ECOEMERGING

2nd quarter 2024
May 2024

"THE DEBATE ON MONETARY SOVEREIGNTY IN EMERGING COUNTRIES IS RESURFACING"

ECONOMIC RESEARCH

BNP PARIBAS

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EDITORIAL

MONETARY SOVEREIGNTY: BEYOND THE MANTRA

The debate on monetary sovereignty in emerging countries is resurfacing with, on the one hand, the plan of Argentinian President Javier Milei to dollarise his economy, and on the other, the temptation of several West African country leaders to abandon the CFA franc. From a strictly economic point of view, dollarisation is effective in tackling hyperinflation. However, to be sustainable in the long term, it imposes severe constraints on fiscal policy and the nature of foreign investment. Conversely, the abandonment of the CFA franc with the aim of recovering the flexibility of an unpegged exchange rate regime and greater autonomy of monetary policy, is an argument that is either weak in theory or unconvincing in practice, even in the short term.

AMONETARY SOVEREIGNTY AND FOREIGN EXCHANGE SOVEREIGNTY: TWO SIDES OF THE SAME COIN

The debate on monetary sovereignty is resurfacing, with on the one hand, the plan of Argentinian President Javier Milei to dollarise his economy, and on the other, the temptation of several West African country leaders to abandon the CFA franc. Admittedly, the motives are very different in nature; in the case of Argentina, they are purely economic and circumstantial, with simple replacement of the peso by the US dollar being, according to Javier Milei, the only way to radically and sustainably fight out-of-control inflation that had reached 288% over a year in March.[1] Secondly, the motive is political and based on the sovereign principle that currency is a government attribute that cannot be delegated to another country. In the case of the CFA franc, delegation takes the form of a fixed parity versus the euro and a convertibility guarantee provided by the French Treasury.

From an economic perspective, monetary sovereignty is not limited to delegation of the exchange rate. It implies monetary policy freedom, i.e., the free choice for a central bank to raise or lower its key interest rate, or to increase or reduce its balance sheet (quantitative policy).

Unfortunately, the choice of currency regime constrains monetary policy; a fixed currency regime requires the central bank to intervene to avoid permanent deviation of its key policy rate from the key rate of the central bank of the country of the anchor currency, or to refrain from implementing a quantitative policy that would lead to a lasting divergence in money market interest rates.

The choice of currency regime may also constrain budgetary policy; in the case of a currency board regime and, even more so, dollarisation, balanced public accounts are a necessary condition to ensure the credibility of fixed parity.[2]

In the past, use of dollarisation or a currency board has proven effective in dampening soaring inflation in the early years of implementation (Argentina in 1991, Bulgaria in 1997, Ecuador in 2000). The challenge, once inflation is under control, is to maintain fiscal discipline and attract productive foreign investment, in order to credibly build disinflation and ensure economic growth over the long term.

REAL EFFECTIVE EXCHANGE RATE OF THE WAEMU AREA

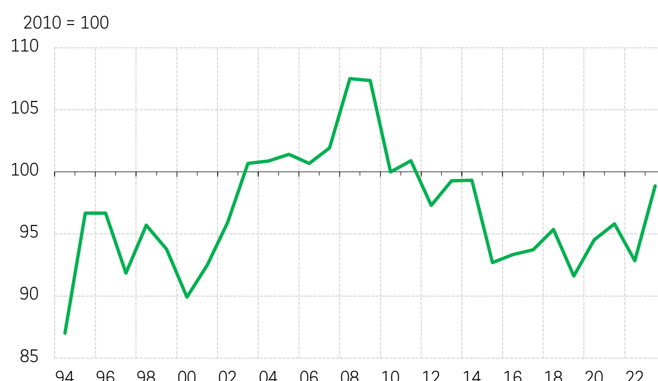

CHART 1 SOURCE: ALI ZAFAR, WAEMU, BNP PARIBAS

Therefore, although particularly brutal from a social point of view, Javier Milei's strategy (aimed at generating a primary budget surplus and removing capital control as quickly as possible) is consistent with the dollarisation plan from an economic point of view.[3] And even though the central bank (BCRA) has cut its key rate since mid-December (from 133% to 70% currently), the aim of the new authorities is not to hope for a recovery in growth through credit. They are simply looking for an urgent way to alleviate the increasing public finance cost of the sterilisation operations carried out by the BCRA to contain the inflationary effect of the monetary financing of the budget deficit. Monetary policy will remain very significantly constrained by inflation.

ABANDONING EXCHANGE RATE PEGGING: UNCONVINCING ECONOMIC ARGUMENTS IN THE CASE OF THE FRANC ZONE

Abandoning the peg of the CFA franc raises more questions. The primary, and never-ending, argument is that the conditions for an optimal currency area (OCA) would not be met. However, meeting all these conditions is so restrictive that this argument has a very limited practical scope.[4] Conversely, there are two interesting arguments to be discussed: the alleged overvaluation of the CFA franc and the

1 In fact, inflation accelerated mainly due to the 54% devaluation of the peso against the USD on 13/12/2023 (to reduce excess demand for dollars and not to rebalance external accounts) and the removal of subsidies. But the inflationary drift was well-established before that.
2 Except in the quite rare scenario in which the private sector has a structural financing capacity or, in more usual scenarios, in which the current deficit is covered by foreign direct investment (FDI) or sources of debt financing for projects generating sufficient foreign currency revenue to stabilise the current deficit at a low level. However, in these two scenarios, the use of a currency board is not necessary when choosing the exchange regime since, in order to attract FDI or hard currency-generating investments, the recipient country must have macro-financial stability and therefore, a moderate and stable level of inflation.
3 We will not be discussing here the technical feasibility of dollarisation in the Argentinian scenario; this is an important topic but not one covered in this editorial.
4 The success of the European system of central banks (as a permanent mechanism for preventing balance-of-payments crises through the role of Target accounts as a buffer and/or a one-off instrument for the rationalisation of financial resources during shocks such as Covid), is a perfect counter-example of this. We should remember that the eurozone was criticised on the basis of non-compliance with the OCA conditions, which was, incorrectly, considered to be at the origin of the sovereign debt crisis during the first part of 2010.

slowdown in growth due to the lack of monetary policy flexibility. Is this really the case?

Observation of the real exchange rate of WAEMU countries over a long period, shows an appreciation of 10% compared to 1994 (year of devaluation), but with three sub-periods: a trend appreciation between 1994 and 2009, then a trend depreciation between 2009 and 2018, and a stabilisation since then. We cannot therefore talk about a clear overvaluation, either in terms of level or in terms of dynamics. Moreover, the BCEAO's foreign exchange reserves have not reached a critical level, as was the case in 1993. Although they have dwindled since 2021, they are still above their statutory limit of 20% of the BCEAO's external commitments, compared to 18% at the end of 1993.

The review of overvaluation can be refined using modelling approaches. In 2021, based on its two principal external imbalance valuation models,[5] the IMF estimated, according to the method, either a slight overvaluation of the CFA franc of 2.9% (1st method) or even an undervaluation of 5.6% (2nd method). In both cases, the spread was small and the IMF concluded that the real exchange rate was in line with the zone's fundamentals. These conclusions are still valid in 2023.

By using a rudimentary general equilibrium model (GEM) but adapted to developing countries,[6] a former World Bank economist and current economic adviser to the United Nations, Ali Zafar, on the contrary, indicated in a recent book on the Franc Zone,[7] a strong overvaluation of the real exchange rate for the entire WAEMU zone, of 20%, ranging from 16% to 26% depending on country. However, as the author states, this result depends heavily on the magnitude of the shock introduced into the model to result in such an overvaluation. More specifically, using the model for Senegal, a terms-of-trade shock (ratio between international prices in dollars of exports and those of imports) of the order of 30% is required to justify an overvaluation of the order of that calculated by Ali Zafar.[8] Moreover, the terms-of-trade shock still needs to last for several years to justify a devaluation in response to the worsening of fundamental balances (budgetary and external balances) and this terms-of-trade shock still needs to not correct an exceptional improvement in previous years. However, in the case of Senegal, over the past two decades, the sharp decline, alone, of nearly 20% in cumulative terms from 2009 to 2013 had precisely followed an improvement of 35% in cumulative terms, also from 2004 to 2008.

The second argument (lack of monetary policy flexibility) seems even less well-founded. In real terms, credit growth in the private sector of the WAEMU was very rarely less than 10% p.a. between 2013 and 2019 (compared with real GDP growth of 6% p.a. on average). Credit growth slowed in 2020-2021, as in most countries, but accelerated again from 2022. It remained sustained in 2023, despite the ECB's monetary tightening.

WAEMU AREA: DOMESTIC BANK CREDIT TO THE PRIVATE SECTOR DEFLATED BY THE CPI INDEX

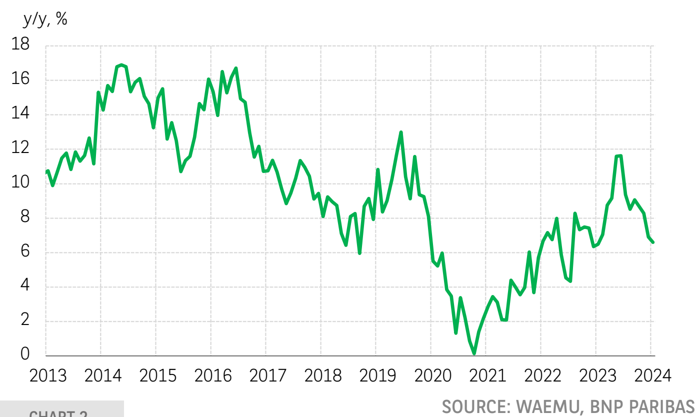

CHART 2 SOURCE: WAEMU, BNP PARIBAS

In summary, the two main economic arguments advocating for monetary sovereignty of the countries of the franc zone (flexibility of unpegged exchange rate and flexibility of monetary policy are either weak in theory (first argument) or unconvincing in practice (second argument).

One development that would make economic sense would be the abandonment of fixed parity versus the euro alone, in favour of pegging it to a basket of strong currencies more representative of the structure of foreign trade, a development that most economists, including Ali Zafar, defend. On the other hand, casting off without a probationary period of stability would be very risky in our opinion, as repayment of public and private debts might well not be possible in the event of devaluation. As politically legitimate as it may be, monetary and foreign exchange sovereignty cannot be decreed, it has to be acquired.

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5 The first method is based on a comparison between the cyclically-adjusted current balance, and exceptional factors (e.g. imports of capital goods required for a major investment project) with a reference value (norm). This value is determined based on: 1/ the coefficients of an econometric estimate over 150 countries between the current balance and a set of structural variables, (structural budget balance, productivity, demographic variables, political and institutional environment, etc.) 2/ the values of these variables for the country in question. The difference between the cyclically-adjusted current balance and the norm, if any, makes it possible, using a standard elasticity of the current balance at the real exchange rate, to calculate the (real) exchange rate gap (misalignment) that would make it possible to close the current balance gap. Indirectly, the real exchange rate is judged as overvalued or undervalued. The other method works in reverse; it consists of estimating the equilibrium exchange rate (also based on structural determinants), directly deducting the misalignment and indirectly the current balance gap.
6 S. Devarajan, D.S. Go, J.D. Lewis, S. Robinson & P. Sinko "Simple General Equilibrium Modeling" in Applied Methods for Trade Policy Analysis - Cambridge University Press - 1997.
7 Ali Zafar: "The CFA Franc Zone - Economic Development & the Post-Covid Recovery" - Palgrave McMillan - 2021.
8 In the GEM of Devarajan et al., the exchange rate is fixed, so that in a situation of terms-of-trade shocks, a drop in the price of domestic goods (and therefore a real depreciation of the exchange rate) is necessary to leave the trade balance stable thanks to the substitution between domestic goods and equivalent imports on the one hand, and the transfer of production from domestic goods to exports on the other. The resulting conclusion, that a (real) devaluation would be a remedy for terms-of-trade shock, is only valid if the elasticity of substitution between imports and domestic goods is less than 1, which is, in theory, the case for emerging and developing countries. In other words, the negative income effect of a terms-of-trade shock (loss of purchasing power) outweighs the substitution effect and leads to a contraction in imports. In the meantime, the increase in the relative price of exports compared to the price of domestic goods results in an increase in exports due to the transformation of the production of domestic goods to exports (assuming an elasticity of transformation less than 1 in the case of emerging and developing countries).

CHINA

TRADE OFFENSIVE

In the first quarter of 2024, China's economic growth was stronger than expected and was largely driven by the export-oriented manufacturing sector. Against a backdrop of sluggish domestic demand and strategic rivalries, particularly with the United States, Beijing is further developing its industrial policy to support economic growth and strengthen "national security". Priority is given to the high-tech and energy transition sectors. With considerable support from the government, these sectors are moving up the value chain, increasing their production capacity, lowering selling prices and gaining export market shares. The flood of green tech products is expected to lead to further trade confrontations in the coming months.

FOCUS ON "NEW PRODUCTIVE FORCES"

At the annual session of the National People's Congress held at the beginning of March, the Chinese authorities set out the main objectives of their economic strategy for 2024. In particular, to achieve the relatively ambitious growth target of "around 5%" for this year and stimulate supply, priority is being given to the "new productive forces" that are the new technology industries – ranging from artificial intelligence to the energy transition sectors (renewable energies, electric vehicles, lithium batteries).

China's industrial policy therefore continues to focus on production and innovation across the entire value chain of the targeted manufacturing sectors. It aims to support a continuous rise in the value chain in order to boost productivity gains and make China a major global tech leader. These priorities are not new (they were set out in the "Made in China 2025" programme published in 2015), but the authorities have increased their level of ambition over the past four years in response to a difficult domestic economic climate and an external environment marked by strong commercial and strategic rivalries, particularly with the US. In particular, industrial policy must contribute to China's "national security" objectives and reduce its dependence on imported materials and foreign technologies.

WEAK DOMESTIC DEMAND

Regarding demand policy, the authorities confirmed in early March the accommodative yet cautious stance they had been following for several months. New public investment in infrastructure is planned in 2024 but, at the same time, efforts are expected to be made to rationalise local government spending and restructure the debt contracted by their financing vehicles. In addition, new fiscal and monetary policy measures are being envisaged to stimulate domestic demand and stabilise the property sector, but the emphasis on boosting household consumption remains limited in reality.

In the short term, this economic policy risks amplifying the divergence in performance between sectors and the imbalance between domestic demand and supply that has been apparent for several months now.

On the one hand, domestic demand and service sector activity remain subdued, still held back by the property sector crisis, regulatory uncertainties and the lack of consumer and private investor confidence. This sluggishness persisted in Q1 2024. Property investment and house sales continued to plummet. The recovery in retail sales has seemingly waned and services growth has slowed (+5.5% y/y in Q1 2024, vs. +8.5% in Q4 2023 and +8.1% over 2023 as a whole) – which is only partially due to the unfavourable base effects stemming from the rebound in Q1 2023. This loss of momentum contributed to a slight rise in the unemployment rate, from 5% in Q4 2023 to 5.2% in Q1 2024. Also reflecting the weak domestic demand and the imbalance between supply and demand, consumer price inflation was, on average, slightly negative in the second half of 2023 (at -0.2% y/y) and zero in Q1 2024, and core inflation has remained low (+0.7% on average over the last nine months). Yet, the lack of inflationary pressures has also been due to the continued fall in food prices since mid-2023 (-3.1% y/y on average).

FORECASTS

	2021	2022	2023e	2024e	2025e
Real GDP growth, %	8.4	3.0	5.2	5.2	4.3
Inflation, CPI, year average, %	0.9	2.0	0.2	-0.1	1.2
Official budget balance / GDP, %	-3.1	-2.8	-3.9	-3.8	-3.5
Official general government debt / GDP, %	46.8	50.6	56.1	59.5	62.0
Current account balance / GDP, %	2.0	2.5	1.4	1.4	1.1
External debt / GDP, %	15.4	13.7	13.8	13.0	12.4
Forex reserves, USD bn	3 250	3 128	3 238	3 260	3 210
Forex reserves, in months of imports	12.6	11.9	12.4	11.9	11.1

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

CHINA: EXTERNAL TRADE

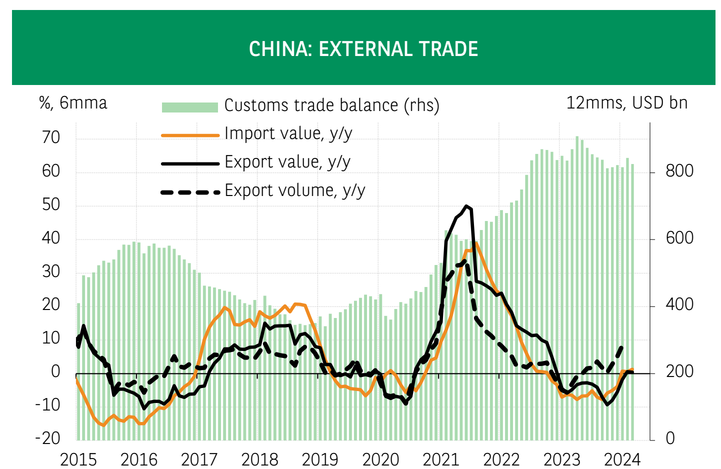

CHART 1 SOURCE: GENERAL ADMINISTRATION OF CUSTOMS, CPB, BNP PARIBAS

A NEW RISE IN EXPORT POWER

On the other hand, industrial production and production capacity continue to grow, especially – but not only – in the high-tech and green-tech sectors. These sectors are largely supported by the government through a wide range of subsidies, tax incentives, low-rate credits and other financing measures[1].

