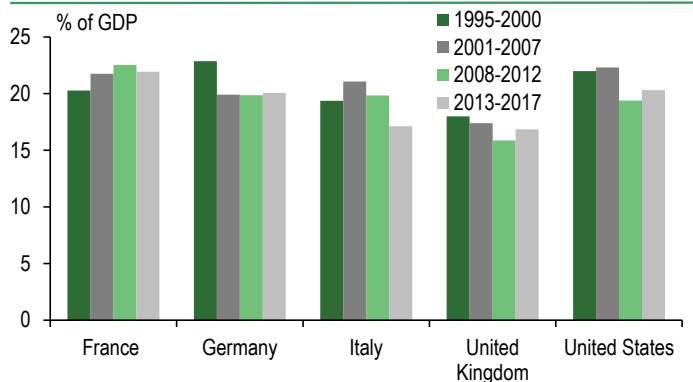


Chart 4 Source: OECD

A regional breakdown of Germany's current account shows that between 2004 and 2010, the main force behind the increase came from the other eurozone countries (chart 3). Since the European sovereign debt crisis, the southern European countries were forced to cut back their spending. Germany's surplus against the rest of the eurozone was reduced. By contrast, partly because of the depreciation of the euro, the surplus vis-à-vis the US widened. In 2017, the euro had lost 17% of its value against the US dollar compared to 2013. Moreover, weaker prices for oil and other commodities strengthened the German balance of payments after 2013.

A country of savers

Current-account positions reflect the difference between domestic savings and investment. This raises the question if the increase in the German surplus since 2000 has been generated by weak investment or rising savings, or a mixture of the two.

It is a widespread view that the rapid increase in the current account surplus was the result of weak public and private investment. However, this is difficult to reconcile with the data. Even though Germany's investment rate is relatively low compared to the other major economies, it has remained remarkably stable since 2001 (chart 4). By contrast the investment rate in some other major economies such as Italy and the US have sharply declined.

If it is not capital spending that has fallen since 2001, it must have been savings that have increased. That is indeed the case. Between 2001 and 2017, the German gross savings rate for the whole economy increased by 7 points (chart 5).

National gross savings rate in major economies

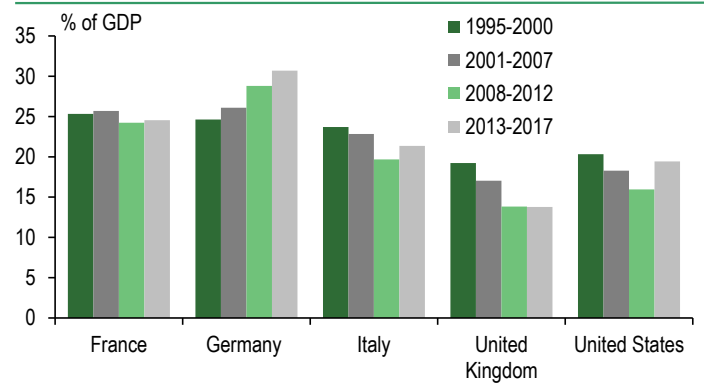


Chart 5 Source: OECD

Looking at the savings rate by sector, the household sector has the highest savings rate, major contributions came from the government sector (4.2 points) and the corporate sector (2.4 points). By contrast, in the other major economies, the national savings rate has declined since the early 2000s. These developments are well illustrated in the Flow of Funds statistics (chart 6). Except for errors and omissions, the balance of the current and capital accounts should equal the total net of the financial account, (see Box 1). If the latter is positive (negative), the country lends to (borrows from) the rest of the world.

Current account, capital account and financial account

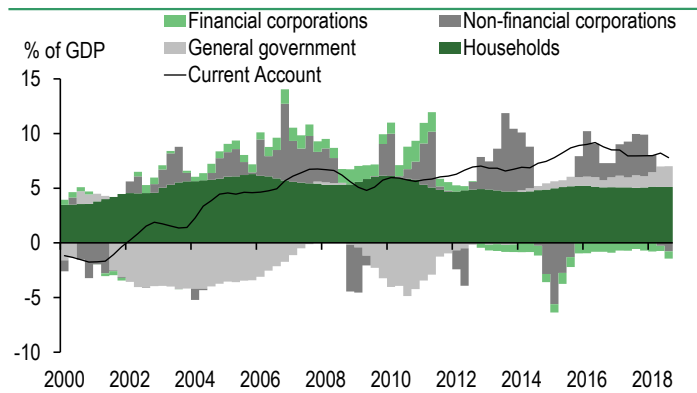
The balance of payments registers the transactions of a country with the rest of the world. These transactions are categorised into the **current account, capital account and financial account**.

The current account records mainly flows of goods and services, whereas the financial account records investment flows.

The capital account, for most countries the smallest of three, consists of capital transfers and the acquisition or disposal of non-produced non-financial assets such as natural resources, radio spectra, goodwill, and marketing assets. With the exception of errors and omissions in the data, the three accounts sum up to zero.

Box 1

Flow of funds: financial balances



The Flow of Funds statistics show that the increase in the current account surplus (as % of GDP) has as main counterpart the growing financial surplus of the government sector from -3.1% in 2001 to 1.2% in 2017. This consolidation was in particular motivated by growing concerns about future financial liabilities related to population aging, such as higher health care spending and pension costs. To keep the budget under control, the government adopted the so-called debt brake (*Schuldenbremse*) in the country's constitution. It limits the structural deficit for the federal government to only 0.35% of GDP, whereas, from 2020 onwards, the budgets of the Länder should always be in surplus, except in cases of natural disasters or strong recessions. The debt brake is in line with the fiscal requirements of the Stability and Growth Pact.

The government also announced reducing the generosity of the public pension system. To compensate these cuts, the government introduced subsidised private pension provisions such as the so-called Riesterpensions. This measure has not resulted in a noticeable increase in overall household savings. It is likely that households shifted savings from existing accounts to the subsidised plans. The financial surplus of the household sector stood at 5% in 2017, only 0.5 percentage point higher than in 2001.

Are German foreign assets a "bad investment"?

Some have argued that German investors would be better off if they had invested the money at home.* Comparing Germany's net international investment position with the cumulated balances of the current account, we notice sizeable losses on net foreign investment since around 2007. These losses amounted to EUR 600 billion or 25% of the cumulated current account balances. If only this were spent on domestic investment, it would have boosted domestic growth, wages would be higher and the government would have received more taxes.

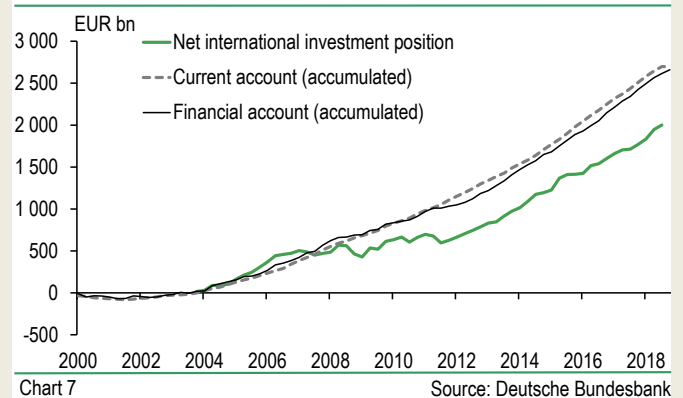
However, it would be surprising that German investors collectively could have made such costly mistakes. The Bundesbank has studied the discrepancies and arrives at a diametrically opposite conclusion.** To a large extent the discrepancies are due to statistically and methodological differences between the flow accounts of the balance of payments and the statement of stocks used in the international investment position and by increases in prices of German external liabilities.

The authors conclude that between 2004 and 2013 the yield on cross-border investment income, excluding valuation effects, equated to a return of 2.8% for German external assets compared with just 2.1% on non-resident's assets in the German market. German direct investment abroad yielded a total return of 7.2%, compared with just 4.9% for foreign enterprises on direct investment in Germany.

*DIW, 2013, *Germany must invest more in its future*, DIW Economic Bulletin, 8/2013

**Deutsche Bundesbank, Monthly Report, May 2014, page 48-50

Growing discrepancy between net foreign assets and current account



Box 2

Another factor is the balance of the non-financial corporate sector, which improved from close to zero in 2001 to 1.5% of GDP in 2017. The increase in the surplus stands in contrast with the investment surveys, in which companies increasingly indicate a willingness to invest.



However, the shortage of skilled workers has become an obstacle for investment in Germany. Central and eastern Europe (Poland, Czech Republic, Hungary and Slovakia) have become favourite investment destinations because of the well-educated labour force, the relatively low wages, and the proximity of Germany. This has been an important factor in the building up of the net international investment position. In general, these investments have been rather profitable (see Box 2).

Current account imbalances, a cause for concern

The surplus of one country implies the deficit of another one (see Box 3). In the case of Germany, the substantial current account surplus has provoked the ire of some trading partners.

Nevertheless, at the eurozone's inception, trade and current account imbalances between the euro area countries did not receive much attention. The issue was even completely ignored in the 1992 Maastricht Treaty, which set conditions for adhering to the single currency. This is not so surprising as many questioned the significance of the current account balance in currency unions. For example, nobody knows the size of the current account balances of Texas or Scotland. These data are not even collected. Moreover, the growing current account deficits in the periphery countries of the eurozone were not seen as problematic, but considered to be part of the catching-up process.

Unfortunately, the eurozone does not work as an optimal currency area as defined by Mundell in 1961 (see Box 4). This has become most obvious since the beginning of the European sovereign debt crisis in 2010, which has resulted in a substantial fragmentation across national bond markets. Moreover, even though the conversion rates are irrevocable, financial markets have never completely ignored the risk of breaking up.

In particular before the financial crisis, some economists argued that current account imbalances are not very worrisome, as such imbalances are the result of transactions between "consenting adults".² Provided that the public sector deficit is not excessive, the current account balance is the result of transactions between optimising, forward-looking households and firms.

The view was defended by the former British Chancellor of the Exchequer Nigel Lawson at the 1988 annual IMF and World Bank meeting in Berlin, and became known as the Lawson doctrine. In his inaugural Adam Smith Lecture in 2010, Lord Lawson reformulated his view.³ In his opinion, current account imbalances are the result of global capital flows searching for investment opportunities. He sees them as "a fact of economic life in a globalised world economy, rather than a dangerous effect that has to be remedied."

² See Obstfeld, 2012, *Does the current account still matter*, NBER Working Paper 17877.

³ Lord Lawson, 2010, *Five Myths and a Menace*. Inaugural Adam Smith Lecture at Pembroke College, Cambridge UK.

Current account discrepancy and the German surplus

The global current account is not zero, but positive and the so-called discrepancy is growing. In 2017, it amounted to USD 440 billion. The discrepancy can be attributed to measurement problems.

Daniel Gros has remarked that the current account discrepancy is narrowly correlated ($R^2=0.86$) with the German current account surplus.¹ In fact, if the German current account surplus rises by one about 50% of the increase is added to the global discrepancy.

According to him, it suggests that a significant part of today's global current account discrepancy might be due to a mismeasurement of the German numbers. Even though it is somewhat hazardous to draw firm conclusions from a single correlation, it certainly illustrates that we should be careful in interpreting trade and current account data. In the EU and in particular in the eurozone, international transactions can no longer be measured with precision.

Germany's current account and the discrepancy at global level

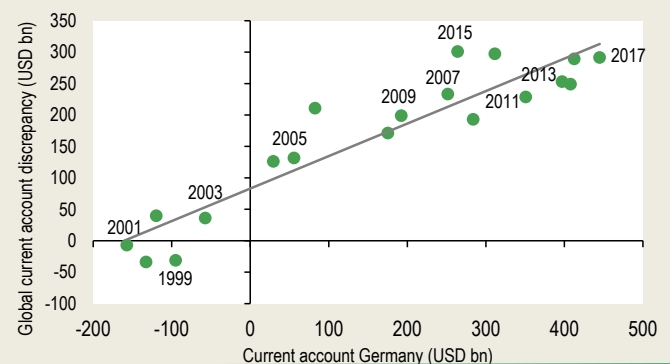


Chart 8

Source: IMF

¹Daniel Gros, 2017, *Is Germany's current account surplus bad for the world economy?* Letter to the Editor of The Economist, published 27 July 2017.

Box 3

The Great Recession and the subsequent European sovereign debt crisis have drastically changed the perception of the role of the current account, in particular in a currency union. After all, a current account deficit needs to be financed even in a currency union.

It is true that the creation of the eurozone has led to larger and deeper financial markets. Before the debt crisis, this allowed firms to borrow more cheaply, in particular in the southern European countries, resulting in substantial current account deficits. However, because of market fragmentation, it became increasingly difficult for the southern European countries to attract foreign capital during the sovereign debt crisis. To prevent financial stability risks from materialising, public funds were used to substitute for the dried-up private funds.



Moreover, the dividing line between public and private debts becomes hazy precisely in crisis situations. For example, during the Great Recession, because of nationalisations, private sector debt often ended up in the hands of the public sector.

Bundesbank research shows that the adjustment of current account deficits is significantly hampered in countries that are members of a monetary union.⁴ This is in particular the case in comparison to a floating exchange rate regime, where current account imbalances are adjusted by means of changes in the exchange rate. But the adjustment is also slower than in a fixed exchange rate regime. In such a regime, national central banks sell foreign currency or raise key interest rates. These policies led to a tightening of credit demand, which ultimately reduces demand for goods and services.

In EMU, the adjustment process is slowed down because, by definition, there is no exchange rate adjustment. Policy operates through the single monetary policy through harmonised short-term interest rates and liquidity assistance measures of the European System of Central Banks (Eurosystem). It cannot be taken for granted that monetary policy at EMU level would be fully in line with the needs of a country with a huge current account surplus and major labour market bottlenecks. As a result, the adjustment needs to come from prices and wages, which tends to be slow. In addition, the bigger the share of intra-eurozone trade, the more it slows the adjustment.

The Bundesbank researchers conclude that *"it is still an open question whether the characteristics of the monetary union are indeed amenable to smoothing necessary corrections and limiting spillovers to other EMU countries, or whether they merely aggravate existing imbalances and delay necessary structural reform."*

Five years on, we have more insight in the question. The southern European deficit countries have indeed slowly adjusted and they now all have current account surpluses. However, they paid a heavy price. Only in Spain and Portugal, GDP is above the pre-crisis peak. By contrast, in Greece, GDP is still around 25% lower than the pre-crisis peak. Moreover, the unemployment rates in Italy, Spain and Greece are still above 10%. Lastly, all these countries struggle with a substantial public sector debt overhang. In Greece, public debt is still around 170% of GDP. One may question if this outcome has been optimal. In a recently carried out survey among economists based across Europe on Germany's trade surplus, more than two-third of the respondents agree or even strongly agree with the proposition that Germany's current account surpluses are a threat to the eurozone economy.