Growth in manufacturing investment has recovered since summer 2023, industrial production capacity has continued to expand, and the post-Covid rebound in industrial production has gradually accelerated (+6.1% y/y in Q1 2024, compared to +6% in Q4 2023 and +4.6% over 2023 as a whole) – with improvements seen in a large number of sectors. At the same time, industrial overcapacity has increased, as suggested by the recent fall in capacity utilisation rates, on average across the manufacturing sector (to 75.3% in 2023 and 73.8% in Q1 2024, compared to just over 77% in 2017-2019), and, most notably, in the automotive sector (74.5% in 2023 and 64.9% in Q1 2024, compared to nearly 80% pre-Covid).

Government support and the increase in industrial production capacity have enabled Chinese companies to aggressively lower their selling prices in order to increase their export volumes and strengthen their market share.

Indeed, China's goods exports have been recovering since November, helped by the improving global electronics cycle and world demand, and by market share gains. Measured in current USD, exports increased again slightly in Q1 2024 in year-on-year terms (+1.5%), after a decrease of -1.2% in Q4 2023 (and -5% over 2023 as a whole). Total exports stood at nearly USD 3,400 billion over the period from April 2023 to March 2024 (compared to USD 2,500 billion in 2019), fuelling a trade surplus of USD 826 billion over the last twelve months; this is almost twice the surplus for 2019 (Chart 1).

While total export value stagnated in March after rallying for two months, total export volume has continued to rise unabated. According to the CPB data, total export volume was up 15% y/y in January 2024, after growing 8% in Q4 2023 (and rising 3% over 2023 as a whole).

MARKET SHARE GAINS

China's share in total global goods exports (measured in current dollars) had increased in 2020-2021 during the Covid crisis, and had then partially fell back. However, it recently increased again, rising from 14% in H1 2023 to 14.7% in H2 2023 (compared to 13.3% in 2019).

This recent increase is visible in a number of markets. First in the European market, with China's share of extra-European Union imports increasing again in H2 2023 to 20.7%, compared to 20.3% in H1 2023 (it was 18.7% in H2 2018). Gains were also recorded in the US market. The trade decoupling trend with the United States has actually stopped in recent months, with China's share of US goods imports rising from 13.3% in H1 2023 to 14.3% in H2 2023 (compared to 22% in H2 2018).

CHINA: EXPORTS BY DESTINATION

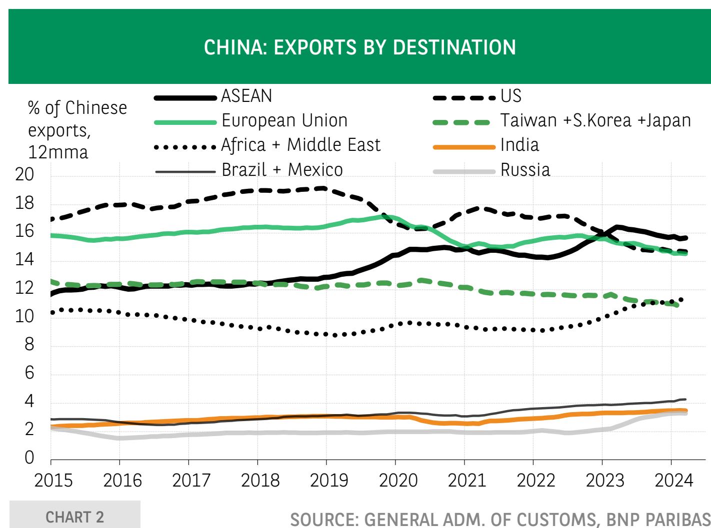

CHART 2 SOURCE: GENERAL ADM. OF CUSTOMS, BNP PARIBAS

At the same time, the diversification of China's trade partners has continued. This has resulted from hikes in US customs tariffs and other protectionist measures put in place since 2018: Chinese companies have redirected some of their export flows from the United States to other markets, partially through relocating the final production stages for goods for the US market to third countries. Since 2022, China has also increased its trade with Russia and with other « Global South » countries (Chart 2).

In addition, China's recent market share gains have been recorded across a wide range of products, including: low value-added consumer goods (such as furniture and toys), organic chemicals and plastics, vehicles, electrical and electronic machinery and equipment and parts thereof. They have been particularly impressive for electric vehicles (with export volumes multiplied by 7 between 2019 and 2023), solar panels (exports multiplied by 5 between 2018 and 2023) and lithium batteries. These three products accounted for approximately 4% of China's total exports in 2023 (about three times their 2019 share).

The flood of Chinese products has given rise to growing concerns among industrial entrepreneurs and governments in the US, the European Union and now emerging countries, and is likely to lead to new trade confrontations in the coming months.

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1 The Center for Strategic and International Studies (CSIS) estimates that China's total industrial policy spending was at least USD 248 billion in 2019, or 1.7% of GDP. South Korea was second on the list of countries included in the CSIS study, far behind China, with industrial policy spending amounting to 0.67% of GDP in 2019. See CSIS: *Red Ink: Estimating Chinese Industrial Policy Spending in Comparative Perspective*, May 2022.

MODI HEADS TOWARDS A THIRD TERM

The reform policies initiated since Narendra Modi came to power in 2014 are expected to continue with his very likely re-election next June. His economic performance has been positive overall, with robust growth, a strengthening banking sector, a surging investment rate and infrastructural deficiencies being reduced. However, the country is still facing many substantial structural challenges. GDP per capita is still much lower than in other Asian countries (China, Vietnam and Indonesia), the manufacturing sector is barely growing and the country fails to create enough jobs for young people, who are still experiencing very high unemployment rates.

GENERAL ELECTION

India's general election started on 19 April and will run until 1 June. The latest polls forecast that the Bharatiya Janata Party (BJP), led by Prime Minister Narendra Modi, and members of the National Democratic Alliance (NDA) will win the election for the Lok Sabha, the lower chamber of India's Parliament, and form a government for the third time running. This victory should help to maintain stability in the country and provide a platform for continuing to introduce reforms. Over the past five years, trust in the ruling coalition has seemingly increased. In April, the alliance was only one seat short of a majority in the Rajya Sabha, the upper house of India's Parliament, which contains 240 seats in total. By contrast, the coalition only held 34.7% of the seats five years ago. Winning a majority in the Parliament's upper house would make it easier to adopt essential reforms for boosting the country's economic growth. However, their adoption may not be enough. During Modi's last term in office, some key reforms adopted by the Parliament were abandoned (such as the agricultural reform) or have still not been fully implemented (such as the labour market reform).

On the international front, India is still not particularly integrated into global trade. Structural constraints and its limited participation in free trade agreements for protectionist reasons (such as the Regional Comprehensive Economic Partnership, which includes China, Japan, South Korea, Australia, New Zealand and the ten ASEAN countries) have limited its expansion. However, the government is gradually changing its strategy. The inclusion of Indian sovereign bonds into the JP Morgan and Bloomberg indices (which will be done gradually from June 2024 for the former and from January 2025 for the latter) should increase its financial integration. On the geopolitical front, India is expected to maintain its neutral stance towards the Ukraine-Russia conflict. Under this "non-alignment" or even "multi-alignment" strategy, it can receive oil and weapons from Russia (which has been its main oil and weapons supplier), while maintaining stable relations with Europe and the United States. Its partnership with the United States was strengthened in 2022 with the Initiative on Critical and Emerging Technology framework, which aims to enhance cooperation on advanced technologies and defence. Conversely, its relations with China are still strained.

FORECASTS

	2021	2022	2023e	2024e	2025e
Real GDP growth, % (1)	9.7	7.0	7.6	6.7	6.6
Inflation, CPI, year average, % (1)	5.5	6.7	5.4	4.7	4.3
General gov. balance / GDP, % (1)	-9.6	-9.2	-9.0	-8.1	-7.3
General gov. debt / GDP, % (1)	85.2	85.0	84.4	83.9	82.5
Current account balance / GDP, % (1)	-1.2	-2.0	-1.7	-1.9	-1.8
External debt / GDP, % (1)	19.7	18.4	18.7	19.0	18.5
Forex reserves, USD bn	618	562	618	578	620
Forex reserves, in months of imports	7.9	6.7	8.6	8.1	8.5

TABLE 1

(1) FISCAL YEAR FROM APRIL 1ST OF YEAR N TO MARCH 31ST OF YEAR N+1
e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

GDP PER CAPITA AT CONSTANT PRICES IN PPP

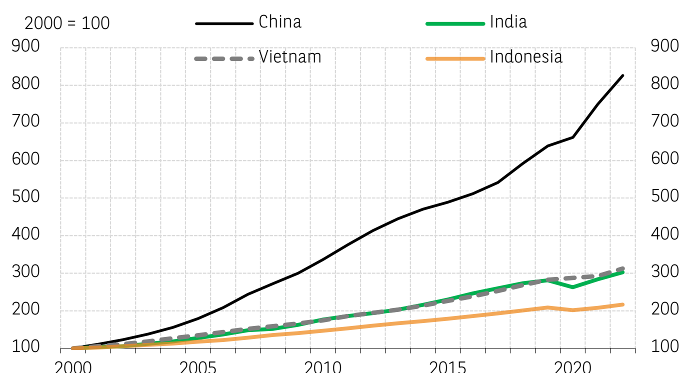

CHART 1

SOURCE: IMF-WEO, BNP PARIBAS

THE ECONOMIC PERFORMANCE FOR MODI'S LAST TERM OF OFFICE

Overall, Modi can boast a positive economic performance: i) the economy has held up well against successive external shocks (the pandemic, rising raw material prices and monetary tightening in advanced economies); ii) the banking sector has strengthened significantly and has helped to boost investment demand; iii) infrastructural deficiencies have been reduced but are still significant: the country rose nine positions on the World Bank's Logistics Performance Index between 2014 and 2023, and now ranks 47th out of 139 countries, ahead of Vietnam and Indonesia.

Over the last five years, average economic growth has been more dynamic than in other Asian countries. It averaged 4.3% per year including the two pandemic years, but stood at 7.2% per year on average if these two years are excluded (over the 2017-19 and 2023-24 periods). At the same time, GDP per capita has risen by 6.1% per year on average (excluding the pandemic) and the poverty rate has fallen by ten percentage points (pp) to 12.9% over the past ten years. However, GDP per capita (in volume and in purchasing power parity terms) is still 2.5 times lower than in China and 1.7 times lower than in Indonesia and Vietnam.

The domestic economic environment is generally favourable for the Prime Minister. Economic growth is expected to exceed 7.6% for the fiscal year ending at the end of March and, although a slowdown is expected for 2024-2025, it is expected to remain robust, buoyed by investments remaining dynamic thanks to rising production capacity utilisation rates and the financial consolidation of companies and banks. In addition, inflationary pressures have eased over the last twelve months (+5.1% y/y in February), even though risks are on the rise (due to climate events and geopolitical pressures).

A MORE ROBUST BANKING SECTOR THAN TEN YEARS AGO

Over the past decade, the government has adopted two measures that have helped the banking sector to recover: implementing the Insolvency and Bankruptcy Code in 2016 and creating a bad bank (which came into operation in 2023). In September 2023, the non-performing loan (NPL) ratio stood at 3.2% of total loans, compared to 10.8% five years earlier. Although public banks are still fragile (the NPL ratio stood at 4.4% in September 2023), their solvency ratios are satisfactory (the Capital Adequacy Ratio stood at 15.2% in September 2023) and publc banks are not expected to need a capital injection to cope with a domestic or external shock, according to the most recent stress tests by the Reserve Bank of India (RBI). Along with the consolidation of banks, growth in credit supply has accelerated significantly (+20.5% y/y in February 2024). Although outstanding credit has remained modest, it has risen by five percentage points over the past five years to 56.7% of GDP in February 2024. According to the Bank for International Settlements, private sector debt remains contained (household debt and corporate debt amounted to 37.2% and 54.7% of GDP, respectively, in Q3 2023). Companies' financial situations are much more robust than ten years ago (their debt remained contained at 72.1% of GDP and their pre-tax profits were enough to cover their debt servicing costs 5.3 times, compared to three times a decade ago). However, the rising household debt levels should be monitored, as households have variable-rate debt. Nevertheless, their overall financial position is still generally good. Their financial assets were enough to cover the value of their liabilities 2.7 times in March 2023.

MAJOR STRUCTURAL CHALLENGES REMAIN

Despite real improvements over the last five years, the country is still facing many structural challenges: i) public finances are still notable for their high level of debt (83% of GDP), some of the lowest budgetary revenues in Asia, which barely exceed 9% of GDP (despite VAT being adopted in 2017), and an interest burden on debt that consumes more than 39.2% of revenues and reduces the budgetary leeway for spending on research and development, infrastructure, education and healthcare; ii) the structurally low level of FDIs (0.8% of GDP in 2023, compared to 1.6% in Indonesia and 2.1% in Malaysia); iii) weak governance; iv) a high exposure to climate risk and v) low employment levels.

Regarding this last point, the strong growth in the youth population is often viewed as one of the key drivers of the growth in India's economy. According to UN forecasts, the proportion of the working age population (15-64 years old) is expected to continue rising until the middle of the century (compared to China, where it has been decreasing since the beginning of the 2010s). In 2023, the median age in India was estimated to be just over 28 years old, according to the UN, while it stood at 31 years old in Malaysia, 33 years old in Vietnam, 39 years old in China and 40 years old in Thailand. However, India is currently not managing to exploit its demographic advantage. Although the employment rate has been rising over the past two years, it only stood at 37.9% in March

INDIA: SIGNIFICANT IMPROVEMENT IN THE QUALITY OF BANK ASSETS

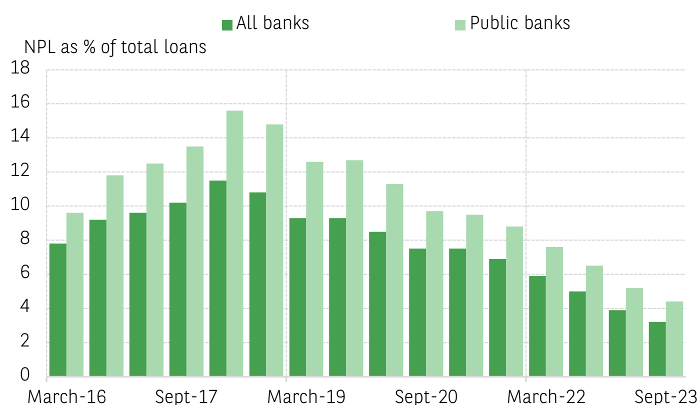

CHART 2 SOURCE: RESERVE BANK OF INDIA, BNP PARIBAS

2024, which is still below its pre-pandemic level (39.8% in March 2020), according to the Centre for Monitoring Indian Economy (CMIE). This low employment level is due to a particularly low levels of activity among women and young people. According to the most recent public survey, the female participation rate stood at just 35.1%, while it was 76.4% for men. The share of young people who are not in a job, looking for work or in training is particularly high. According to the International Labor Organization (ILO), it hit 23.5% in India in 2023, which is similar to the rate in Indonesia (22.3%), but well above the prevailing level in other Asian countries (10.2% in Malaysia, 11.3% in Vietnam and 13.3% in Thailand). The unemployment rate among India's young people is particularly worrying. In December 2023, it likely hit (according to the CMIE) 45.4% for 20-24-year-olds and 15.5% for 25-29-year-olds, while the national average was 7.6% in March 2024.

THE MANUFACTURING SECTOR IS STILL HARDLY GROWING

One of Narendra Modi's stated goals was to make India the new factory in the world, by developing its manufacturing sector. Despite the measures taken to attract foreign direct investment (opening up many sectors to foreign companies and slashing corporate tax rates in 2019) and to boost highly labour-intensive sectors through Production Linked Incentive Schemes that have been in place since 2020, the manufacturing industry's share in the country's value-added has not increased. In fact, it has actually decreased slightly. It stood at just 16.9% during 2022-2023, compared to 17.2% in 2013-2014. In addition, apart from specific business segments, such as cars, pharmaceuticals and textiles, activity is barely growing in other sectors. However, industrial development is seemingly essential in order to meet the huge job creation needs. The share of employment in the manufacturing sector is still low (12% of total employment in 2023, according to the most recent survey) and has fallen by 0.5 percentage points over the last five years. By contrast, manufacturing employment stood at 28.7% in China (in 2020) and 21.4% in Vietnam, according to the ILO.