Some even consider the German current account surplus bad for the world economy. According to the former Fed Chair Ben Bernanke it contributes to the global saving glut.⁵ Nobel Prize laureate Krugman calls the Germany fiscal surpluses an international version of the paradox of thrift.⁶

⁴ Sabine Herrmann and Axel Jochem, 2013, *Current account adjustment in EU countries: Does euro-area membership make a difference?*, Discussion Paper 40/2013, Deutsche Bundesbank.

⁵ Ben Bernanke, 2015, *Germany's trade surplus is a problem*, Ben Bernanke's Blog, The Brookings Institution, 3 April 2015.

⁶ Paul Krugman, 2013, *The Harm Germany Does*, New York Times, 1 November.

A non-optimal currency area

Being a currency union between sovereign countries, the eurozone has retained some characteristics of a fixed exchange rate regime.

The difference between a currency area consisting of different regions and one consisting of different countries can be illustrated by a following simple example provided by Mundell in 1961. Assume two currency zones, one between two regions A and B and one between two countries A and B. The national governments follow a full-employment policy. What happens if for some reason the initial equilibrium is disturbed by a demand shift from goods of country/region B for goods in country A/region A? To achieve a new equilibrium, a change in the terms of trade will be required. The goods of country/region B should become relative cheaper of compared to those from country A/ region B. In both cases, the monetary authorities can try to inflate the economy by lowering interest rates.

In a currency union between two countries, country A could tighten its macroeconomic policies for example by introducing credit restrictions to prevent prices from rising. In that case, the onus of the adjustment falls completely on country B. The policy of country A to restrict prices results in a recessive tendency world-wide. It makes it even harder for country B to return to full employment.

In the case of currency union between regions, the monetary authorities can increase the money supply. This will fuel inflation in region A and turning the terms of trade against region B. This will again restore full employment in region B.

Mundell, comparing a fixed exchange rate regime and a single currency area, summarizes the situation as follows: *"In a currency area comprising different countries (...) the pace of employment in the deficit countries is set by the willingness of surplus countries to inflate. But in a currency area comprising many regions and a single currency, the pace of inflation is set by the willingness of central authorities to allow unemployment in the deficit regions."*

*Mundell, R. A. (1961). *A theory of optimum currency areas*. The American economic review, 51(4), 657-665.

Box 4

How should policy adapt?

One of the weaknesses of EMU, or by extension, any fixed-exchange rate regime, is that debtor countries have to adapt, while creditor countries are not under any pressure to reduce their surpluses. Already John M. Keynes had perceived the danger of deflationary tendencies in a fixed exchange rate regime during the Bretton Woods negotiations.⁷ He thought that the desire of hoarding money was much stronger than the desire to invest because of the risk involved. Investment comes in

⁷ Robert Skidelsky, 2010, *Keynes, A very short introduction*, Oxford University Press



bursts of optimism, called animal spirits. A country with a deficit loses foreign exchange reserves and has to deflate its domestic prices. By contrast, a country with a surplus can accumulate liquidities without limit.

Keynes sought to repair this asymmetry between creditors and debtors in his 1941 plan for a Clearing Union. Surplus countries were not anymore allowed to hoard their surplus or lend them out at punitive rates. These funds were to be made available to debtors through the mechanism of an international clearing bank. The Keynes Plan was vetoed by the US, which did not accept that its “hard-earned” surpluses to be automatically placed at the disposal of “profligate” debtor countries.⁸ It is unlikely that Germany would agree with a policy along the lines of Keynes Plan. However, as Martin Wolf justly remarks, “the eurozone will fail if it is run for the benefit of creditors alone”.⁹

For the moment, the only way to persuade creditor countries to increase their spending is to exercise peer pressure on them. In the recent past, IMF, OECD and ECB have all called on Germany to use the available fiscal space.¹⁰ The European Union has a formal process to monitor countries with balance of payments imbalances. As part of the annual macroeconomic imbalances procedure (MIP), the European Commission has identified Germany as a country with imbalances in its large current account surplus.¹¹ It recommends Germany to strengthen private and public investment, to improve the efficiency and the investment friendliness of the corporation tax system, to create conditions to promote higher wage growth, and to reduce disincentives to work more hours, in particular for low-wage and second earners. Failure to follow the recommendations exposes the country to the possibility of sanctions, including fines.

The results of the MIP are mixed. According to the European think-tank Brueghel, Germany has one of the lowest implementation rates of country specific recommendations (CSR).¹² That is not very surprising, as the CSR does not play any role in German politics. The coalition agreement, concluded in early 2018, includes an investment programme in particular in digital infrastructure without making any reference to the MIP. Moreover the government remains fully committed to fiscal consolidation and maintaining a budget surplus.

Peter Bofinger, a frequently dissident voice in Germany’s Council of Economic Experts, attributes Germany’s reluctance to reflate its economy to Walter Eucken’s influence on macroeconomics.¹³ Walter Eucken (1891-1950) is considered as the father of Ordoliberalism. He rejected demand management, fearing that this would lead to state

socialism. His views were formed in Nazi Germany that implemented Keynesian ideas even before the publication of the “General Theory”.

Michael Burda (Humboldt University of Berlin) does not share the view that German economists would reject Keynesian demand policies.¹⁴ It is taught in all macroeconomic courses in German universities. In his opinion, the rejection of demand management is simply national interest. Germany is a much more open economy than other large European countries, and would less benefit from such a policy.

This view is also shared by the President of the Bundesbank, Jens Weidmann.¹⁵ According to model simulations, an additional wage increase in Germany of 2 percentage points, would have hardly any effect on the peripheral eurozone countries. Only Ireland could expect a moderate lift. By contrast, the German economy would suffer. Employment would ultimately fall by as much as 1% and output by 0.75%. A credit-financed increase in public spending would boost activity and exports in the periphery countries even less. The reason is that the import share of German public demand is only 9%, compared with 21% for private demand and 41.5% for German exports.

For the German authorities, the solution is supply side reforms. The painful Hartz labour market reforms between 2003 and 2005 have laid the basis of Germany’s turnaround in economic performance almost a decade later. This explains why Germans have less patience with short-term policy solutions, such as fiscal stimulus, and put the emphasis on structural reforms.¹⁶

Weidmann calls in particular for structural reforms in the services sector in Germany and the rest of the European Union. This would strengthen Europe’s growth potential. In a report commissioned by the European Policy Centre, Copenhagen Economics estimates that the digital economy can boost EU GDP by at least 4 percent in the longer run [between 2010 and 2020] through the creation of a Digital Single Market.¹⁷ This would not only strengthen the growth potential of Germany but even more so that of those European countries specialised in (digital) services. The further opening of the German services sector to foreign providers may lower the Germany’s current account surplus because of a widening deficit on the services balance.

Given current policies, it is likely that Germany’s current account surplus will diminish in the coming years thanks to increased public spending and higher pay settlements. Removing the rigidities in the services sector might also contribute. Nevertheless, given the country’s demographics, the German current account is likely to remain firmly positive in the foreseeable future.

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⁸ The Bretton Woods system did not display the deflationary character that Keynes predicted. This was due to the profligacy of the US, which flooded the world with dollars. It ultimately led to the collapse of the Bretton-Wood between 1971 and 1973.

⁹ Martin Wolf, 2016, *Germany is the eurozone’s biggest problem*, Financial Times, 10 May 2016.

¹⁰ For example, in the IMF Blog on 17 January 2018, IMF Managing Director Christine Lagarde called on Germany to boosting wages, investing in infrastructure and reducing the large trade surplus.

¹¹ The European Commission uses as indicator the 3-year average of the current account balance as % of GDP, with as indicative thresholds +6% and -4%.

¹² Konstantinos Efstathiou and Guntram B. Wolff, 2018, *Is the European Semester effective and useful?* Policy Contribution Issue n°09, June 2018, Brueghel.

¹³ Peter Bofinger, 2016, *German macroeconomics: the long shadow of Walter Eucken*, VOXEU, 7 June 2016.

¹⁴ Michael Burda, 2016, *Dispelling three myths on economics in Germany*, VOXEU, 23 September 2015.

¹⁵ J.Weidmann, 2014, *External imbalances in the euro area*, speech at the International Business cycle conference, Kiel institute for the world economy, 17 March 2014.

¹⁶ Germany is also sensible for moral hazard. These views are formed by its experiences with its own federal structure. The German Länder are jointly and severally liable for each other’s debt. As a result, the smallest states have allowed their debt to soar.

¹⁷ Copenhagen Economics (2010), *The economic impact of a European digital single market*.



Angola: Taking steps forward

Sara Confalonieri

The first year in office of the new president Joao Lourenço's reveals a rather positive shift in economic policies, given his determination to clean up politics and the scope of the economic reforms engaged so far. The abandon of the currency peg has eased some pressures on the fx market though they still remain important. The financing package recently signed with the IMF will help to implement structural reforms aimed at diversifying the economy by fostering the development of the private sector. Nevertheless, the overall near-term economic outlook remains embedded in international oil price developments due to the lack of economic diversification. Additionally, the still ailing banking system keeps on straining the private sector. Therefore, the recovery is bound to be very gradual at best due to the persistence of major macroeconomic imbalances.

Despite the new government's positive shift in economic policy and the upturn in oil prices, the country still faces several challenges. The oil sector is deteriorated, foreign currency liquidity is exposed to high tensions, the household purchasing power is being eroded and the banking system is facing severe difficulties. This is evidenced by the sovereign spread on foreign-currency debt, which continues to be higher than global emerging market one, thus keeping the borrowing on the international capital markets relatively expensive. The IMF financial support, after almost two years of cooperation, is a very welcome measure which could reassure economic agents. The Angola government's economic policy has clearly changed but the recovery will take time.

Economic reforms are ongoing

Since taking office in September 2017, President Lourenço has made significant reforms to improve financial sector transparency, enhance efficiency in SOEs, liberalize the foreign exchange rate regime, and pursue a more business-friendly trajectory in order to improve international investors' perception of the country's business climate. In its first year in office, the new government's agenda that focused on anti-corruption and free market economic reforms have sent positive signals of political change.

In April 2018 the ruling party, the People's Movement for the Liberation of Angola (MPLA), called for an extraordinary congress in September 2018 that marked a political transition of the party's leadership (the last vestige of Dos Santos hegemony) to the new president who thereby gained uncontested authority with Angola's political elite and businessmen.

After changing several key political and economic positions to remove the Dos Santos legacy, the government undertook several reforms to attract new investments and faster potential growth.

Most of them have been made to support private sector development. After the simplification of administrative red tape to attract FDI (issuance of visas and residency permits), progress has also been made in getting electricity, promoting competition and combating monopolies. A new law was approved on non-resident investment with the elimination of the

minimum commitment of USD 230,000 and the obligation to associate with a local partner holding an equity stake of at least 35%. In order to govern interactions between government and investors, the Agency for Private Investment and Exports (AIPEX) has been created. Moreover, about 74 state-owned companies¹ are on the privatization list.

The government also seems to be driving some moderate improvement in transparency and the reduction of corruption². An anti-corruption unit was created in March 2018 and several high-profile officials from the previous administration were dismissed and prosecuted. If the prosecution for fraud and final arrest of the former president's son suggest that the Dos Santos family's influence has waned significantly in the past year, the arrest of a few high profile individuals will not be sufficient to resolve the endemic levels of corruption within key Angolan institutions.

However, according to the World Bank 2019 Doing Business ranking, Angola has progressed by only two notches (to 173 from 175 out of 190 countries), mainly due to some improvement in obtaining electricity, registering property and trading across borders. Likewise, small positive achievements are registered in the Governance Index related to voice and accountability, government effectiveness, political stability and control of corruption. Despite this, the Angola's business environment remains burdensome.

The new foreign exchange policy has improved fx liquidity. After abandoning the dollar peg in January 2018, the central bank has gradually depreciated the kwanza (AOA) in a controlled manner through a series of auctions. Starting from October 2018, the volume of foreign currency has increased and the central bank stopped direct sales of foreign currency, which will be handled by authorized retail banks. At the same time, the approval of legislation to facilitate the repatriation of funds held abroad aims to reduce the shortage of hard currency.

¹Enterprises up for total or partial privatization include the country's ports, the national airline (TAAG), the Bank of Commerce and Industry (BCI) and the Ensa insurance company.

²As evidenced by Angola's low score (167th out of 180 countries) in the Transparency International's Corruption Perception's Index.



Lastly, the hydrocarbon sector has also been the subject of deep reform with the passing of a new legislation to define clear and transparent rules for the development of gas reserves as well as some tax cuts for marginal oil fields (those with smaller reserves or with specific technical challenges). In addition, President Lourenço created the new National Oil & Gas Agency. This agency will take over the attribution of oil concessions and the management of production sharing agreements that were previously managed by Sonangol.

A renewed relationship with the IMF

Relationships between Angola and the IMF have been historically tense owing to the fund's criticism of Angola's opaque resource management. Only in 2009, during the last oil price crash, Angola took on a USD 1.4 bn stand-by arrangement (SBA) for the first time to help it manage liquidity challenges.

Angola authorities seriously started again in 2018 to cooperate with the IMF, which considers the current political transition to be an extraordinary break in Angola's recent history, following the ambitious reforms launched to address macroeconomic and structural imbalances.

More precisely, they are implementing: (i) a Macroeconomic Stabilization Program (MPS) and (ii) the National Development Plan for 2018–22 to address structural bottlenecks, promote human development, public sector reform, economic diversification, and inclusive growth.

The key objectives of the MPS are: i) strengthening of fiscal and debt sustainability, (ii) modernizing the monetary policy framework and exchange rate policy, (iii) reducing financial sector vulnerabilities and (iv) fostering private-sector-led growth and economic diversification by improving governance and the business environment.

To support the implementation of these reforms, the Angolan government asked for an IMF support program, which was officially signed on the 10th of December 2018. The USD 3.7 billion three-year extended arrangement under the Extended Fund Facility allows an immediate disbursement of USD 990.7 million, while the remaining amount will be disbursed over the remainder of the facility period, subject to semi-annual reviews.

Moving forward, the IMF facility will ease fx liquidity pressures in the near term and send a strong signal on policy stability that is likely to reassure economic agents.

A standstill economy

The sharp decline in oil price from the record high in 2011-2013 has derailed Angola's economic performance from the 4.5% average level recorded between 2011 and 2015. The real GDP growth strongly slowed down at 0.9% in 2015 and finally entered into recession in 2016 (-2.6%).