Whoever is elected to form a government on 4 June 2024 will not only have to continue the reforms undertaken, but also get them implemented more quickly.

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INDONESIA

NEW PRESIDENT PRABOWO INHERITS A STRONG ECONOMY

Subianto Prabowo will become the new President of Indonesia on 20 October. He will inherit a strong economy with robust and stable growth (5.1% on average over the last ten years, excluding the COVID-19 period), a low fiscal deficit, moderate public debt and sound external accounts. However, there are major challenges ahead for the new President. In the next decade, the country's demographic dividend will begin to fade. He will need to adopt reforms more quickly in order to get significantly more young people and women into employment and attract more foreign direct investment. Without this, Indonesia will become an "old" country before it becomes a "high income" country.

A NEW PRESIDENT THAT FOLLOWS THE SAME PATH AS THE PREVIOUS ONE

Subianto Prabowo, who had already been a presidential candidate in 2014 and 2019, won the presidential elections in February in the first round.

The future government is expected to follow a similar foreign policy to Joko Widodo's government. However, future President Prabowo is seemingly more ambitious for his country, both economically and politically on the international stage. The former general, who made a point of putting "national security" at the forefront of his campaign, is expected to continue his defence spending commitments from his time as Minister of Defence. He is also possibly expected to be more receptive to the United States' security interests in the region, as the United States and Europe are its main arms suppliers.

At the same time, the future President is aspiring to make his country a key economic player in Asia. In order do this, he will look to attract investments from China (its biggest investor behind Singapore) and penetrate this market. However, this "multi-alignment" could be difficult to sustain should there be stand-offs in the South China Sea, as Indonesia's economic and nationalist objectives would then run counter to each other.

A STRONG ECONOMY

The government, which will officially take office next autumn, will inherit a strong economy.

Since 2014, apart from the years of the COVID-19 pandemic, economic growth has remained robust and stable. It has reached 5.1% per year on average over the last ten years (excluding the pandemic period). In 2024, it is expected to remain dynamic, despite slowing down slightly to 4.9%, before rebounding to 5.1% in 2025, once the uncertainties surrounding the change of government have passed. In the short term, the main risks to the economy are linked to the international environment.

Inflationary pressures have accelerated slightly since the beginning of 2024. They stood at 3% year-on-year (y/y) in March 2024 compared to 2.6% in January, a rate which is still short of the new target set by the monetary authorities (2.5% +/- 1pp since 1 January 2024). This slight acceleration is mainly due to rising food prices, as well as a slight upturn in prices excluding energy and food (+1.8% y/y).

Even though the rising inflationary pressures are under control, they could restrict Bank Indonesia's monetary easing plans. Its monetary policy is already being constrained by the United States' monetary policy. The prospect of the Fed postponing its decision to cut its key rates (initially expected in June 2024) has led to capital outflows and a 4.6% depreciation of the rupiah against the dollar since the start of the year. The yield spread between Indonesian and US government bonds narrowed over the first three months of the year.

Despite the recent downward pressures on the rupiah, Indonesia's external accounts are sound. In 2023, after two years of surplus, the current account balance fell back into negative territory as a result of a drop in the value of goods exports caused by falling exported commodity prices (-25.3% for palm oil and -56.4% for coal). However, the current account deficit is still very small, standing at 0.1% of GDP, partly thanks to rising tourism revenue. In addition, foreign direct investment (FDI) flows were sufficient to cover the entire current account deficit. The deficit is expected to increase slightly over the next three years, unless the prices of commodities exported by Indonesia rise sharply

FORECASTS

	2021	2022	2023e	2024e	2025e
Real GDP growth (%)	3.7	5.3	5.0	4.9	5.1
Inflation (CPI, year average, %)	1.6	4.2	3.7	3.0	2.4
Gen. Gov. balance / GDP (%)	-4.6	-2.4	-1.7	-2.3	-2.9
Gen. Gov. debt / GDP (%)	40.7	39.7	39.2	38.8	39.0
Current account balance / GDP (%)	0.3	1.1	-0.1	-0.5	-0.5
External debt / GDP (%)	34.9	30.1	29.7	29.7	29.4
Forex reserves (USD bn)	131	124	133	128	130
Forex reserves, in months of imports	7.4	5.6	5.9	5.7	5.8

TABLE 1 — e: ESTIMATES & FORECASTS. SOURCE: BNP PARIBAS ECONOMIC RESEARCH

INDONESIA: REAL GDP GROWTH IS ROBUST EXCLUDING DURING THE COVID

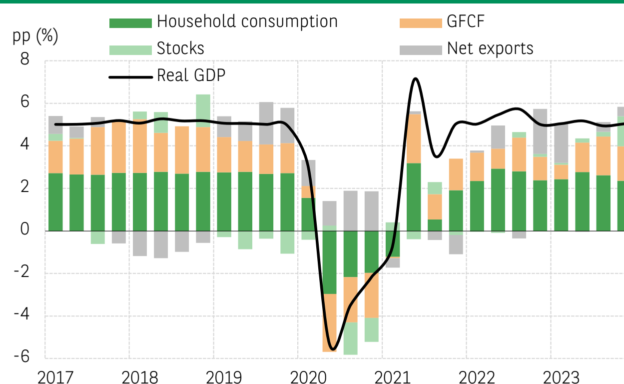

CHART 1 — SOURCE: CEIC, BI, BNP PARIBAS

thanks to the geopolitical climate. However, there should still be enough FDI flows to cover the current deficit.

The recent downward pressures on the rupiah are not a cause for concern. Despite contracting slightly since the start of the year, foreign exchange reserves reached USD 130.4 billion in February 2024 (i.e. 5.9 months of imports) and overwhelmingly covered the external debt repayments that would be falling due over the next 12 months (USD 69.8 billion). External debt is still low (29.7% of GDP). Even though the country is still exposed to volatile capital outflows, the central bank has enough foreign exchange reserves to contain the depreciation of the rupiah. In addition, the stock of portfolio investments held by foreign investors is lower than five years ago (20.1% of GDP in Q4 2023, compared to 26.7% in 2019).

One of the main risks identified since Subianto Prabowo's election is a slip in the fiscal deficit. His campaign rhetoric suggested that his fiscal policy could be much less conservative than his predecessor's. In particular, he promised substantial measures for students, which will cost an estimated 2% of GDP, even though the country's fiscal leeway is limited. Government receipts are still low (13.3% of GDP) and interest payments on government debt are consuming 16.6% of revenue. The government fiscal deficit and debt are moderate (standing at 1.7% and 39.2% of GDP, respectively, in 2023), but their financing could pose a potential risk. The domestic capital markets are still underdeveloped and the country is still structurally dependent on external financing. Even though the share of public debt held by foreign investors had plummeted due to the central bank's policy of purchasing bonds on the primary market over the 2020-2022 period, it still stood at 37.4% of total debt at the end of 2023.

MAJOR CHALLENGES FOR INCREASING GROWTH

In order to achieve the 7% growth target that Prabawo championed during his election campaign, the new government will have to continue, and even accelerate, the reforms undertaken during the Widodo era. In particular, it must successfully manage to quickly and fully capitalise on the "demographic dividend[1]", which will begin to evaporate in the coming decade. According to projections by the United Nations (UN), the share of the working age population will start to decline from 2030, with the working population growth rate falling below the dependent population growth rate. From 2044, the dependency ratio will fall below 50% and economic growth could then slow down before the country successfully manages to significantly increase the population's income levels.

Since 2014, Indonesia's real GDP per capita (at purchasing power parity) has increased by 2.9% per year on average. For comparison purposes, in South Korea, during its own demographic dividend period (1987-1997), GDP per capita increased by 7.5% per year on average. Therefore, even though Indonesia managed to reach the upper middle-income group of countries in 2019, and then came back into it in 2023 (having fallen out of it during the COVID-19 crisis), its economic growth is now relatively modest compared to previous growth rates recorded in the past in other Asian countries. This reflects the fact that the country is not fully benefiting from its demographic dividend.

INDONESIA: LOW CURRENT ACCOUNT DEFICIT

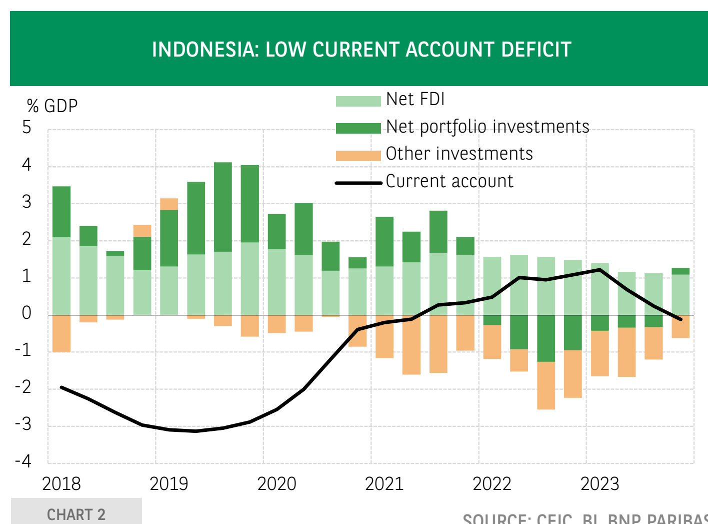

CHART 2

SOURCE: CEIC, BI, BNP PARIBAS

In order to capitalise on its demographic dividend, a country must invest in human capital (education and training) and adopt economic policies that i) promote the extensive use of its labour force (in order to respond to the sharp increase in the labour supply) and ii) aim to attract FDIs.

However, the level of job creation among women and young people remains highly insufficient. According to Statistics Indonesia, the unemployment rates for 15-19 year-olds and 20-24 year-olds were 29.1% and 17%, respectively, in 2022. According to the International Labour Organization, the employment rate for women was 51.7% in 2023, compared to 79.1% among men. In addition, agriculture is still the sector with the largest share of the country's employees (28.2% in 2023), while the share of employment in the industrial sector has been stable over the last decade, standing at 13.8%. It's a similar case for the industrial sector's value added share, which is still small (19.7% in 2023) and has not increased in ten years. To accelerate the pace of job creation, the government must successfully manage to develop the labour-intensive industrial sectors, which involves attracting more FDIs. However, FDI inflows in Indonesia, which are already structurally weak, fell by 0.4 pp in 2023 to 1.6% of GDP, the lowest level recorded in the last five years. This low level is due to cyclical factors (the drop in global liquidity and uncertainty stemming from the February 2024 elections), but also due to Indonesia's low level of integration into global trade. The country's market shares are low (1.1% of global exports) and have barely increased over the past twenty years (+0.2 pp). Its governance is still weak (it was ranked 107th out of 213 countries in 2023) and its working population are inadequately trained. According to the OECD, 42% of 25-34 year-olds have not attained an upper secondary educational qualification. Spending on education is still too low (3% of GDP, compared to 4.8% in South Korea). From a fiscal perspective, the government must optimise its tax structure and increase its revenue in order to meet the needs of young people and achieve its goal of becoming a high-income country by 2045.

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1 Its dependency ratio is less than 50% (the share of the working age population is larger than the share of the dependent population) and working population growth is higher than dependent population growth.

SINGAPORE

THE NEW PRIME MINISTER WILL STAY ON TRACK

On 15 May 2024, Lee Hsien Loong, Singapore's Prime Minister for the past twenty years, will hand over the reins to his current Deputy Prime Minister, Lawrence Wong. This change in leadership is not expected to alter the highly disciplined management of monetary and fiscal policies, or the government's economic development strategy, which is aiming, in particular, to adapt the country to climate change and to boost its potential growth. In 2024, economic activity is expected to pick up slightly, notably thanks to the improving global electronics cycle; inflationary pressures should continue to abate, but will nonetheless remain high. Against this backdrop, the authorities are expected to keep monetary policy settings unchanged this year.

A SLIGHT ECONOMIC UPTURN

After Singapore's activity recovered very strongly in 2021, its economic growth slowed to +3.8% in 2022 and +1.1% in 2023, mainly as a result of global demand weakening, strong inflationary pressures and tighter credit conditions. In 2023, growth in the service sector (73% of GDP) normalized following the post-COVID rebound and slowed to +2.3%. Activity in the goods producing sectors fell by -2.9%, dragged down by the contraction in the manufacturing sector (-4.3%). Activity in the construction sector remained buoyant (+5.2%), but has still not yet returned to its pre-COVID levels.

From a demand perspective, investment, stocks and goods exports were hit really hard by monetary tightening and the downturn in the global electronics cycle in 2022 and 2023. On average over 2023, stocks collapsed, and total investment stagnated (-0.2% in real terms), due to the falling investment in machinery and equipment combined with rising investment in construction and transport infrastructure. Net exports of goods and services contributed positively to real GDP growth, as a result of a stronger fall in import volumes than in export volumes over the first three quarters of the year, followed by exports bouncing back sharply in Q4. Finally, private consumption growth slowed in 2023 (to +3.8%) due to the post-COVID rebound effects fading out, inflationary pressures (which decreased over the course of the year, but were still high) and the impact of the contraction in manufacturing activity on employment and wages. As a matter of fact, the effect of disinflation on purchasing power has been offset in recent months by lower nominal wage growth. Meanwhile, the unemployment rate has remained very low (2% at the end of 2023).

Economic growth will accelerate in 2024. Domestic and external headwinds are easing, but have not vanished completely, however. Moreover, there is still a high risk of further trade and financial shocks in the current international environment. We are expecting real GDP growth of 2.2% y/y, which is relatively modest compared to the pre-COVID period.

Economic activity has started to improve in recent months, aided by the recovery in the electronics cycle in Asia. Industrial production has bounced back and goods exports have picked up, by +0.2% y/y in value terms in Q4 2023 and by +5% in Q1 2024 (after plummeting by -13% y/y over the first three quarters of 2023). These exports are mainly made up of re-exported goods (55% of the total in 2023), non-oil local products (27% of the total, mainly made up of semiconductors) and local oil products (18%). As a matter of fact, electronics are the leading export sector of Singapore, which is also a key oil refining and trading hub.

The recovery in electronics activity seen in Q4 2023 paused into the start of 2024 (production and exports), but it is expected to pick up again quickly (and moderately), in line with the forecasts of improved global demand in this sector. This should have positive knock-on effects on the rest of the economy, stimulate investment and encourage restocking in the manufacturing sector.

In addition, Singapore is expected to continue to enjoy the gradual upturn in tourism-related activity. Over the twelve months from April 2023 to March 2024, the number of tourists travelling through Singapore Airport (62.5 million arrivals, departures or transits) was up almost 50% y/y, but was still 10% below its 2019 level.

Private consumption growth could regain momentum by the end of the year. Improving labour market conditions should follow the recovery in

FORECASTS

	2021	2022	2023e	2024e	2025e
Real GDP growth, %	9.7	3.8	1.1	2.2	2.2
Inflation, CPI, year average, %	2.3	6.1	4.8	3.1	2.0
Budget balance / GDP, % (1)	-0.8	-0.3	-0.5	0.1	0.5
Gross government debt / GDP, %	133	157	171	175	180
Current account balance / GDP, %	18.0	19.3	19.5	21.0	20.0
Forex reserves, USD bn	418	289	351	403	455
Forex reserves, in months of imports	7.9	4.7	6.1	6.5	6.9

TABLE 1 e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH
(1) FISCAL YEAR FROM APRIL 1ST OF YEAR N TO MARCH 31ST OF YEAR N+1

SINGAPORE: ECONOMIC GROWTH GETTING BETTER

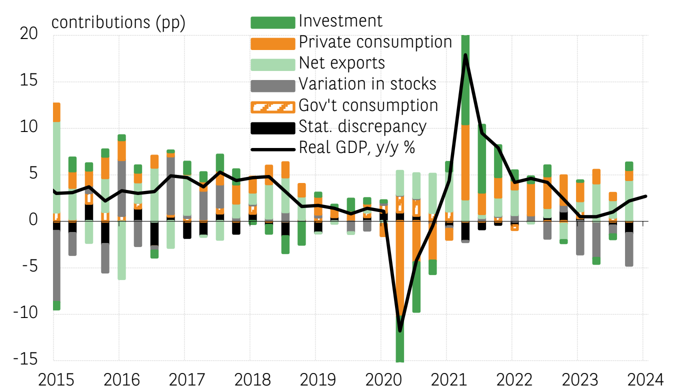

CHART 1 SOURCE: SINGAPORE DEPARTMENT OF STATISTICS, BNP PARIBAS

manufacturing activity, and inflation should continue to decline slowly. Conversely, private demand could continue to be dampened by restrictive monetary conditions.