Angola: Overview of the Reform Agenda, 2017-2022

Authorities' Macroeconomic Stabilization Program 2017-2018	Extended Fund Facility 2018-2021		Authorities' National Development Plan 2022
	Fiscal policy	Monetary policy and Banking sector	
<ul style="list-style-type: none"> - Upfront consolidation to contain the growth of public debt. - Greater exchange rate flexibility. - Improved profile of public debt through liability management operations. - Start settling domestic payments arrears. - Revise AML/CFT legislation. 	<ul style="list-style-type: none"> - Strengthening non-oil tax revenue including through adoption of a VAT. - Rationalize expenditure including through a subsidy reform. - Enhance debt management by fostering the development of the primary market for domestic debt. - Reduce fiscal risks by implementing a strategy for Sonangol to divest from its non-core business. - Strengthen PFM by enforcing internal controls and eliminating arrears. 	<ul style="list-style-type: none"> - Eliminate the foreign exchange backlog, and remove the priority list for foreign exchange allocation. - Strengthen liquidity management by operationalizing the base money targeting framework. - Conduct an asset quality review of eight systemic banks. - Submit a new AML/CFT law. - Begin publication of monthly program for regular foreign exchange auctions. - Enact an insolvency law. 	<ul style="list-style-type: none"> - Pursue fiscal consolidation by increasing the share of non-oil revenue and reducing subsidies to SOEs. - Bring the public debt ratio to safer levels in the medium term. - Eliminate domestic arrears. - Raise non-oil GDP through development of agriculture and manufacturing - Improve Angola's position in the Doing Business ranking. - Adopt and start implementing an anti-corruption strategy.

Table 1

Source: IMF



Despite the progress that has been made since the arrival of Joao Lourenço's new government and the upturn in crude oil prices during the first three quarters of 2018 the Angolan economy is expected to report its third consecutive year of recession. It is confirmed by the overall economic sentiment, measured by the "Indicador de Clima Economico" (ICE), which remains in negative territory. According to the recently released data from the National Statistics Institute, the economy contracted by 2.7% year-on-year in Q1/Q3 2018, posting the third consecutive quarter in recession. This contraction is still attributed to the decline in extracting and refining activities, which account for 33% of GDP, as well as trade and construction (close to 20% of GDP).

Recession lasts for the third consecutive year

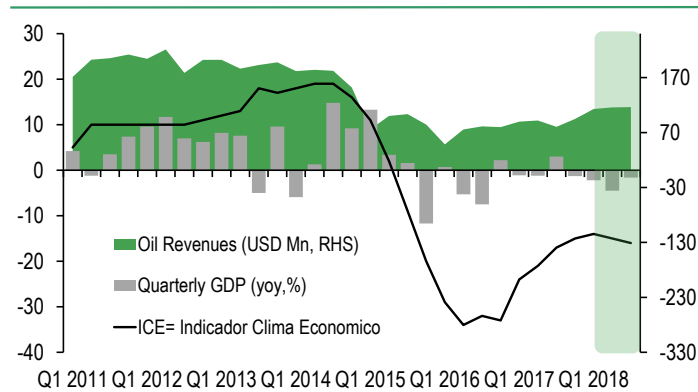


Chart 1 Source: INE,EIA, Reuters, BNP Paribas

Still depressed oil & non-oil sectors

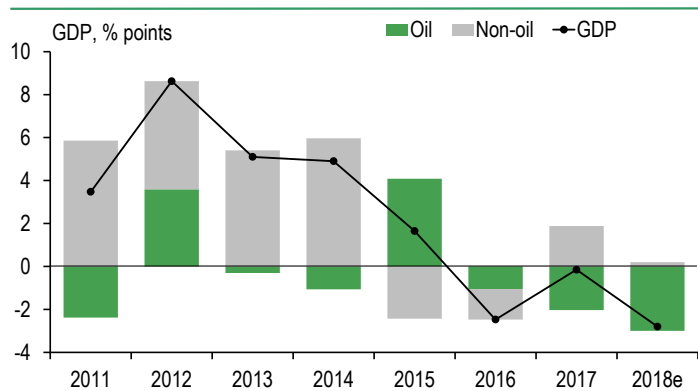


Chart 2 Source: INE,BNP Paribas

The oil sector (accounting for 35% of GDP in 2018) continues to face the consequences of both the freeze on most oil exploration projects (considered too expensive) and the massive layoffs to reduce operating costs. Oil production has declined continuously, from 1.8 m barrels per day (b/d) in 2015 to 1.49 m b/d in December 2018, mainly due lack of investments in offshore fields, which are quite costly to maintain, while others have reached maturity production peak and production has started to decline. The period of near-paralysis was also due to deteriorating relationship between Sonangol and the majors' oil companies.

In 2019 the total production is supposed to improve with the start-up of the new Kaombo oil field from Total³. But the Kaombo ramping up production could take time and its contribution would be visible in oil data by the end of this year. Additionally, the overall oil production will be lowered by 47,000 barrels per day cut in the first term of 2019 in accordance with last year's OPEC agreement. Both effects would lead to an average estimated oil production almost flat for 2019.

As per the non-oil sector (65% of GDP), it is affected by import restrictions (on non-priority products), persistently high inflation and the expiration of certain subsidies that had lifted households' purchasing power. Companies continue to battle with commodity shortages, insufficient equipment and financial problems arising from heavy fiscal pressures. The banking system's deteriorated financial situation will continue to strain private sector development.

Like in many sub-Saharan economies, private consumption in Angola remains the most significant contributor to overall GDP, accounting for around 53% of GDP in 2018, while government consumption and gross fixed capital formation have been less supportive and much more volatile. But lower public spending, high inflation levels and the weak banking system are progressively having an impact on domestic purchasing power, keeping domestic demand subdued.

Looking ahead, financial and policy support from the IMF should bring the Angolan economy out of recession in 2019. More precisely we expect real GDP growth to come to positive territory because of: i) oil GDP expansion coming from stabilisation of oil production and ii) resilient nonhydrocarbon sector.

Nevertheless, the outlook remains highly uncertain. Despite political willingness to continue implementing structural reforms, still-burgeoning corruption, the depreciation of the currency and ballooning government debt are key downside risks to the outlook. Although recent moves to bolster the business environment are encouraging, more comprehensive efforts are imperative to tackle high levels of bureaucracy, low human capital, poor regulation, high levels of corruption and the crowding out of private investment by the public sector.

Fiscal improvements in 2018

Impressive progress was made on reducing the size of the fiscal deficit in 2018. The kwanza's depreciation increased the value of US dollar-denominated oil earnings (which accounted for around half of fiscal revenue last year), and coupled with the rebound in oil prices, allowed a significant fiscal consolidation, decreasing the fiscal deficit from -6.3% of GDP in 2017 to only 0.5% in 2018. The government used most of its higher than anticipated revenues in kwanza to repay some of its

³ Located 260 km from the Luanda coast, this is the biggest deep-water oil project in Angola with two production and storage units. Overall production is estimated to be about 230,000 b/d. Today the first FPSO (floating production storage and offloading) has been ramping up production since August 2018 while its second FPSO is expected to be operational before the summer of 2019.

domestic debt, mostly Treasury bills (whose stock fell by 50% between January and December) and clear domestic payments arrears in 2018.

Fiscal boost in 2018 but increasing interest costs (% of GDP)

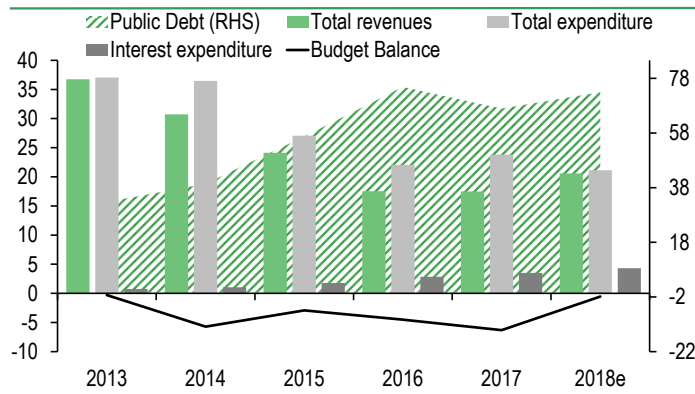


Chart 3 Source: IMF, BNP Paribas

According to the draft 2019 Budget document, the government forecasts an ambitious plan to generate a surplus of 1.4% of GDP in 2019 based on an oil price of USD 68 per barrel. This optimistic forecast seems unlikely to happen in 2019 due to the average oil price forecast being much lower than 2018's level (USD 62 per barrel on average against USD 72 in 2018), while the local currency's depreciation will be much less marked. But following a weaker international oil price outlook for 2019, the government decided to readjust spending obligations mainly in the provincial budgets.