NO MONETARY POLICY EASING IN SIGHT

Consumer price inflation hit record highs in the final few months of 2022 and early 2023, and has eased since. The increase in the CPI index stood at 6.1% on average in 2022, then at 4.8% in 2023 and 3% y/y in Q1 2024, compared to an annual average of 1.7% in 2010-2019. Energy price and food price inflation declined during 2023, and core inflation also eased against a backdrop of moderating wage and domestic demand growth. However, core inflation has settled above 3% for a few months (compared to its average of 1.6% in 2010-2019). As a matter of fact, the disinflationary trend has recently been curbed by the hike in the rate of the goods and services tax (+1 pp to 9% in January), rising gas and electricity prices as a result of the hike in the carbon tax, and the new increase in international oil prices. Price hikes for some services are also expected in the very short term. Disinflation is then expected to continue in 2024, with the CPI index expected to increase by 3.1% on average over the year.

The Monetary Authority of Singapore (MAS) quickly tightened its policy in 2022 in response to rising inflation. Monetary policy settings were then kept unchanged in 2023, against a backdrop of disinflation and slowing activity. Going forward, monetary policy easing is not expected before the end of 2024 due to persisting inflationary risks. Singapore uses the exchange rate as its monetary policy instrument (and not interest rates, which is justified by the fact that the high degree of openness of the economy makes it very sensitive to imported inflation). Monetary conditions are tightened or eased through increases or decreases in the appreciation target of the nominal effective exchange rate of the Singapore dollar (SGD) and adjustments in the mid-point of its fluctuation band. Between January 2022 and March 2024, the SGD appreciated by less than 1% against the US dollar (standing at SGD 1.34 per USD in March 2024), but by nearly 10% in nominal effective terms.

Singapore's interest rates rose rapidly in 2022 and H1 2023, before settling at a high level – as a consequence of domestic monetary policy tightening and in line with US and global interest rates. The Singapore Overnight Rate Average (SORA) rose from 0.1% in Q4 2021 to 3.7% in Q3 2023, and has not come down from this historically high level since then. Meanwhile, credit activity has contracted since 2022, affecting all economic sectors. Credit conditions are expected to remain restrictive in the short term.

THE GOVERNMENT CAN PRIORITISE LONGER-TERM GOALS

Fiscal policy has been normalizing over the last two years. The fiscal balance, which had gone into a large deficit during the pandemic, has improved rapidly. It should return to surplus again from the 2024 fiscal year (from April 2024 to March 2025).

As a result, the government can prioritise longer-term objectives, which are as follows: i) increasing social spending (in particular, healthcare, social housing and training), in order to respond to high living costs and increasing demands of an ageing population; ii) support for digitalising the economy and developing new sectors, such as the biomedical and fintech sectors; iii) investments in infrastructure to adapt to climate change, in renewable energy (which currently plays a very small part in Singapore's energy mix) and in low-carbon technologies.

SINGAPORE: STILL TIGHT MONETARY CONDITIONS

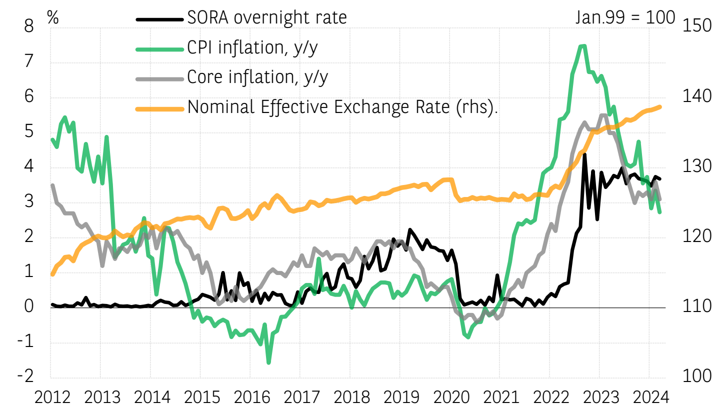

CHART 2 SOURCE: MAS, DEPARTMENT OF STATISTICS, BNP PARIBAS

This strategy aims both to adapt the country to climate change (Singapore is particularly vulnerable to extreme weather events and rising sea levels, with 30% of its territory located under 5 metres above sea level) and reduce its greenhouse gas emissions (with a 2050 Net Zero target), and to limit the structural slowdown in economic growth. This slowdown is mainly due to lower productivity gains and an ageing population. Economic growth is projected to stand at 2.4% per year on average over the next five years, compared to 3.2% in 2015-2019.

Singapore has strong financial and institutional capacity to cope with these challenges. From the financial standpoint, the government has very comfortable headroom for increasing its spending. Public finances are healthy, thanks to strict rules of fiscal discipline that have been followed for a long time. Government gross debt is seemingly high (171% of GDP in 2023). However, on the one hand, no debt can be incurred in order to finance recurring or operating expenses and only a limited proportion of public borrowings is used for investments (in particular, a bond issue programme was launched in 2021 to finance major infrastructure projects, including green projects). Public debt is actually mainly made up of bonds issued for the Central Provident Fund (which is filled by compulsory citizen contributions) and securities issued to be used as benchmarks on the local bond market. On the other hand, the government has very large fiscal reserves and assets, which are higher than its gross debt stock.

From the institutional and political standpoint, Singapore is highly stable and has efficient institutions, which helps with implementing a long-term economic strategy. Indeed, this strategy is not expected to be in jeopardy as a result of the upcoming change at the head of government, the first for twenty years: on 15 May 2024, Prime Minister Lee Hsien Loong will be replaced by the current Deputy Prime Minister Lawrence Wong, who has been the chosen successor since 2022 and is the leader of the "fourth generation" of the PAP (People's Action Party, which has been in power since 1965).

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PERSISTENT TWIN DEFICITS

Romania recorded a softer economic growth in 2023 but remained one of the best performing economies in the region. The short-term outlook is strong. The gradual fall in inflation since the end of 2022 should pave the way for an accommodative but cautious monetary policy. The persistence of twin deficits remains a major concern. So far, the country has been able to rely on a certain resilience in capital flows to partly offset the current account deficit. Fiscal consolidation is one of the government's short-term priorities, although there is limited room for manoeuvre this year given the busy electoral calendar. Public debt is sustainable in the short and medium term.

GOOD ECONOMIC GROWTH PERFORMANCE

In 2023, the Romanian economy experienced the strongest growth in the region at +2.1% on average. By comparison, GDP grew by 1.1% in Slovakia and 1.9% in Bulgaria. Poland narrowly avoided a recession.By contrast, economic activity in the Czech Republic and Hungary contracted by 0.2% and 0.7% respectively.

In Romania, GDP growth nevertheless slowed down markedly in 2023. It was mainly driven by investment, while consumption, which is usually the main driver of growth, made a smaller contribution than in previous years. This was mainly attributed to tighter credit conditions and strong inflationary pressures in the first half of the year.

Economic growth is expected to accelerate over the next two years. Consumer spending will benefit from the fall in inflation, the expected increase in wages and pensions this year, and a relative easing in credit conditions. Retail sales and import volumes have already improved since the end of 2023. Furthermore, if the gain in confidence in industries observed in March (European Commission index and PMI index in the manufacturing sector) is confirmed, industrial production, which has remained sluggish in recent months, should pick up. Public investment will probably be supported by European funds. By contrast, projections for private investment are mixed this year, with projects likely to be postponed while awaiting the forthcoming elections on one hand and the confirmation of the improvement in domestic and foreign demand on the other hand.

Economic activity will nevertheless be constrained by a cautious monetary policy (against a backdrop of strong wage pressures) and by a fiscal policy geared towards consolidating public accounts in the years ahead. It should be noted, however, that a degree of fiscal flexibility is expected this year in view of a pivotal election year.

A CAUTIOUS MONETARY POLICY AHEAD

Inflation, calculated from the harmonised price index, gradually fell to 6.7% y/y in March 2024, after peaking at 14.6% in November 2022. However, this figure is well above regional inflation. By way of comparison, it was 2.7% y/y in Poland over the same period, 2.2% in the Czech Republic and even 3.6% in Hungary, the country with the highest inflation rate in 2023.

Headline inflation is mainly driven by core inflation, with a contribution of 5.4 points. The situation has reversed compared to 2023, with food and energy making a marginal contribution this time. One point to highlight is that year-on-year core inflation has been higher than headline inflation since July 2023. This is mainly due to strong wage pressures. In 2023, the minimum wage was raised twice, from 2,550 lei to 3,000 lei, and then to 3,300 lei last October. Meanwhile, wages across all sectors rose by an average of 14.5% in 2023. In the short term, wage pressures will likely persist, in a context where the labour market remains tight, with a relatively stable unemployment rate of 5.6% over the last twelve months. As a result, Romania is likely to record the highest inflation rate in the region this year.

Monetary authorities in Romania have adopted a cautious policy with the key rate being maintained at 7% since January 2023. In the short term, the central bank is likely to move towards monetary easing.

FORECASTS

	2021	2022	2023e	2024e	2025e
Real GDP growth, %	5.7	4.1	2.1	3.0	3.1
Inflation, CPI, year average, %	4.1	12.0	9.7	5.6	4.0
General gov. balance / GDP (%)	-7.2	-6.3	-5.7	-5.4	-5.2
General gov. debt / GDP (%)	48.6	47.2	48.9	50.4	52.2
Current account balance / GDP, %	-7.2	-9.3	-7.0	-6.5	-6.0
External debt / GDP, %	56.7	50.5	52.3	51.8	50.8
Forex reserves, EUR bn	45.8	52.3	66.0	72.0	77.0
Forex reserves, in months of imports	5.9	5.3	6.9	7.1	7.3

TABLE 1 e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

ROMANIA: INFLATION

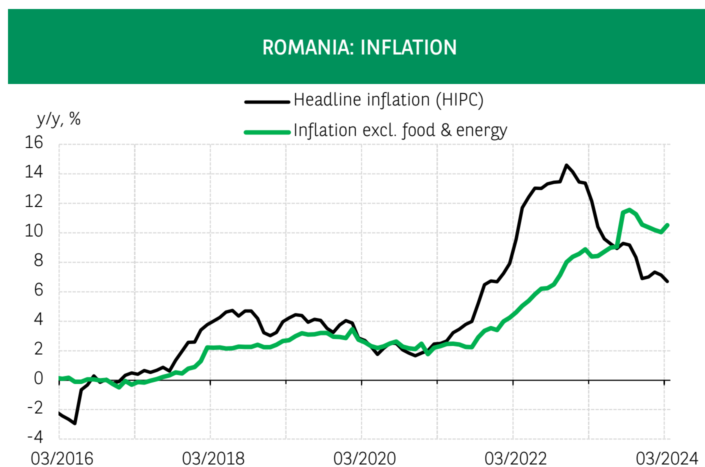

CHART 1 SOURCE: EUROSTAT, BNP PARIBAS

However, it will probably be measured, given strong wage pressures alongside with an inflation, which is still expected to be well above the official inflation target (1.5-3.5%) this year. By comparison, Hungary and the Czech Republic have already started their monetary easing cycle. The Central Bank of Poland, by contrast, has returned to a monetary status quo since the end of 2023, after two key rate cuts in September and October.

A BUSY ELECTION YEAR

This year's political calendar is packed with the European and local elections, followed by the presidential elections (first round on 15 September and second round on 29 September). But the main focus will be on the parliamentary elections scheduled in December. The interpretation of opinion polls on the parliamentary elections is premature at this stage, but whatever the outcome of the elections, the reforms currently under way should continue. Romania, which has been a member of the European Union since 2007, has made significant progress in terms of convergence (GDP per capita at 72% of the EU average) and is pursuing its integration within the EU. Indeed, it partially joined the Schengen area on 31 March 2024. The future government will also face serious challenges in terms of both public and external accounts.

A HIGH CURRENT ACCOUNT DEFICIT BUT PARTLY OFFSET BY FDI INFLOWS

The current balance is structurally in deficit. The deepening in the deficit observed in 2021 and 2022 was led by a deterioration in the energy balance. In 2023, it remained at a level well above the pre-Covid-19 period, although it fell slightly due to an easing in commodity prices. In the short term, the deficit is unlikely to improve significantly due to the expected rise in imports, driven by the improvement in consumption and investment.

The current account deficit has been deteriorating for several years, but has largely been covered by capital inflows, especially foreign direct investment (FDI) and European funds. In 2023, net FDI inflows covered 28.8% of the current account deficit. The coverage ratio rises to around 60% when European funds are included. In addition, foreign exchange reserves have continued to rise since 2019, reaching EUR 66 bn in 2023. In the short term, the country is an attractive destination for FDI inflows and is benefiting from the reorganisation of production activities by euro zone companies (nearshoring). Similarly, portfolio flows (EUR +14.4 bn in 2023) should be supported by relatively high yields in the region.

EXCESSIVE DEFICIT PROCEDURE LIKELY TO CONTINUE

Since 2020, Romania has been under an excessive deficit procedure by the European Commission due to the permanent spending measures introduced by the government in 2019, which has increased the budget deficit. The successive shocks to the Romanian economy have worsened this deficit since 2020. In 2023, the deficit remained significant even though it fell very slightly to -5.7% of GDP (compared with -6.3% in 2022, -7.2% in 2021 and -9.3% in 2020). Last year, the increase in the tax rate for certain companies and the end of tax breaks for certain sectors helped to contain the deficit. The pension reforms, introduced in November 2023, are designed to bring pensions back onto a sustainable path in the medium term. However, this will also lead to an increase in pensions of around 40% in 2024. Similarly, large-scale

ROMANIA: GOVERNMENT DEBT AND FISCAL DEFICIT

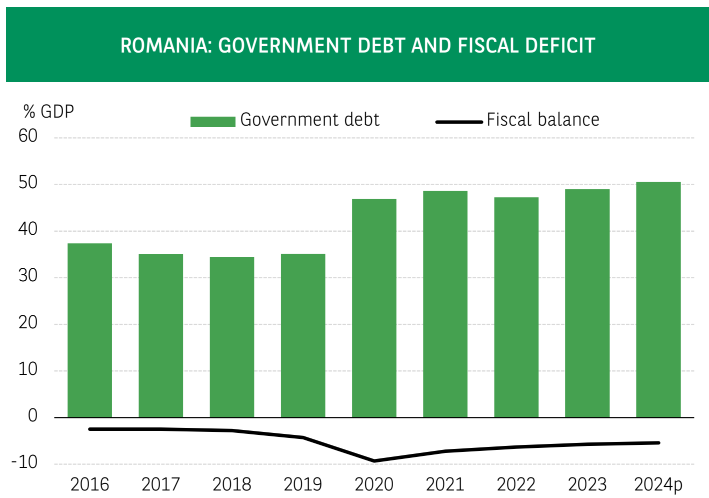

CHART 2 SOURCE: MINISTRY OF FINANCE, EUROSTAT, BNP PARIBAS

consolidation measures are likely to be limited this year, given the large number of elections to be held. As a result, the budget deficit is likely to be around 5% of GDP this year, which means that Romania will inevitably remain under the excessive deficit procedure. The escape clause, which allowed EU Member States to deviate temporarily from the Stability and Growth Pact during the Covid-19 pandemic, expired in December 2023.

However, financing the budget deficit is not a major problem, due to the inflow of European funds and a certain resilience of foreign demand for domestic debt. Public debt is sustainable in the short to medium term and is not expected to exceed 60% of GDP over the next five years. Fiscal consolidation could accelerate after the elections, given Romania's commitments under EU's Stability and Growth Pact. In the short term, broadening the tax base is a priority, especially as tax revenues as a share of GDP are structurally low (31% of GDP in Romania in 2023, compared with 39.8% in Poland and 41% in the Czech Republic).

Despite an increase in funding costs on bond markets over the last two years, the interest burden on the debt expressed as a percentage of tax revenues was contained at 5.9% in 2023. One point of caution concerns the size of the government's foreign currency-denominated debt, which accounted for 53.8% of the total in 2022 (25.4% of GDP). However, the relative stability of the Romanian exchange rate against the euro (as part of an administered exchange rate regime) limits the government's

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TURKEY

THE CALM AFTER ELECTIONS

Since the local elections on 31 March, financial conditions have stabilised. Markets reacted favourably to the defeat of the ruling party at local level. The result of the elections is not expected to change the economic stabilisation programme of Finance Minister Mehmet Şimşek. The Monetary Policy Committee maintained its key rate at its last meeting in April, a rate which it had raised again in March. Household consumption continues to drive growth, which will remain sustained this year unless fiscal policy becomes very restrictive, which is unlikely. The rebalancing of growth components is underway, although it is not yet sufficient to curb the non-energy current account deficit.

EASING OF FINANCIAL MARKETS AFTER THE ELECTIONS

Since the local elections on 31 March, financial conditions have eased in Turkey. The USD to TRY rate has stabilised at around 32, while it had depreciated by 9% between January and March. The main index of the Istanbul Stock Exchange (BIST 30) has gained 9% (in local currency) since the end of March. The 5-year CDS maturity spread remained stable, at below 300 basis points, a level attesting to a stronger investor confidence in Turkish sovereign risk. Only yields on 10-year government bonds (26%) remain as high as they were before the elections. But this can be explained by an inflation still very strong (68.5% y/y in March 2024) and monetary tightening; the policy rate of the central bank (TCMB) was raised to 50% on 22 March (compared to 8.5% on 22 June 2023).