The introduction of VAT in July 2019 will provide some support to non-oil fiscal revenue, but uncertainty persists about the rate, how it will be introduced⁴ and the risk of further delays. Moreover, government efforts to improve the overall efficiency of expenditure will prove tricky, particularly moves to contain public-sector wages, or scale back utility prices. As a result, we expect public finances to remain in deficit in 2019 and slightly deteriorate (-1.5% of GDP).

A still heavy debt burden

The kwanza's major depreciation in the transition to a more flexible exchange rate regime contributed to an increase in the government's interest payments, from 3.3% of GDP in 2017 to 4.2% in 2018 (respectively equivalent to 19.2% and 23.2% expressed as proportion of revenue). Additionally, about 80% of total public debt is foreign-currency denominated. Therefore, public debt is projected to reach more than 73 percent of GDP in 2018, up from 67% in 2017, largely due to the strong kwanza depreciation occurred in 2018.

The heavy debt burden also adds to the government's financing challenges and total external debt servicing currently consuming 21% of export earnings (up from 10.5% at end-2014). Therefore, negative shocks to the revenue base (like a sharp fall in oil prices) could

⁴ Except that the tax will be applied to the 373 companies described as major contributors for a period of two years before rolling out more widely.

significantly undermine the government's ability to service its uncollateralized debt⁵ and repay the IMF.

Fiscal Financing Needs and Sources, 2018-2021

% of GDP	2018	2019	2020	2021
Gross financing needs	17.3	13.5	13.2	11.6
Overall deficit	0.5	0.8	0.8	0.6
Arrears	1	2	0.6	0.4
Debt amortization	15	11	11.9	10.4
Other	0.8	-0.1	-0.1	0.2
Gross financing sources	17.3	13.5	13.2	11.6
Debt issuance	17	13.1	13.4	11.8
Domestic	9.1	6.8	7.4	5.7
External	7.9	6.3	6	6.1
Other	-0.1	0	-0.1	-0.1

Table 2 Source: IMF, BNP Paribas

The large gross financing needs in 2018 are estimated by the IMF to have amounted to 17.3 percent of GDP. The amount is sizeable and challenged by large domestic debt amortization needs with low domestic rollover rates (about 50 percent according to the IMF). Therefore, Angola remains highly dependent on external funding. Bilateral loans from China⁶ have so far been the government's favoured sources. In 2018, the Treasury depleted its cash buffers and issued USD 3.5 billion in Eurobonds in mid-year, and partially rolling over a USD 1.5 billion dollar-denominated domestic bond in August. Therefore, to close the remaining fiscal financing gap, the authorities requested budget support from the IMF.

As per Angola's sovereign wealth fund, it is making efforts to regain control of its assets. Through international legal actions, it continues to recoup more of its mismanaged assets. The new management is searching for a new international fund manager and external auditor for the assets it has brought back under its control. The authorities are preparing legislation to strengthen the fund's governance and transparency and set clearer deposit and withdrawal rules. The authorities committed to capitalizing the fund again only when the budget generates surpluses and government debt is below 60 percent of GDP.

Measures to contain SOE-related fiscal risks

The liabilities of nearly 80 of Angola's non-financial SOEs are sizable and increased in 2017. Their capacity to generate income, hence dividends for the Treasury, appears limited. Energy-related Sonangol is the largest of them, and it recently reduced its financial debt after receiving a USD 10 billion capital injection (roughly 10% of GDP).

⁵ According to IMF, Angola uncollateralized loan agreements with several creditors (including Credit Agricole, KfW, Commerzbank, UKEF, Afreximbank, and China's ICBC and Eximbank) amount at about USD 7 billion, i.e. 16% of total external debt in 2018).

⁶ Angola has succeeded in maintaining good relations with China, securing a new USD 2 bn loan from the state-owned China Development Bank in October 2018.



The government has committed to improve SOEs' economic efficiency by launching an ambitious SOE restructuring program to start in 2019 over a two-year period. The program would include closing insolvent SOEs and privatizing or restructuring those that are economically viable. Moreover, the creation of a new oversight institute under the Ministry of Finance is expected to strengthen SOE governance and monitoring.

SOEs' Non-financial Performances

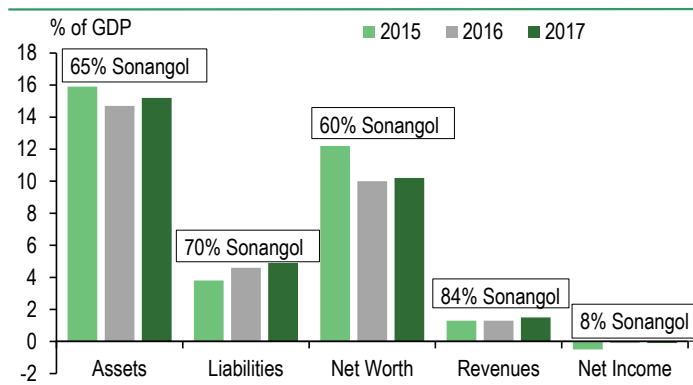


Chart 4 Source: IMF, BNP Paribas

Control inflation versus growth bolstering

The Banco Nacional de Angola (BNA) official priority remains achieving price stability (with an inflation target range of 7-9%) but also supplying the foreign exchange market. Given the economy's structural rigidities, low monetary transmission and heavy reliance on imports, the central bank intends to perform a controlled depreciation to prevent the escalation of inflationary pressures.

After having peaked at 42% in December 2016 as a consequence of the oil shock, inflation has been slowing despite the marked depreciation of the official exchange rate. This was possible thanks to both some coercive measures⁷ and the monetary policy tightening through the reserve requirement ratio and the policy rate.

Thanks to a narrowing gap between the kwanza's dual exchange rates⁸, inflation continued to trend downward in most of 2018, reaching 18.2% y-o-y in December 2018 compared with 26% in December 2017 and 40% in December 2016. This disinflationary trend allowed the Central Bank to begin a cycle of gradual monetary easing in July 2018 by cutting its policy interest rate by 150 basis points to 16.50% for the first time in more than two years. The Central Bank lowered again the key policy rate by 75 basis points to 15.75% at its latest meeting on January 25, 2019.

Considering the VAT introduction and the partial recovery in commodities prices, CPI inflation will remain elevated in the medium

⁷ In 2017 the government introduced price limits for basic goods, centralised flour sales and recently approved a new set of customs tariffs.
⁸ The parallel market was already the norm in many transactions.

term and the inflation target range of 7-9% will be hard to be reached, unless the currency re-appreciates.