The AKP, the party of President R.T. Erdogan, is weakened after the local elections. The Kemalist CHP party, the main opposition party, won 37.7% of votes compared to 35.5% for the AKP. The major cities (Ankara, Istanbul) remained in the hands of the CHP, and the number of municipalities controlled by the AKP fell from thirty-nine to twenty-four.

The markets therefore reacted favourably to this defeat of the ruling party at local level. The result of the elections is not expected to change the economic stabilisation programme of Finance Minister Mehmet Şimşek. In addition, the BCRA's Monetary Policy Committee maintained its key rate at its last meeting in April. In this context, the rebalancing of growth components is underway, although it is not yet sufficient to curb the non-energy current account deficit.

ECONOMIC GROWTH IS DOING BETTER THAN JUST HOLDING UP

In Q4 2023, growth was still dynamic at 1.0% Q/Q (4.8% y/y), mainly thanks to sustained household consumption (3.6%) despite the acceleration in inflation. The balance of foreign trade also contributed to growth, albeit only slightly (+0.3 percentage points). Investment, on the other hand, fell (-0.8%), but after a very strong increase in Q1-Q3 2023 (+11%) and also in previous years. It should be noted that investments in machinery and capital goods (measured at constant prices) and imports of non-automotive capital goods (measured in dollars) were 80% higher at the end of 2023 compared to the end of 2019, an unparalleled performance among OECD countries.

In Q1 2024, growth held up very well. On average over January-February, manufacturing production was up 3.5% compared to Q4 2023 (after +2.5% in 2023on year average) and, over January-March, automotive production rose by nearly 6% (after +8.6% in 2023 on year average). Credit card payments, which have contributed significantly to the momentum of household purchases since mid-2021 (see Chart 1), still showed spectacular growth of 40% over a year in real terms. In addition, according to statistics for the official average hourly wage for the entire economy, the catch-up in purchasing power since 2023 has continued, with a further, very significant revision of the minimum wage.[1] At the same time, public consumption and investment may have once again contributed to growth (see below). On the other hand, exports, measured in dollars, shrank by 1% q/q, and private capital investment is expected to have contracted once again. The downward correction in capital

FORECASTS

	2021	2022	2023e	2024e	2025e
Real GDP growth, %	11.4	5.5	4.5	3.0	3.0
Inflation, CPI, year average, %	19.6	72.3	53.9	56.2	28.7
Gen. Gov. balance / GDP, %	-2.8	-1.0	-5.2	-4.8	-3.5
Gen. Gov. debt / GDP, %	37.9	26.9	25.6	25.0	25.0
Current account balance / GDP, %	-0.9	-5.4	-4.0	-3.0	-2.0
External debt / GDP, %	53.3	50.6	45.1	42.1	41.0
Forex reserves, USD bn	72.5	83.0	93.0	98.0	103.0
Forex reserves, in months of imports	3.1	2.6	2.9	3.0	3.0

TABLE 1 e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

TURKEY: HOUSEHOLD CONSUMPTION

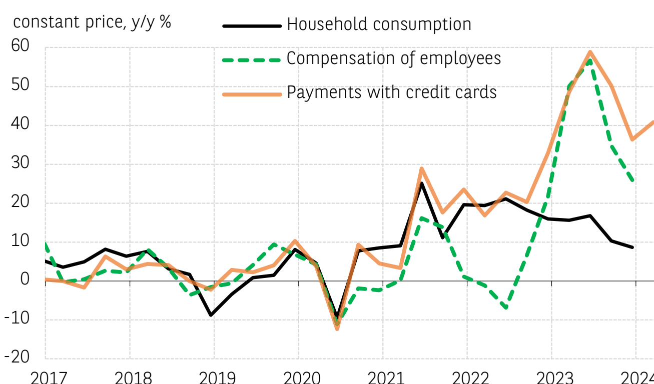

CHART 1 SOURCE: TURKSTAT, TCMB, BNP PARIBAS

1 The minimum wage was revised from 50% on 1st January 2024 (multiplied by 2 over a year) to TRY 20,002 per month, i.e., EUR 580.

goods imports continued over January-February and, according to the TCMB survey indicator, investment intentions continued to weaken, although they remain at a historically high level.

Ultimately, growth is likely to remain positive in Q1. Also, for the whole year, in a scenario of a decline in monthly inflation already observed (3.3% in March compared to 4.3% in January)[2] and stabilisation of the lira, allowing the central bank to ease its tightening a little, GDP growth should be at least 3%, unless fiscal policy becomes very restrictive, which is unlikely.

CONTROLLED BUDGET SLIPPAGE

The anticipated budgetary slippage throughout last year, following revision of the budget in June 2023 and publication of the Medium-Term Economic Plan (MTEP) in September, ended up happening at the very end of the year. The central government deficit stood at 5.2% of GDP in December, compared to just 2.7% in September. At the end of March 2024, in cumulative terms over twelve months, it reached 5.4%. Nevertheless, it is twice as low as a major research institute, the TEPAV, had feared a year ago. Moreover, the accounts published by the Ministry of Finance are on an accrual basis and not on a cash basis. These accounts consider expenditure commitments for 2023, whether disbursed or not. The budget implementation published by the Treasury, which is, conversely, based on actual disbursements, also shows a slippage, but from a much lower level (from 2.4% at the end of 2023 to 3% in March). In Q1 2024, expenditures excluding interest increased by 16% in real terms compared to Q1 2023. However, there is no acceleration compared to 2023 as a whole (excluding December).

For 2024, the MTEP target is 6.4% (including earthquake-related expenses). In theory, this target is quite credible. However, there are two reservations regarding changes to public finance metrics. Firstly, the weight of interests on debt has increased significantly, from 1.9% of GDP (11% of income) in March 2023 to 2.7% (respectively, 13.6%) one year later. However, this deterioration is not a matter for concern. Secondly, the central government's debt does not take into account expenditures incurred in relation to the earthquake (as these have not been disbursed).

By the end of March, debt represented just 25% of GDP. If we add the 2.4 points of GDP difference between the deficit based on commitments and the deficit based on cash and, taking into account our deficit forecast for 2024 (4.8%), an assumption of nominal GDP growth of 60% and an appreciation of the lira's real exchange rate of just over 20% (against a USD-EUR basket), the ratio will remain unchanged at 25% of GDP. For 2025, fiscal consolidation is expected to be more marked, with a primary balance sheet in equilibrium compared to -1.8% of GDP in 2024.

STABILISATION OF EXTERNAL ACCOUNTS NOT YET COMPLETED

The TCMB's foreign exchange reserves have stabilised since the local elections (see Chart 2). These reserves had been eroded over the first three months of the year, not due to a deterioration in the balance of payments, but as a result of stronger demand for dollars from residents and a reduction in the position of fx swaps of the commercial banks with the Central Bank.

TURKEY: CENTRAL BANK (TCMB) INTERNATIONAL RESERVES

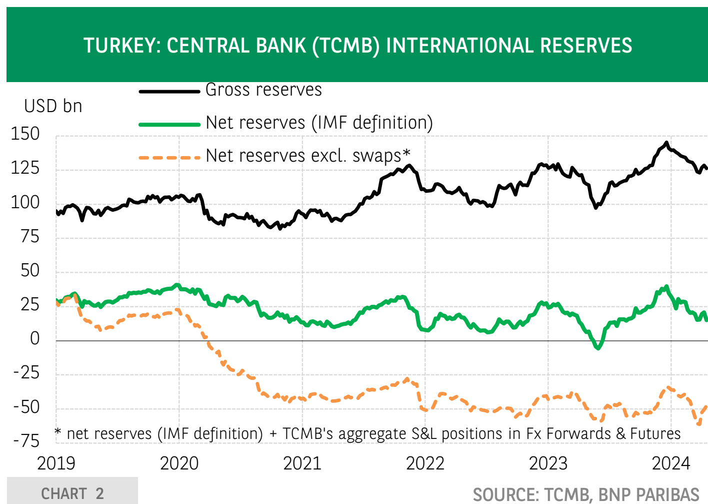

CHART 2 SOURCE: TCMB, BNP PARIBAS

In February, and in cumulative terms over 12 months, the current balance deficit fell to USD 32 billion (2.8% of GDP), a division by two compared to its peak in spring 2023. This improvement can only be explained by a lower deficit in the balance of "gold & energy" items, which shrank from 10% to 6% of GDP. However, the trade balance of other products, the trade balance of services (dominated by tourism revenues, which reached USD 40 billion over 12 months) and the trade balance of revenues, aggregated, still show a major surplus.

The expected decline in the errors & omissions item was offset by the surplus of the balance of portfolio investments. On the other hand, in Q1 2024, residents' deposits covered by the currency risk protection mechanism (KKM) were predominantly transferred to dollar deposits despite the rise in interest rates on deposits in TRY. In mid-April, the equivalent of USD 70 billion remained in deposits not yet transferred (and therefore still held in TRY). With the tourism season, it should be possible for the current account deficit to stabilise at around 2.5% of GDP. If so, this should support the recent stability of the lira and favour transfers from KKM deposits to deposits in TRY.

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2 Over a year, the peak in inflation should be reached in May (slightly above 70%), to end up at around 40% in December.

BRAZIL

RESISTING THE PULL OF A DOWNTURN

After stagnating in the second half of 2023, economic activity has strengthened in recent months, supported by a surprisingly resilient labor market, amongst other. This good start to the year was however not overtly obvious given the divergence of many indicators. The pace of rate cuts is expected to slow down in the second half of 2024. Monetary easing is indeed coming up against slower-than-expected disinflation and upside risks to inflation expectations. The latter have been dented by the revision of the budgetary targets for 2025-28 and a more pronounced interventionism by the State, anxious to revive investment. The annual G20 summit in November and COP30 next year will provide an opportunity for Brazil to strengthen its leadership of the Global South in support of issues pertaining to the environment, poverty alleviation and redistribution.

ECONOMIC PERFORMANCE DEFIES EXPECTATIONS (ONCE AGAIN)

As has been the case over the past three years, activity indicators in the first quarter performed much better than expected: in the wake of its rebound last December, the leading indicator of GDP (IBC-Br) continued to rise in January and February 2024. Meanwhile, PMI surveys for March indicate an expansion in activity both in services and manufacturing. These prints have undermined a scenario anticipating a cooling down of the economy in the wake of stagnating GDP figures in the second half of 2023. The unprecedented dengue fever outbreak that the country is undergoing since the start of the year (more than 3 million cases recorded) has yet to have a significant impact on GDP growth.

Consumption has been the driving force behind the economic recovery, backstopped by higher transfers[1] and the solid performance of employment. The labour market has yet to show signs of slowing down – defying expectations. In seasonally adjusted terms, unemployment retreated slightly in the first quarter, while average income (in real terms) continued to rise (9th consecutive month of increase in February). These favourable developments explain the solid growth in retail sales as well as that of service activities.

The reading of certain indicators did however cast some doubt over the strength of economic activity, considering the declines in industrial production and consumer confidence (in January and February), as well as the relative slowdown in export volumes (+0.9% in Q1 vs. Q4 2023). Besides, there has been no particular uptick in lending (real credit growth has been stable at around 3.5% year-on-year, since September 2023). Meanwhile, the stock market (-15% in dollar terms) and the currency (-7.5% against the dollar) have suffered setbacks – underperforming most other major emerging markets and net oil exporters since the start of the year. In the first two months of the year, the equity market recorded nearly USD 3.6 bn in net capital outflows from non-residents.

FORECASTS

	2021	2022	2023	2024e	2025e
Real GDP growth, %	5,1	3,1	2,9	2,2	2,0
Inflation, CPI, year average, %	8,3	9,3	4,6	4,1	4,1
Fiscal balance / GDP, %	-4,3	-4,6	-8,9	-7,1	-6,9
Gross public debt / GDP, %	77	72	74	77	80
Current account balance / GDP, %	-2,8	-2,9	-1,3	-0,7	-1,3
External debt / GDP, %	42	36	37	42	40
Forex reserves, USD bn	362	324	355	348	350
Forex reserves, in months of imports	14	11	12	13	12

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

BRAZIL: CONTRIBUTIONS TO REAL GDP GROWTH (PERCENTAGE POINTS)

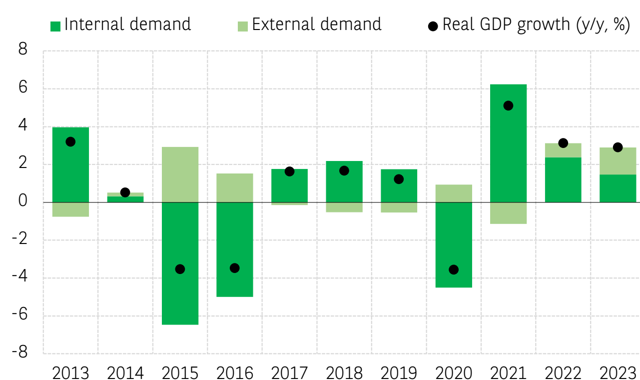

CHART 1 SOURCE: IBGE, BNP PARIBAS

MULTIFACETED BUDGET SUPPORT

The solid performance of activity in Q1 has led us to revise our GDP growth forecast upwards for this year (2.2% vs. 1.8% previously). The stronger start to the year has in particular been a welcomed development for public accounts (the government recorded a surplus of BRL 5 bn in tax revenues compared to initial forecasts over the first two months of the year). This additional boost is expected to help the government achieve the primary balance target (excluding interest payments) set by the new fiscal framework (zero deficit target in 2024 with a tolerance of 0.25 percentage points of GDP). However, Lula – whose popularity has taken a hit in recent months and who will, later this year face his first electoral test (municipal elections in October)

1 Advanced payments of extra salaries for pensioners and settlement of judicial payment orders owed by government entities to individuals and companies (*precatorios*).

– is keen to further stimulate domestic demand[2]. The Head of State has already announced i/ a new financing program to support microenterprises and microentrepreneurs (*Programa Acredite*), as well as ii/ a subsidy program (*Mover*) for the automotive industry to stimulate, among other things, the national production of electric vehicles (nine car manufacturers have already announced investments of USD 17 bn by 2030). The government is also looking into supporting households with their electricity bills.

Aside from the introduction of a tax on offshore investment funds, the government, however, has struggled to increase revenues for the long haul. Several government initiatives have had a hard time moving forward in Congress or have been suspended until after the elections (e.g. creation of a dividend tax or modification of the income tax). At the end of March, the Ministry of Planning and Budget therefore announced the freezing of BRL 2.9 bn (USD 581 mn) of discretionary spending. The budgetary targets set in the Project for the Annual Budget Law (PLOA) for 2025 have also been revised in order to spread the fiscal effort over time (ie. provide greater room to maneuver in the short term) : amongst the changes put forward, the primary surpluses targeted for 2025 and 2026 (0.5% and 1% of GDP) were adjusted down by 0.5 and 0.75 points of GDP respectively. The target of achieving a 1% surplus was ultimately postponed to 2028.

Given these obstacles, Lula in recent months, has showcased greater levels of interventionism with large groups (Petrobras, Vale, Braskem) in the hope of reviving investment[3]. For example, the government, which owns roughly 37% of Petrobras, tried to spur the oil-giant to waive dividend payments to investors so the company would be better positionned to both invest and absorb the cost associated with a rise in oil prices (to keep prices low at the pump).

SLOWER THAN EXPECTED RATE CUTS

Despite the cumulative 300 basis point rate cut since August 2023, and the cuts to come this year, monetary policy is likely to remain in restrictive territory[4] – at least as long as private operators' medium-term inflation expectations remain above the BCB's target. The government's ambiguity with regard to its budgetary objectives and Lula's renewed interference in certain large companies are weighing on expectations but also on the currency – which, in addition, has suffered from a strengthening dollar. The weakening of the currency (and its effect on imported inflation), the escalation of geopolitical tensions and their effects on commodity prices, as well as slower monetary easing in advanced economies are constraining the reaction function of the Brazilian monetary authorities. These considerations, in addition to local factors, are slowing down the disinflationary process (e.g. prolonged effect of El Niño on food prices, accelerating inflation in the service sector, persistence of wage pressures and a rate of unemployment below the NAIRU rate[5]).