Reaching inflation target will take time

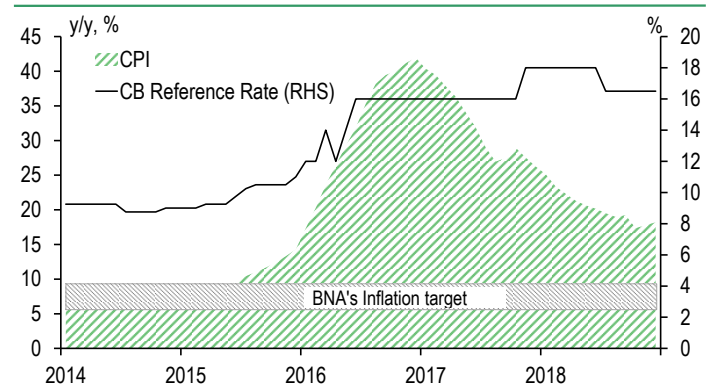


Chart 5 Source: BNA, BNP Paribas

Current account improved due to oil price relief

The current account balance is expected to post a surplus in 2018 (1.9% of GDP). In 2018, the trade surplus generated by the recovery in oil prices was enough to offset the deficits in the balances of services and revenue. But based on our oil forecast in 2019 (average of USD 62 per barrel against USD 72 average in 2017) the CAD is expected to deteriorate to -1.9% of GDP.

Traditionally one of the largest recipients of foreign direct investment inflows in Africa, Angola experienced years of net divestments (from 2010 to 2014), largely reflecting the impact of the 2008-09 financial crisis with foreign oil firms divesting from Angola. In 2017 most of the oil companies repatriated some of their investments abroad, which led to a negative net outflow in FDI. Moreover, foreign FDI inflows remain constrained by the persistent risk of restrictions on repatriation of foreign investors' fx revenues. Resident FDI outflows have fallen so far due to the impact of falling oil prices on Sonangol's investment capacity.

This trend combined with rising external public-sector liabilities and contracting fx reserves has shifted the net international investment position (NIIP) into negative territory so far.

Angola's external debt only includes the external debts of the central government, state-owned oil company Sonangol, state-owned airline TAAG, and public guarantees denominated in foreign currency, as we have no information on private sector external debt. It increased to 45% of GDP in 2018 due to GDP contraction and is projected to remain elevated in the medium term (around 50%). Angola's external debt remains vulnerable to unfavorable current account developments and large exchange rate depreciations (according to the IMF's assessment, external debt would rise to about 70 percent of GDP in response to the 30 percent depreciation in the real effective exchange rate).

CAD lowering but NIIP deteriorating

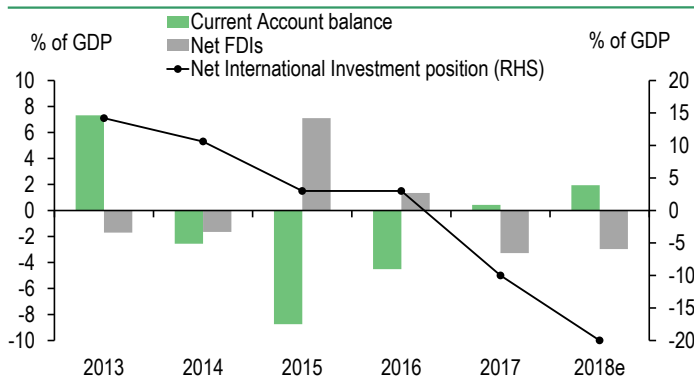


Chart 6 Source: IMF, BNP Paribas

Easing FX shortages

In the last quarter 2018 the kwanza has begun to stabilize, after its sharp correction. Indeed, after the abandonment of the peg to the US dollar in January, the kwanza depreciated 46% yoy between end of 2017 and end 2018. The "peg" is not being completely replaced by a free float, as upper and lower "bands" for transactions keep the fluctuation of the kwanza within $\pm 2\%$ points of the rate determined at the previous auction.

Nevertheless, the gradual floating of the kwanza has entailed an easing of dollar shortage and capital controls. Since 3Q 2018 the central bank has been addressing the backlog of FX demand from 2014–17 via increased sales of FX and more frequent auctions (from one to three auctions a week). It also eliminated the priority list, allowing private exporters and international oil companies to supply foreign currency (provided proper documentation is supplied) to importers in order to increase the availability of foreign currency. Starting from end-September 2018, the central bank holds weekly auctions with commercial banks which determine the kwanza's value.

Despite the upturn in crude oil prices, the central bank's foreign reserves have continued to decrease (expected to be USD 15.4 bn in Q4 2018 from USD 17.4 bn in Q4 2017). Consequently, the bulk of foreign exchange controls⁹ is likely to be maintained in the medium term.

⁹ Approved in 2012, the legislation on foreign-exchange controls rules covers the trade of goods, services and capital movements arising from the overall crude oil and natural gas processes. The exchange operations encompass (i) the purchase and sale of foreign currency, (ii) the opening of foreign currency bank accounts in Angola by resident or non-resident entities and the transactions carried out through these bank accounts, (iii) the opening of national currency bank accounts in Angola by non-resident entities and the transactions carried out through these bank accounts and (iv) the settlement of all transactions of goods, services and capital movements. In general terms, these rules imposed on upstream oil and gas companies provide that (i) all foreign-exchange transactions must be carried out through Angolan banks and (ii) the bank accounts opened in Angolan banks must be funded sufficiently to satisfy tax obligations and the purchase of all goods and services from local and foreign companies.

Notwithstanding efforts by the government to repatriate funds held in overseas accounts, the currency will continue to come under pressure. The spread between the official and parallel exchange rates is still wide (it narrowed from 150 percent in December 2017 to roughly 20 percent in November 2018). Moreover, the depreciation in the parallel rate market started at end September 2018 indicates that net demand for USD is still large. Therefore pressures remain in 2019 and a further 20% devaluation of kwanza is very likely.

Despite improvements, pressures on reserves persist

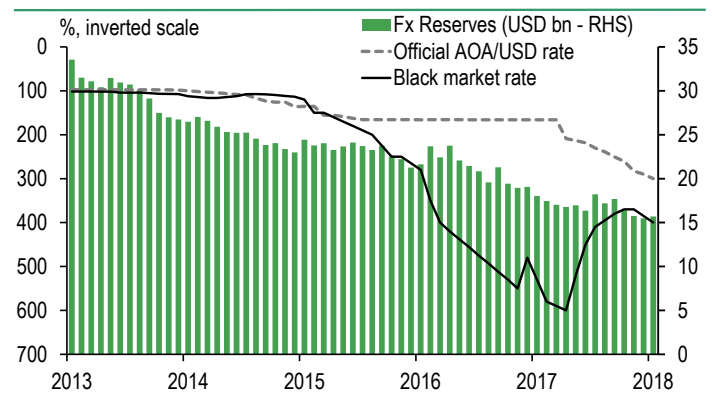


Chart 7 Source: IMF, Kinguila, Bloomberg

A still ailing banking sector

With total assets of 13.6 trillion Angolan kwanzas (USD 43.8 billion) as of November 2018, the Angolan banking system is the third-largest in Sub-Saharan Africa. Thirty commercial banks were authorized to operate in Angola as of December 2017. They offer basic banking services including deposits, corporate and retail lending and foreign exchange services. The six largest banks¹⁰ controlled around 75% of the sector's assets as of December 2017, thus leaving a long tail of much smaller banks. As regards ownership, it is mostly spread out among a mixture of SOEs, Portuguese parent institutions and Chinese investors.

The sector's growth has slowed over the past four years due to the economic downturn coming from oil's lower prices and declining output. In this context, the central bank's prioritization of price stability and exchange rate management has hindered bank operations so far. As a consequence, the overall banking system remains relatively small, with domestic credit accounting for just 30% of GDP, as of November 2018. In this context, the reappointment¹¹ of Mr José Massano, as central bank governor was intended to restore credibility in the financial sector.