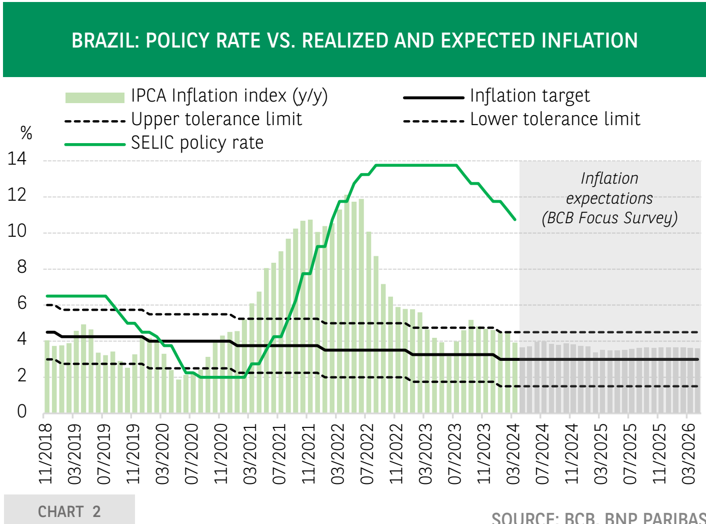

CHART 2 SOURCE: BCB, BNP PARIBAS

In view of this context, and in order to give itself greater room to manoeuvre in the coming months, the BCB has shortened the horizon during which it provides indications on the future direction of its monetary policy (forward guidance). It announced a further half-point cut to the SELIC rate at the next meeting in May, without however vocalizing its position beyond that. Market participants have thereby adjusted their expectations and are now anticipating smaller rate cuts in the second half of the year. The change in the profile of the BCB's monetary policy council (COPOM) at the end of the year (Lula appointing the new governor in particular) should, through its effects on inflation expectations, be another point of vigilance for the markets in H2.

BRAZIL IN THE SPOTLIGHT

Brazil holds the rotating presidency of the G20 and will hold its annual summit in November 2024 in Rio de Janeiro. A year later, the country will host the UN Climate Change Conference (COP 30) in Belem in the Amazon. In addition to issues surrounding the decarbonization of economies, the main themes likely to occupy the agenda include the fight against poverty and inequality, the reform of international taxation and the representation of the Global South in international financial governance. The formation of a Global Alliance against hunger and poverty as well as the proposal for the introduction of a global tax on the super-rich are amongst some of the initiatives already proposed by the government. In its quest to define the contours of a new, more redistributive globalization, Brazil will have the daunting task of building consensus in a context of growing geopolitical divergences.

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2 Especially since the contribution of external demand to GDP growth is expected to be much more modest this year, perhaps even negative after having been responsible for half of the GDP growth in 2023.
3 In 2023, investment recorded a negative contribution to growth of 0.6 percentage points and the investment-to-GDP ratio reached the same level as during the Covid-19 pandemic in 2020 (16.5%).
4 The ex-ante real rate (nominal interest rate minus expected inflation for the next 12 months) remains a few points higher than the neutral rate (rate compatible with an economy at equilibrium) estimated between 4.1% and 5.5% according to a study by the BCB.
5 The realized unemployment rate (7.7% in February) is about one percentage point below the *non-accelerating inflation rate of unemployment (NAIRU)* which most economists estimate to be in the range of 8.5% to 9.5%.

CHILE

A BUSY POLITICAL AGENDA

Chile's economic growth stabilised during the second half of 2023, inflation eased and the current account deficit fell. The expected upturn in activity in 2024 should ensure that growth comes close to its potential, driven by household consumption, private investment and mining exports. Political pressures have eased after the decision to suspend the process of adopting a new Constitution (which is expected to be left alone for a number of years). Nevertheless, Gabriel Boric's government and the opposition parties are still clashing on a number of areas, most notably, fiscal reform, pension system reform and the energy sector framework law.

A RETURN TO GROWTH

Investment and private consumption were adjusted downwards in the final quarter of 2022 and in the first half of 2023, after the emergency measures introduced in 2020-2021 were brought to an end and real GDP fell for three consecutive quarters. Activity stabilised starting from the second quarter of 2023, with real GDP growing by 0.6% and 0.4% y/y during Q3 and Q4, respectively. In the end, economic growth stood at 0.2% for 2023.

The short-term outlook is brighter. Expected real GDP growth for 2024 is nearly 2%, thanks, in particular, to the upturn in private consumption and mining exports. The rapid disinflation process (inflation slowed to 7.6% y/y in 2023, after 11.6% in 2022, and continued to ease during the first few months of 2024, taking it to 3.2% y/y in March 2024) is expected to lead to higher real incomes. At the same time, the (aggressive) monetary easing cycle is continuing (since July 2023, the Central Bank of Chile has already cut its key rate by 480 bp to 6.5% as at the start of April, and further cuts are expected in the short term). This should improve access to credit for both consumers and investors. At the same time, investment and exports will benefit from increasing demand for Chilean mining products (mainly copper and lithium), as well as green hydrogen. However, the risks are still on the downside. In particular, political tensions could result in continued stalemates over reforms and could hurt consumer and investor sentiment.

A PERIOD OF REFORMS

Since coming into office in March 2022, President Boric and his government have been vocal about their desire to introduce a large number of reforms. A number of bills have been introduced (most notably on pension-system reform and accelerating the energy transition), but the various Constitutional bills have been the main focus of political debates.

The rejection of two proposed new Constitutions (the first, which was supported by the government but viewed as too progressive, was rejected by 62% of the votes in the referendum on 4 September 2022, and the second, which, conversely, was viewed as too conservative and was denounced by the government, was rejected by 55.8% of the votes in the referendum on 17 December 2023) is emblematic of the polarised political climate in the country and the difficulties faced by both the government and the opposition parties. By mutual agreement, the draft constitution is being put on hold for a number of years (as a result, the current Constitution shall continue to apply for the time being), so that political debates can focus on other areas.

FORECASTS

	2021	2022	2023e	2024e	2025e
Real GDP growth (%)	11.7	2.4	0.2	1.9	2.0
Inflation (CPI, year average, %)	4.5	11.6	7.6	3.3	3.0
Central Gov. balance / GDP (%)	-7.5	1.1	-2.5	-2.1	-1.6
Public debt / GDP (%)	36.3	38.0	39.2	40.5	40.7
Current account balance / GDP (%)	-6.6	-8.7	-3.7	-3.4	-3.3
External debt / GDP (%)	75.0	76.4	74.3	74.1	74.2
Forex reserves (USD bn)	51.3	39.1	46.3	46.3	46.3
Forex reserves, in months of imports	5.3	4.9	7.0	7.5	7.6

TABLE 1 — e: ESTIMATES & FORECASTS — SOURCE: BNP PARIBAS ECONOMIC RESEARCH

CHILE: INFLATION AND POLICY RATE

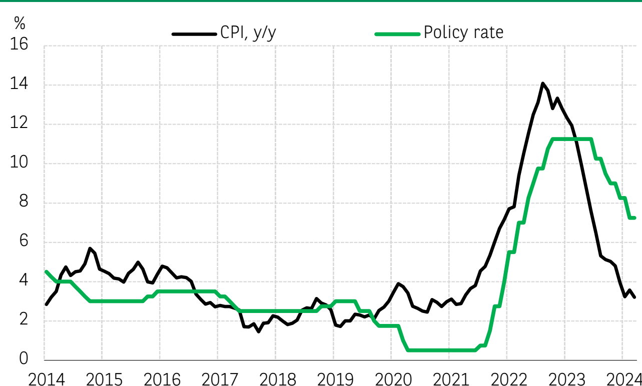

CHART 1 — SOURCE: CENTRAL BANK, BNP PARIBAS

Political pressures are expected to remain high over the coming months and further difficulties could arise for the government: there are high expectations from the public, but the President and the government are unpopular, while the opposition parties have a majority in the Senate, which has already restricted the government's efforts to introduce reforms since coming into office.

What's more, the government does not have long to push ahead with its key reforms, before political discussions are monopolised by the local and regional elections (October 2024), followed by the general elections (presidential and parliamentary elections, in November 2025). First of all, a second version of the fiscal reform (the first was rejected in March 2023) was tabled in Congress in January 2024. This new version proposes an increase in tax revenue of nearly 1.5% of GDP by 2026 (compared to 4% of GDP in the first bill), achieved almost exclusively through reinforced measures to enforce tax payment compliance (whereas the initial bill planned to increase income and wealth taxes). The additional revenue is expected to be used to finance further social spending, meaning that this spending will only have a marginal effect on public finances. The bill is currently being debated in the Senate and these debates are turning out to be heated.

At the same time, the draft reform of the pension system (which mainly sets out to improve the replacement rate and coverage), initially tabled in mid-2022, was approved by the Chamber of Deputies (the lower house of the National Congress of Chile) in January 2024, after many amendments were made to the original bill. This bill is now being discussed in the Senate and its scope could be further reduced. The increase to the minimum old-age pension, approved by elected representatives, is unlikely to be under threat. Conversely, the creation of a public administrative agency, resulting in the role of AFPs (Administradoras de Fondos de Pensiones, the administrations responsible for managing pension funds) being scaled back to simply financial management over pensions, approved by elected members of the lower chamber, could be reconsidered during senators' discussions. In addition, while the government has already had to accept that the revenue linked to the new employer contribution (of 6% of an employee's salary) cannot be fully used to strengthen the solidarity pillar, the Senate could decide that the revenue can only go into individual accounts.

Finally, discussions about the energy transition framework law are continuing. In April 2023, the government tabled a particularly ambitious National Lithium Strategy in Congress, aimed at improving national lithium production efficiency (including bringing Chilean companies into the lithium value chain) and increasing tax revenue, while establishing a "socially and ecologically" sustainable framework. At the end of March 2024, the government stated that lithium mining at the "strategic" salt flats of Atacama (the only one in operation for the time being) and Maricunga would be undertaken via public-private partnerships majority-owned by the State. Five other salt flats may be mined under public-private partnerships and, finally, 26 other salt flats (accounting for less than 20% of the country's total production) will be opened to private companies.

SLOWER THAN EXPECTED FISCAL CONSOLIDATION

Against this backdrop, the fiscal consolidation targets set by the government (to reach a balanced budget in 2028) seem optimistic. After a surplus in 2022 (of 1.1% of GDP), the fiscal balance was once again in the red in 2023, with a deficit of 2.5% of GDP, as the increase in revenue from lithium mining was not enough to offset the effects of lower activity and falling copper prices. Revenue was down almost 8% y/y in total. At the same time, spending increased by almost 10% y/y. Over the next two years, we expect a slight decline in the fiscal deficit: despite activity recovering, public pressure on increasing social spending is unlikely to dissipate.

CHILE: BUDGET DEFICIT AND PUBLIC DEBT

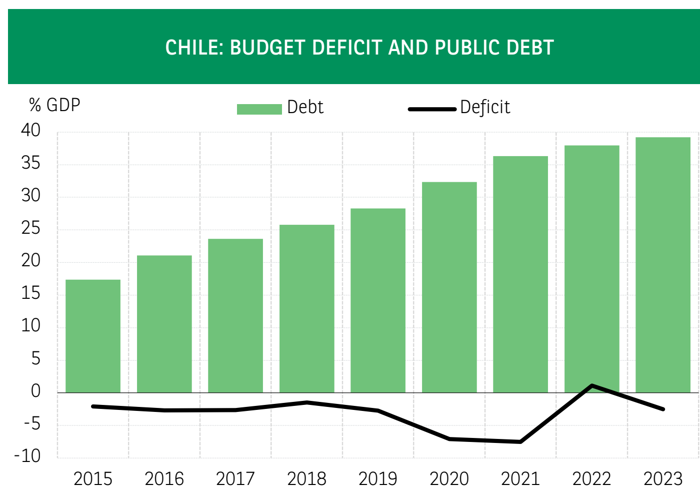

CHART 2

SOURCE: MINISTRY OF FINANCE, BNP PARIBAS

Nevertheless, even if fiscal consolidation is slower than the authorities are expecting, sovereign risk is still limited. Public debt has increased significantly in recent years, but is still moderate (standing at 39.2% of GDP, compared to 28% of GDP in 2019). Debt is expected to continue rising gradually over the next few years, but its profile is still good. Debt maturity is still higher than 10 years, and contingent debt remains low, which is evidence of the low public-sector debt and the careful and effective regulation of the financial system.

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UNITED ARAB EMIRATES

THE CHALLENGE OF THE LOW-CARBON TRANSITION

The economy of the United Arab Emirates (UAE) is still one of the most dynamic in the region. The strong performances are due to the UAE's sectoral diversification and the attractiveness of Dubai to tourists and investors. Despite the tense geopolitical environment, the short-term outlook is bright, as hydrocarbon production is expected to increase and the steady growth in services and real estate is expected to continue. However, geopolitical risk, oil market uncertainties and US monetary policy are all factors that could threaten this outlook. Uncertainty about the pace and scope of the low-carbon transition is making the longer-term outlook much more uncertain. The UAE's strategy is to continue to increase its hydrocarbon production capacity in order to take advantage of favourable production conditions and to diversify exports.

DYNAMIC NON-HYDROCARBON SECTORS

In 2023, economic growth in the UAE (which stood at +3.1%, according to central bank estimates) was among the strongest in the region, thanks to its dynamic non-oil sectors (+5.9%) and the relatively small drop in hydrocarbon GDP (-3%). Activity was up 3.1% in Abu Dhabi (around 60% of the UAE's economy), boosted mainly by the construction sector and financial services. The hydrocarbon sector (around 47% of GDP) contracted by 2.9% as a result of OPEC's decision to limit production in order to bolster prices.

In Dubai (around 22% of the UAE's GDP), the dynamic services sector is expected to drive growth to around 3.5% of GDP. The logistics and transport sectors and, to a lesser extent, retail were the primary growth drivers in 2023.

In the short term, the outlook for the non-hydrocarbon sectors is positive. Residential real estate is expected to continue growing, despite an expected slowdown in Dubai, given the rapid construction rate seen since 2020. More broadly, the UAE's attractiveness to tourists and foreign investors is supporting the real estate sector. For example, the visa system has recently been relaxed and foreign investors are now allowed to hold up to 100% of the capital of a company registered in the United Arab Emirates. Tourist numbers are expected to continue growing, albeit at a slower pace than in 2023. This is because the spike in the number of visitors in 2023 (+19% in Dubai) was partially as a result of COP28 being held in the country.

The short-term outlook for the oil sector is more mixed. Although there are some signs of global oil demand recovering, OPEC+ countries will be cautious before easing the restrictive quota policy. We expect oil production in the UAE to increase by around 1.7% in 2024.

Overall, growth is expected to hit 3.9% in 2024 and accelerate to 5.4% in 2025, thanks to the expected increase in oil production in particular.

FORECASTS

	2021	2022	2023e	2024e	2025e
Real GDP growth (%)	4.4	7.9	3.1	3.9	5.4
Inflation, CPI, year average, %	-0.1	4.8	1.6	2.1	2.0
Gen. Gov. balance / GDP (%)	4.0	9.9	6.5	5.7	4.5
Gen. Gov. debt / GDP (%)	36	31	31	26	22
Current account balance / GDP (%)	11.5	11.6	9.3	7.8	6.9
External debt / GDP (%)	97	85	87	87	85
Forex reserves (USD bn)	128	134	184	192	202
Forex reserves, in months of imports	4.8	4.6	5.9	5.9	5.9

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

UAE: REAL GDP GROWTH

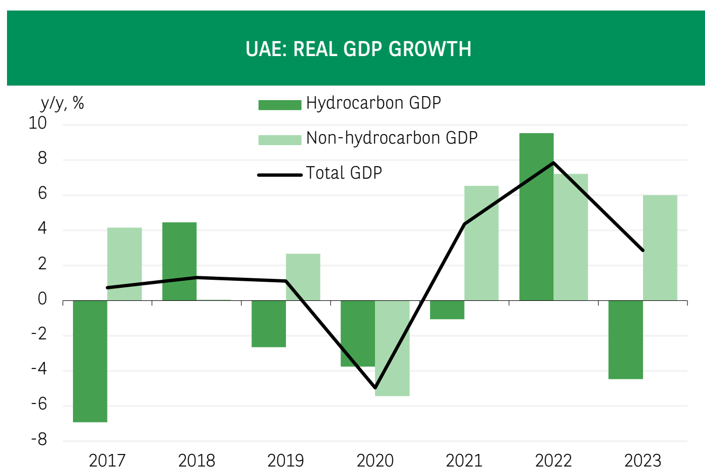

CHART 1

SOURCE: IMF, BNP PARIBAS

POTENTIAL RISKS TO GROWTH

Oil market developments still have a major impact on activity, despite the country having a diversified economy compared to the rest of the region. In recent years, the increase in oil production capacity across North and South America has restricted the cartel's influence on the oil market, which may limit the increase in production quotas for OPEC countries.

Interest rates being kept high in the United States is another constraint, as the Central Bank of the UAE has to follow the Fed's monetary policy due to the Emirati dirham being pegged to the US dollar. Although the Fed is expected to start cutting rates this year, this will likely be done at a moderate pace, given the buoyant economic activity in the United States.

The geopolitical environment may have serious adverse repercussions for the United Arab Emirates, given the size of the services sector, which is traditionally more sensitive to political risk than industry, and the UAE's dependence on maritime trade routes. If the Strait of Hormuz were to be blockaded, this would severely limit oil export

capacity. Indeed, the pipeline connecting Abu Dhabi's oil fields to the Port of Fujairah has a capacity of 1.5 mb/d, while exports average 2.6 mb/d. However, disruption to shipping traffic in the Red Sea has hardly affected oil exports, as Asia is by far the largest export market. Therefore, paradoxically, the increased geopolitical risk may positively impact activity in the UAE, and Dubai in particular, which is home to nationals from countries that have come under geopolitical tensions in recent years.

ROBUST PUBLIC AND EXTERNAL FINANCES

Public and external liquidity and solvency indicators are robust at the consolidated level. Non-hydrocarbon budget revenue accounts for approximately 45% of total government revenue. It comes from taxes and dividends from government-owned companies. On the other hand, government spending is growing at a moderate pace. Against this backdrop, the fiscal breakeven oil price per barrel is below USD 60/b, generating a surplus in the public accounts. Government debt is low (27% of GDP in 2023) and is decreasing. The government net asset position is confortable, given that the assets held by sovereign funds are worth at least twice the GDP.

The contingent debt of the seven Emirates (defined as the contingent debt of non-banking government-related entities in which the government holds a majority stake) is high (29% of Abu Dhabi's GDP and 38% of Dubai's GDP), but it does not pose a systemic risk.

THE UAE IN THE LOW-CARBON TRANSITION

Reliance on hydrocarbons (revenue from hydrocarbons accounts for about 40% of export revenue (excluding re-exports) and 55% of government revenue) is exacerbating the uncertainties around the low-carbon transition. There is a two-fold risk at play. On the one hand, hydrocarbon assets could lose their value (and become stranded assets) and therefore stop generating enough revenue for the economies in question, while on the other hand, the economic diversification may remain unsufficient. While many countries have a low-carbon transition as a goal, its pace and economic implications are currently very uncertain. Nevertheless, for oil producers, the risk of facing serious economic difficulties in a relatively short period of time (two decades) is not negligible, according to the IMF[1].

Against this backdrop, the UAE is developing a two-pronged strategy: continuing to make optimum use of its hydrocarbon resources, by increasing its production capacity, and preparing for the post-hydrocarbon era by accelerating the diversification of its economy. Unlike other producers in the region, the UAE is aiming to increase its oil production capacity in the medium term. It is currently estimated to stand at just over 4 mb/d, and the country is targeting 5 mb/d by 2027. At the same time, gas extraction is expected to increase so that the country becomes a net gas exporter by 2030. Currently, part of the UAE's domestic consumption is covered by imports from Qatar. At the same time, the targets for decarbonising the energy mix are ambitious. On the one hand, they involve electrifying more than 50% of the energy mix by 2050 (20% currently) and, on the other hand, decarbonising electricity generation. In 2022, around 18% of the electricity mix was decarbonised, if nuclear energy is included (13% of the electricity mix). The country has major renewable energy ambitions (which only involves solar energy, given the features of its climate), aiming to triple its production capacity between 2022 and 2030.

1 R. Cherif, F. Hasanov and M. Sarsenbayev, *Call of Duty. Industrial Policy for the Post-Oil Era*, IMF, WP/24/74.

UAE: CRUDE OIL PRODUCTION

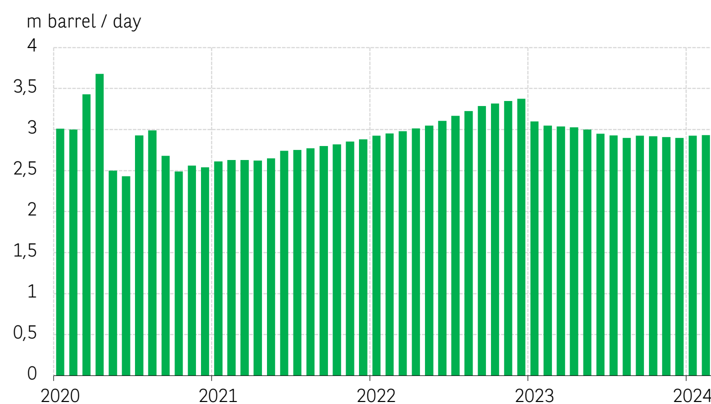

CHART 2

SOURCE: OPEC, BNP PARIBAS

THE CHALLENGE OF DIVERSIFYING EXPORTS

The energy transition adds a new dimension to the process of economic diversification. For more than twenty years, diversifying Gulf economies has mainly been about creating jobs by developing the private sector. As highlighted in the IMF report, the energy transition involves another diversification, as these economies will now have to diversify their exports, given falling income from hydrocarbons. Up until now, diversification has mainly been concentrated in sectors with limited productivity (tourism) or in non-exportable goods sectors (real estate), and has not been seen in many sectors involving exportable high value-added goods or services (with the exception of logistics and energy-intensive industrial sectors, such as petrochemicals and aluminium).

The UAE has a number of key assets that it can leverage in order to implement this new diversification. Substantial financial resources will enable the Federation to invest internationally in renewable energies (Masdar) or to hold stakes in innovative companies. In addition, its research and development expenditure are somewhat higher than the rest of the region (standing at around 1% of GDP on average between 2000 and 2018, compared to less than 0.5% for the other Gulf countries). Nevertheless, the UAE is facing stiff international competition in its willingness to develop new export sectors, particularly around trying to attract innovative companies and skilled labour. For exemple, in the artificial intelligence (AI) sector, considerable resources are being deployed to increase the capacities of data centres, which are essential for developing the AI sector. Growth in this sector is currently still too small to have a real economic impact. Overall, even though the UAE seems best placed within the region to implement the second wave of diversification, and while it is too soon to measure its effects, there are still major uncertainties around whether it can keep up its current level of economic development within the low-carbon transition.

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SOUTH AFRICA

A LONG, HARD ROAD

The South African economy narrowly avoided recession at the end of 2023. The poor quality of the country's infrastructure is significantly slowing down activity. In addition, the government lacks fiscal leeway and disinflation is slow and uneven, forcing the central bank to maintain its restrictive monetary policy. Faced with numerous macroeconomic challenges, the African National Congress (ANC) has initiated long-awaited reforms, but at a pace that is deemed insufficient. It is likely to pay the price at the general elections in May and lose its absolute majority in Parliament for the first time in its history. The choice of the party with which to form a coalition could disrupt the momentum of reforms and the trajectory of public debt.

FROM ENERGY CRISIS TO LOGISTICS CRISIS

In 2023, South Africa's economic growth slowed to 0.6%, held back by the accumulation of constraints due to the country's failing infrastructure. Firstly, the power cuts imposed by the state-owned company Eskom reached a peak with 335 days of load shedding, including 106 days at critical levels 5-6 (compared with 205 days, including 32 at levels 5-6 in 2022). According to the central bank (SARB), the electricity shortage subtracted 1.5 percentage points (pp) from GDP growth. In addition, logistics bottlenecks, which are penalising rail and sea transport, persisted in 2023 (chart 1). Last December, the state-owned company Transnet, which is in charge of this sector, had accumulated a backlog in the delivery of goods estimated at 0.7% of GDP. Against this backdrop, the economy narrowly avoided recession in Q4 2023: GDP rose marginally (+0.1% q/q) after contracting in Q3 (-0.2% q/q).

With economic growth expected to reach 1.1% in 2024, the outlook remains gloomy, although improving slightly. Load shedding will continue, but the worst of the energy crisis is over: the increase in private power generation facilities following the liberalisation of the sector in 2022 has gradually reduced demand for Eskom, while supply rebounded in Q4 2023 with the (temporary) resumption of activity at the Kusile power stations. Nevertheless, logistical difficulties will persist and prevent a more dynamic upturn in activity. On the demand side, investment and the rebound in consumption should support economic growth: after two quarters of contraction, household consumption picked up again in Q4 2023, and this momentum should continue as inflation gradually recedes. Since July 2023, growth in the consumer price index has remained below the SARB's upper target (6%), but in March 2024 it still stood at 5.3% y/y. The disinflation process will still be slow and uneven in the coming months: inflation is not expected to return to its preferential target (4.5%) until the end of the year. In addition, the Governor of the central bank recently announced that the preferential inflation target could be revised downwards by the end of 2024 in an attempt to make the economy more competitive. If such a measure is confirmed, the start of the SARB's monetary easing cycle, which is not currently expected before September 2024, could be delayed.

FORECASTS

	2021	2022	2023e	2024e	2025e
Real GDP growth, %	4.7	1.9	0.6	1.1	1.7
Inflation, CPI, year average, %	4.6	6.9	5.9	4.8	4.5
Central Gov. balance / GDP, % (1)	-5.1	-4.7	-5.4	-4.8	-4.7
Central Gov. debt / GDP, % (1)	67.8	70.9	74.0	76.4	78.4
Current account balance / GDP, %	3.7	-0.5	-1.6	-2.8	-3.0
External debt / GDP, %	38.2	40.5	41.0	41.8	41.2
Forex reserves, USD bn	57.6	60.6	62.5	63.0	63.5
Forex reserves, in months of imports	5.4	4.8	5.3	5.0	5.2

TABLE 1

(1) Fiscal year from April 1st of year N to March 31st of year n+1
e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

SOUTH AFRICA: ONGOING INFRASTRUCTURE CONSTRAINTS

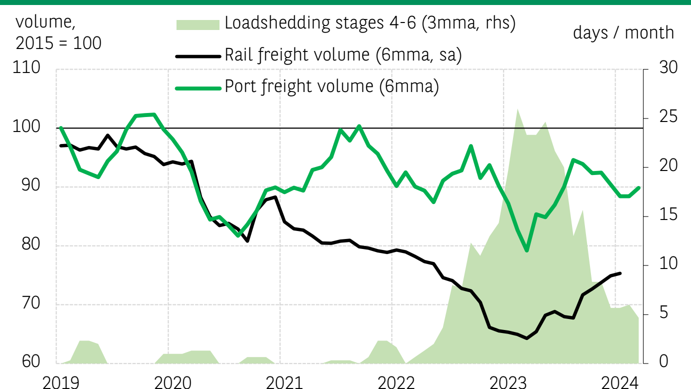

CHART 1

SOURCE: STATS SA, TRANSNET, ESKOMSEPUSH, BNP PARIBAS

A SHORTAGE OF PHYSICAL AND HUMAN CAPITAL

The infrastructure crisis is the result of chronic under-investment, but the severity of the failures of Eskom (electricity) and Transnet (logistics) over the past two years has finally made economic agents react. Thus, in 2023, investment continued the rebound that began in 2022, recording growth of 4.2%, driven by private sector investment (+4.9%, 72% of total gross fixed capital formation). However, at 15.2% of GDP, the investment rate has barely caught up with its 2019 level and remains below the 2011-2015 average (18%). It is also well below the average for upper-middle-income countries (34% of GDP), to which South Africa belongs.

Labour market trends are also worrying: at 32% at the end of 2023, the unemployment rate was still 3 pp above the levels seen in 2019. The extended unemployment rate, which takes into account discouraged jobseekers, was over 41%. Among young people (aged 15-24), unemployment was even more pronounced, exceeding 60% on average over 2023. In addition to the unfavourable economic climate, these figures also reflect a mismatch between the supply of skills and business demand. According to the OECD, in 2022 only 50% of 25-34

year-olds had a higher secondary education qualification, and only 1% of them had a master's degree (or equivalent). Yet public spending on education as a proportion of GDP is among the highest in the world (6.2% of GDP in 2022). Improving the quality of education in the long term will therefore require better management of spending.

It will take several years to make up the ground lost over the past decade in terms of physical and human capital, and thus sustainably restore the country's long-term growth potential. In the meantime, in an environment of weak economic growth, pressures on public finances will become increasingly acute.

PRAGMATISM IN PUBLIC FINANCES

The attempt at fiscal consolidation in 2023 has not borne fruit. Over the first eleven months of the fiscal year (April 2023 to February 2024), expenditure rose by a moderate 4.7% y/y, but revenue stagnated at +0.8%. The latter is being dragged down by the 11% contraction in corporate taxes, which had reached record levels in 2022 thanks to the strong performance of the mining sector, among others. For the 2023/24 fiscal year as a whole, the public deficit is expected to reach 5.4% of GDP, compared with 4.7% a year earlier.

Given the weakness of economic growth and the need to consolidate public finances, there is little room for manoeuvre in the budget. Thus, despite a difficult election campaign for the ANC, expansionary measures for 2024/25 were limited. The Social Relief of Distress (SRD) allowance has been extended until March 2025 but has still not been officially made permanent, and its increase for 2024/25 (+5.7%) is more or less indexed to inflation. Although the National Health Insurance Bill was passed by Parliament at the end of 2023, it did not receive any additional financial support in last February's budget. In addition, after much controversial debate, the Treasury has finally opted for cautious management of the profits made on its Gold and Foreign Exchange Contingency Reserve Account (GFECRA) held at the SARB: of the ZAR 507 bn in profits, ZAR 150 bn (2% of GDP) will be withdrawn over the next three years and will be used to reduce pre-existing financing requirements, not to finance new spending.

Despite these efforts, the Treasury's budget forecasts seem too optimistic to us. On the one hand, the economic growth rates forecast for the short and medium term seem too high. On the other hand, the primary budget surplus is likely to remain lower than forecast and public debt is unlikely to stabilise by 2026-27 (chart 2). The upward trend in debt interest costs (21.6% of government revenue in 2023/24) and weak GDP growth will automatically push up the debt-to-GDP ratio, beyond the Treasury's control. In addition, there are still major risks of fiscal slippage (materialisation of contingent liabilities owed to state-owned companies, perpetuation of the SRD, financing of health insurance). The announcement of the 2024/25 budget in February did not have the desired effect of reassuring investors: interest rates on Treasury bonds rose again (reaching 12.5% on the 11-year bond in mid-April, compared with 11.4% in mid-January), while the share of foreign investors in the domestic Treasury bond market fell to a record low of 24.6% in March. The uncertainty surrounding the May elections is also a major factor in investor concerns.

TOWARDS A COALITION GOVERNMENT

All eyes are now on the general elections of May 29th. Despite strong differences over the outcome of the vote, which calls for caution, all the polls so far point to one common result: the ANC is set to lose

SOUTH AFRICA: TRAJECTORY OF THE PUBLIC DEBT RATIO

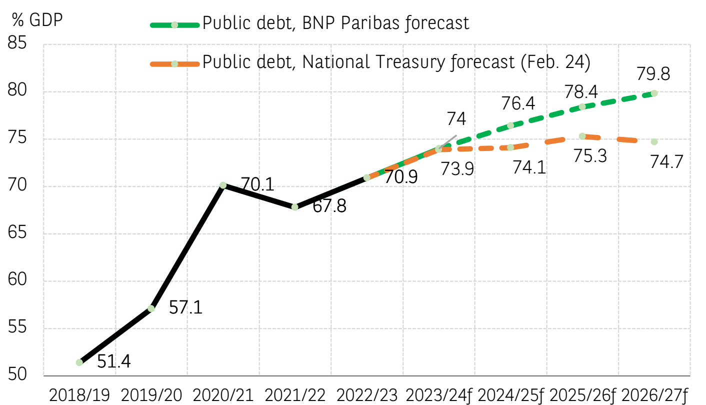

CHART 2

SOURCE: NATIONAL TREASURY, BNP PARIBAS

its absolute majority in Parliament. Since last December, the ruling party has fallen in the polls following the creation of the uMkhonto we Sizwe (MK) party, led by Jacob Zuma, the country's president from 2009 to 2018. Zuma, who is still very popular in the province of KwaZulu-Natal (2nd largest province in terms of the number of voters), could win between 7% and 13% of the vote, according to the most recent polls.

If the ANC manages to hold on to around 44-45% of the vote, it should be able to form a coalition government with a minority party. This would enable it to pursue its policy of structural reform over the next five years without too much trouble, thus guaranteeing relative economic and political continuity. On the other hand, if the ANC were to fall below the 44% mark, an alliance with one or more rival parties would be more delicate and would require compromises (transfer of a key ministerial portfolio). With a month to go before the elections, everything could change: the Constitutional Court still has to decide whether Jacob Zuma can stand in the elections. Its decision could reshuffle the deck.

PRESSURE ON EXTERNAL ACCOUNTS

In 2023, the current account deficit increased to 1.6% of GDP (compared with 0.5% in 2022). With the fall in the price of the raw materials the country exports (the price of coal, which accounts for more than a quarter of mining output, fell sharply in 2023), the trade surplus shrank from 2.9% to 0.9% of GDP. Net capital inflows held up well, amounting to 1.3% of GDP over the year as a whole, but slipped into negative territory in Q4 due to net portfolio investment outflows. The same dynamic is set to continue in H1 2024, putting downward pressure on the exchange rate. Since the beginning of the year, the South African rand (ZAR) has been trading above ZAR 18.5/USD. These pressures are likely to intensify in the coming weeks, ahead of the elections. In 2024, external accounts are also expected to suffer from the widening of the current account deficit, expected to reach 2.8% of GDP.

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MOROCCO

RISKS UNDER CONTROL

In Morocco, the latest GDP growth and inflation figures were better than expected, but the latest drought in the country undermines its economic recovery. Regional instability is another real risk to bear in mind. However, the country's adequate economic policy management and solid fundamentals remain supportive factors of macroeconomic stability.