¹⁰ Banco Angolano de Investimentos, Banco Económico, Banco de Fomento Angola, Banco BIC Angola and Banco de Poupança e Crédito.

¹¹ He was already BNA governor between 2010 and 2014.



Moderate credit growth and improved soundness indicators

According to the Banco Nacional de Angola, the nominal credit growth averaged 15% y-o-y in September 2018 against an average of -5% in the same period in 2017. But considering that more than 30% of total loans are FC denominated, a significant portion of this overall credit growth has been underpinned by the kwanza's depreciation which has inflated the nominal growth of foreign denominated loans. Without kwanza depreciation, the fc denominated credit growth would be at around 2% yoy at end September 2018.

Weak economic activity in the past three years has eroded the banking sector's soundness. Overall, the capital ratio remains healthy (at 21.5% at November 2018), loan-to-deposit ratio is low (at 53.3%) and most banks are profitable (with an average 3.0% return on assets,). All banks have migrated to the IFRS accounting system that, inter alia, has more robust provisioning requirements.

Domestic credit's growth back to positive

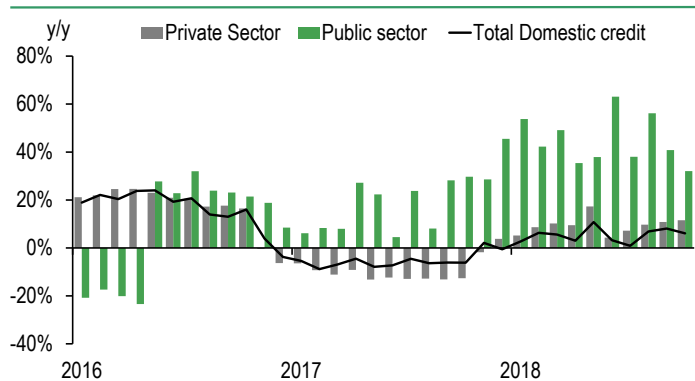


Chart 8 Source: BNA, BNP Paribas

Financial soundness indicators

	2015	2016	2017	2018*
Capital Adequacy ratio	19.8	19.2	18.9	21.5
NPL ratio	11.6	13.1	28.8	26.7
Return on assets (ROA)	1.7	2.2	2.1	3.0
Loan / deposits	59	51.6	49.3	53.5

(*) = November 2018

Table 3 Source: BNA, IMF, Fitch, BNP Paribas

In the aftermath of the oil price collapse the level of NPLs rose dramatically, reaching 29% of total loans in December 2017 compared with an average of 10.6% between 2013 and 2016. Nonperforming loan levels varied considerably from bank to bank, with state-owned institutions hit particularly hard by the oil price crash of 2015/16¹², while

¹² Four-fifths of the banking system's NPLs were concentrated in the state-owned Banco de Poupança e Crédito (BPC) - a systemically important bank whose rescue package has cost the government an estimated 1.6% of GDP between March 2018

other banks contained the deterioration of their balance sheets through provisioning and limited lending. Thanks to the gradual recovery in global oil prices and Recredit's¹³ repurchases of bad loans, asset quality has started to improve in 2018, with NPLs reaching 26.7% in November 2018. However, overall asset quality remains poor and further improvements will be slow because of the still challenging operating environment given the recent decline in oil prices and the overall cut back in oil production. Poor asset quality is putting pressure on both liquidity and capitalization.

As per liquidity, the banking system is characterized by a high level of local currency liquidity since lending to small and medium-sized enterprise (SME) remains limited because of banks' weak appetite for risk and poor credit management capabilities. On the contrary, the tight funding although the liberalization of foreign exchange has stemmed some pressures on foreign currency liquidity, and forex liquidity conditions will remain challenging in 2019.

With regard to capitalization, in February 2018 the central bank has tripled the commercial banks' minimum capital requirement (from AOA 2.5 bn to AOA 7.5 bn by end-2018). As a consequence, the ratio of capital to risk-weighted assets increased to 21.5% in November 2018 from 17.8% in November 2017. As many as one-third of 29 banks currently operating in Angola are expected to struggle to meet this new limit¹⁴, a new wave of banking consolidation is very likely in the medium term.

Downside risks remain significant

Nevertheless, downside risks remain very high and weigh on the Angolan banking sector's credit soundness. Firstly, in case of disappointing oil production, real GDP growth will contract bringing down credit growth. Additionally, any faster currency depreciation or higher food prices will see inflation accelerate and prompt the BNA to tighten its policy stance. Though Angola's monetary policy transmission mechanism between the benchmark interest rate and loan growth is weak, pressure should be expected on commercial banks to raise lending rates and limit demand for credit.

Even if prudential requirements are gradually moving towards international standards, compliance-related deficiencies in the banking system persist, as is reflected by the loss of dollar- correspondent banking relationships with international banks¹⁵. Angolan banks have

and January 2019. The BPC has resumed lending but remains weakly capitalized and dependent on the BNA for liquidity.

¹³ Set up in 2016 by the government with a market capitalization equivalent to USD 2 billion, Recredit is a state-owned enterprise whose priority is the renegotiation of debt with banks and individuals with which it has agreements to purchase non-performing loans. Beyond that, however, the authorities have little capacity to intervene in the banking sector should it need to support a failing institution.

¹⁴ On June 26 2018, the central bank suspended the board of Banco Angolano de Negócios e Comércio (BANC) and appointed a provisional team of directors due to the bank's inability to meet the capital requirement. On January 2 (2019), the central bank announced that Banco Mais and Banco Postal had failed to meet the legal requirements to continue banking activity and revoked their licenses.

¹⁵ US banks terminated banking relationships with their Angolan counterparts in 2015 and deprived them of access to dollars because of the suspicion that they were controlled by political interests.



suffered from a loss of correspondent banking services, such as dollar clearing services and the sale of physical dollar notes, as foreign banks seek to avoid money laundering and terrorism financing compliance-related risks.

There has been some progress in addressing these risks. In 2016, the Financial Action Task Force (FATF) recognized that Angola has made significant progress in improving its regime to combat money laundering and terrorist financing and therefore will no longer be subject to the FATF's monitoring process. However, opacity remains a source of concern (timely data are scarce) and still prominent government ownership in the sector also triggers governance issues. Therefore, we do not expect dollar-correspondent banking services to resume in the short term.

Additionally, an inadequate legal framework for secured lending that includes impediments to enforcing property ownership hinders banks' financing activities. High levels of corruption also tend to make the operating environment both unpredictable and costly.

Despite some progress related to regulatory framework supervision and improving financial indicators, systemic credit risk in Angola's banking system remains very high in the medium term.

The election of Joao Laurenço has been followed by a lot of expectation for a political transition ending the Dos Santos extensive patronage network as well as changing the economic policy.

The signing of a financing agreement with the IMF would diversify the sources of international financing and definitively reassure economic agents. But the balance between the need for reform and the social acceptance of austerity measures is very fragile.

The private sector's supportive measures implemented last year by president Lourenço are intended to improve the business environment and attract international investors. But, important deficiencies remain (corruption issues, institutional weaknesses, weak human capital and still underdeveloped infrastructures) that would constrain the overall economic activity.

The main risk is that Angola's economy continues to be driven by the hydrocarbon sector as a source of GDP growth, fiscal income and foreign exchange earnings. This leaves the country vulnerable to the risks of low oil price and decrease in production levels. Therefore, growth recovery would be gradual and the still weak foreign direct investment and portfolio investment would oblige the country to rely on external debt financing.

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