Faced with an accumulation of shocks over the past five years, the Moroccan economy is holding up well. The authorities are maintaining a prudent economic policy that willnot jeopardise the stabilisation seen in the country's economy since the Covid-19 crisis. Most encouragingly, they have also sought to learn from these events by launching ambitious reforms, such as the development programme for the Marrakech region, hit by an earthquake in September 2023, which goes far beyond reconstruction. In addition, this year will once again see measures implemented to strengthen the social safety net, starting with introducing monthly direct support for disadvantaged families or continuing to expand social security coverage.

The headwinds are still strong. In addition to regional instability, Morocco is once again under water stress and the resulting drop in agricultural production will adversely affect economic growth. However, the good macroeconomic fundamentals will help the economy to navigate through this further period of turbulence largely unscathed.

FORECASTS

	2021	2022	2023e	2024e	2025e
Real GDP growth, %	8.0	1.3	3.1	2.4	3.9
Inflation, CPI, year average, %	1.4	6.7	6.1	2.4	2.3
Central Gov. balance / GDP, %	-5.9	-5.2	-4.5	-4.3	-3.8
Central Gov. debt / GDP, %	69.5	71.6	71.0	70.4	69.9
Current account balance / GDP, %	-2.3	-3.6	-0.6	-2.4	-2.8
External debt / GDP, %	45.8	49.5	49.1	49.3	49.9
Forex reserves, USD bn	35.6	32.3	36.3	37.2	38.0
Forex reserves, in months of imports	7.1	5.3	5.9	5.7	5.6

TABLE 1 e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

EXTERNAL-ACCOUNT STABILITY IS NOT UNDER THREAT

The dynamics of external accounts are not raising any major concerns. After widening to 3.6% of GDP in 2022, the current account deficit fell to 0.6% of GDP in 2023 (see chart 1), thanks to the drop in the global prices of the main commodities imported by Morocco and the good performance of the main sources of foreign currency. With 14.5 million visitors in 2023 and revenue rising above USD 10 billion (7.4% of GDP) for the first time, the tourism sector had a record year, as did financial transfers from the Moroccan diaspora, which were up almost 6% (USD 11.4 billion, or 8.1% of GDP). The overall export performance was more mixed (+0.2%). However, with car exports (+27.4%) offsetting the 34% drop in phosphate and derivative exports, there is evidence that the economy is becoming more resilient to external shocks. Car production has almost tripled over the last ten years or so, hitting 536,000 units last year, making the sector the country's leading export source (+77% between 2019 and 2023). Combined with the boom in other industrial niche markets (such as electronics and aeronautics), this sustained development has reduced the economy's vulnerability to fluctuating terms of trade and to the demand from its main trading partners. Morocco has continued to increase its market share on the European continent. Despite a rise in imports, due to increased investment and rising food needs as a result of the drop in agricultural production, the current account deficit is expected to be kept at under 3% of GDP this year.

External financing needs will be manageable to cover. In contrast to the global trend, net flows of foreign direct investment (FDI) rose by 60% between 2020 and 2022 to hit 1.6% of GDP. They fell to 0.7% of GDP in 2023 due to the dual effect of major investments outside Morocco and a 18% drop in inflows. However, they are expected to rebound from this year, in view of the growing number of projects announced. In addition, the country has good access to international financial markets, a moderate external debt (less than 50% of GDP) and sizeable foreign exchange reserves (5.9 months of goods and services imports). In a still unstable environment, the provision of a USD 5 bn flexible credit line by the IMF is also reassuring.

MOROCCO: EXTERNAL ACCOUNTS

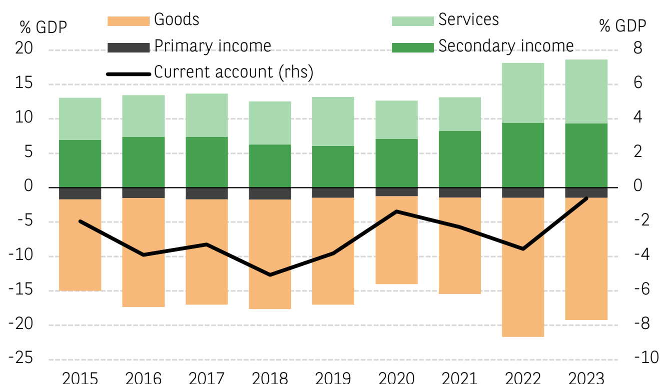

CHART 1 SOURCE: EXCHANGE OFFICE, BNP PARIBAS

BUDGETARY CONSOLIDATION: MOROCCO IS STAYING THE COURSE

The credibility of the government's budgetary consolidation strategy is another factor contributing to the country's macroeconomic stability. Despite a record amount of public investment of 7.7% of GDP, the budget deficit shrank by 0.7 points in 2023, to 4.5% of GDP, thanks to strong tax revenues and the drop of 1.1 point of GDP in energy and food subsidies, which followed the normalization of world commodity prices (after skyrocketing in 2022). The government is expecting a deficit of 4.3% of GDP in 2024 (excluding revenue from privatisations) before it comes back down to its pre-pandemic level of 3-3.5% of GDP by 2025-2026. Economic volatility and the implementation of expensive measures could lead to slippage, but this risk is seemingly under control.

The authorities are relying on a VAT reform to simplify the system and broaden its tax base to meet their goal. Above all, subsidy expenditure (butane gas, wheat and sugar) is expected to fall sharply, dropping from 2.1% of GDP in 2023 to just 0.5% in 2026, thanks to a complete overhaul of the subsidy system, which will both absorb the increased cost of introducing direct support for households and reduce the inherent volatility of this budget item. The lack of tension on the global gas market, which makes up the bulk of the expenses incurred by the subsidy system, is conducive to the implementation of this socially sensitive reform. Increased use of public-private partnerships is ultimately likely to be favoured for streamlining public investment and keep it above 6% of GDP.

Against this backdrop, government debt is expected to continue falling, dropping below 70% of GDP in 2025. This is still 10 points above its 2019 level, but its favourable structure provides room for manoeuvre. Denominated three-quarters in local currency and held by resident investors, it is not very sensitive to external risks. Furthermore, monetary tightening remained moderate, which enabled interest cost to be kept at under 10% of budgetary revenue. Yet, there is not much evidence to suggest that this situation would deteriorate in the future, in view of the inflationary shock dissipating.

MOROCCO: MONETARY ENVIRONMENT

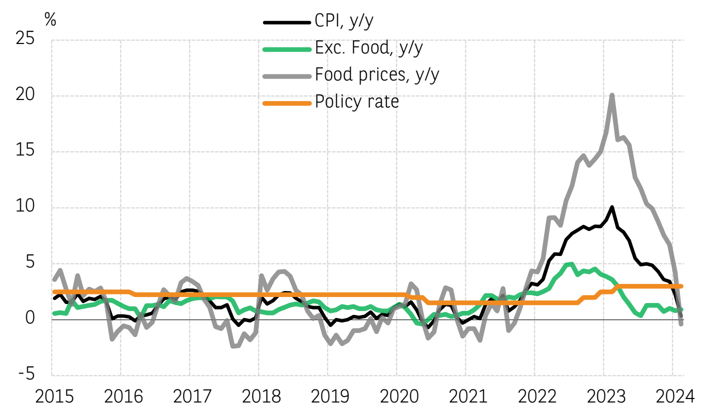

CHART 2

SOURCE: CENTRAL BANK, HCP, BNP PARIBAS

FALLING INFLATION, MONETARY STATUS QUO

The fall in inflation is significant. In February 2024, the consumer price index (CPI) was only up 0.3% year-on-year, compared to a peak of 10% at the start of 2023. The main reason for this trend is falling food inflation (see chart 2). However, the slowdown in inflation has been widespread, with the CPI excluding food up only 0.9% in February. This decline in inflation is validating the cautious strategy of the monetary authorities, which waited until September 2022 to start hiking rates, and only doing so moderately, by 150 bp in total. At 3%, the key rate was below inflation for a long time, but this is no longer the case. Therefore, questions could be raised about easing. However, a number of factors suggest that the status quo will prevail this year. In particular, the announced increase in butane gas prices and the fall in agricultural production will create inflationary pressures in the coming months. The impact should be modest. Average inflation is expected to stand at 2.4% in 2024, compared to 6.1% in 2023. However, while the risk is not under control, the central bank will remain vigilant. Against a backdrop of a high interest-rate differential between Europe and Morocco, the country's financial attractiveness should also be maintained, especially for the Moroccan diaspora, which accounts for a major percentage of bank deposits (18%). Finally, given that investment is beginning to increase again, the economy is seemingly coping with the current monetary conditions.

A THWARTED RECOVERY, BUT HOPE FOR THE FUTURE

With growth of 4.1% in Q4 2023 compared to 3.3% as initially estimated, economic activity was surprisingly strong. After an increase of 11.6% in Q3, the strong investment momentum continued (+19.6%), and household consumption (+3%) began to look rosier again, thanks to abating inflationary pressures. With an average growth of 1% over the entire year, following the 0.7% decline in 2022, household consumption is still weak, however. At a sectoral level, industrial activities mainly boosted growth in Q4.

The outlook for 2024 is mixed. Excluding agriculture, real GDP growth is expected to reach 3.3% (2.8% in 2023), once again driven by investment, while the recovery in consumption will remain sluggish due to the high unemployment level, which now stands at 13% – almost three points higher than its pre-pandemic level. In addition, the labour market will once again be hurt by the underperforming agricultural sector. According to the Bank Al-Maghrib, cereal production is expected to halve to 25 million quintals due to poor weather conditions. The sector accounts for 10% of GDP and 30% of employment. A sharp contraction in the agricultural value added will have a number of consequences for the economy. As a result, growth forecasts have been lowered by almost one point to 2.4%.

Conversely, GDP growth could rebound to almost 4% in 2025, provided that agricultural production returns to normal levels. This volatility is not new, but the repeated droughts in recent years present many challenges. Seawater desalination projects have been launched to address this. Above all, Morocco is building on its undeniable comparative advantages so that it can benefit from industrial nearshoring and decarbonisation processes, and therefore continue to diversify. Coupled with the strengthened social safety net, the authorities are hoping to increase the economic growth potential to 5-6%, compared to the current level of 3.5%. The significant rise in greenfield FDI projects from under USD 4 billion in 2021 to USD 38 billion in 2023 suggests that the country is on the right track.

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SENEGAL

A PIVOTAL YEAR

At a time when Senegal is preparing to launch its gas and oil production, the reconfiguration of the political landscape is generating immense hope among the population. The opposition candidate, Bassirou Diomaye Faye, won the presidential elections in the first round on the back of a breakthrough project. But the challenges ahead are huge, especially on the employment front. Despite a decade of robust growth, the economy has undergone little transformation and suffers from low productivity gains, which it will be difficult for the sustained investment effort to continue to mask, given the now high level of debt.

POLITICAL CONTEXT: BETWEEN RELIEF AND CAUTION

The swearing-in of the new President Bassirou Diomaye Faye on 2 April marked the end of an electoral process that had been unprecedented in more ways than one. At 44, he is the youngest President elected to lead the country. For the first time, the outgoing President, Macky Sall, was not standing for another term. Never since the country became independent has an opposition candidate succeeded in being elected at the first ballot. With 54% of the vote against 36% for Amadou Ba, the government's candidate, Mr Diomaye Faye therefore has a solid mandate, even if the lack of a majority in the National Assembly is likely to force him to seek alliances before a possible dissolution.

Little known, with no elective mandate and still in prison two weeks before the election, Mr Diomaye Faye owes his meteoric rise largely to the defeat of his mentor, Ousmane Sonko, who was disqualified because of a judicial conviction. His victory also reflects the population's support for a breakaway programme characterised, among other things, by a strengthening of economic sovereignty. It envisages strong measures such as reforming the CFA franc, or even abandoning it, and renegotiating oil and gas contracts, production of which is due to start this year.

The election was closely followed by the international community. After weeks of political crisis triggered by the outgoing President's decision to postpone the elections, in a region marked by a succession of coups over the past three years, the solidity of Senegal's democratic institutions has once again reassured its main partners. The 80 basis point (bp) fall in 5-year risk premiums on international sovereign bonds since the announcement of the results also attests to investors' relief. In addition to the easing of the political climate, the softening in the rhetoric of Mr Diomaye Faye and his movement in the run-up to the elections suggests that economic policy is likely to be more tame, particularly on the issue of the CFA franc, where the authorities now seem to favour a community-based approach. The formation of the government also reflects the delicate balance to be struck between the desire for change and the need to provide some reassurance. Unsurprisingly, Ousmane Sonko was appointed Prime Minister of a tightly-knit team of twenty-five ministers, many of whom are senior members of the presidential camp. Nevertheless, expertise seems to have prevailed in the allocation of key posts, as in the case of the new Finance Minister, Cheikh Diba, who until now has held the post of Director of Budget Planning in the same ministry.

However, caution is still called for. There is little budgetary leeway to implement the project, given that the country is committed to an IMF support programme and is heavily in debt. The working relationship stemming from the unprecedented pairing of a substitute candidate turned President and a Prime Minister, leader of the political movement, could also prove difficult. Yet the challenges facing the authorities are immense, commensurate with the hopes of the population.

FORECASTS

	2021	2022	2023e	2024e	2025e
Real GDP growth (%)	6.5	4.2	4.1	8.8	10.1
Inflation (CPI, year average, %)	2.2	9.6	6.1	3.2	2.0
Gen. Gov. balance / GDP (%)	-6.3	-6.6	-4.9	-3.9	-3.3
Central. Gov. debt / GDP (%)	67.4	67.5	71.0	67.6	64.3
Current account balance / GDP (%)	-11.2	-19.9	-14.6	-7.9	-3.6
External public debt / GDP (%)	49.9	46.6	47.9	46.0	45.0
Forex reserves (USD bn)	4.2	3.9	4.7	5.4	6.0
Forex reserves, in months of imports	4.5	3.2	3.7	4.2	4.5

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

REAL GDP GROWTH

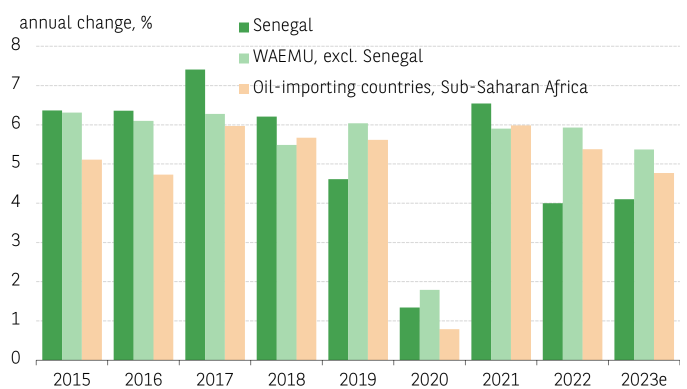

CHART 1

SOURCE: IMF, BCEAO, BNP PARIBAS

ECONOMIC GROWTH: HIGH BUT POORLY DIVERSIFIED

One of the main challenges will be to put the Senegalese economy on a more solid and, above all, more inclusive growth path. At first glance, this may seem paradoxical for a country that is emerging from a 10-year cycle of growth in excess of 5%, and for which the outlook is for real GDP growth of 9-10% in 2024-2025 thanks to the start-up of oil and gas production. However, the impact of hydrocarbon development

on the rest of the economy should not be overestimated, particularly in terms of employment. Aside from the revenue generated by the sector, the economy could ultimately benefit from a reduction in energy costs as a result of the substitution of imported oil by locally produced gas. However, this transition will require substantial investment, the outcome of which remains uncertain. In any case, it will take time. What's more, the boost to real GDP from oil and gas production is only likely to be temporary. From 2026 onwards, growth is expected to fall back to 5-5.5%, driven almost exclusively by non-hydrocarbon activities. This is far from a foregone conclusion.

The COVID-19 crisis, followed by the shock of the war in Ukraine, highlighted some of the limits of Senegal's development model. The country has held up fairly well overall, but economic growth between 2020 and 2023 slowed more than the average for other WAEMU countries and oil-importing economies in sub-Saharan Africa (see chart 1). Inflationary pressures were also stronger in 2022 (9.7% in Senegal compared with 6.6% for the rest of the WAEMU). In fact, Senegal was unable to take advantage of the favourable context of the pre-pandemic period to transform itself. The service sector still dominates (around 60% of GDP) but remains dominated by low value-added activities, while agriculture accounts for only 10% of GDP. For a sector that employs 60% of the working population, the limited weight of agriculture reflects above all its low productivity. A similar observation can be made for the secondary sector, where exports are not very diversified, apart from the boom in precious metals (gold, titanium and zircon).

In the absence of productivity gains stemming from a sectoral recomposition , the growth of the Senegalese economy has heavily relied on capital accumulation. The investment rate rose from 18.5% in 2010 to over 33% in 2023, a dynamic that is striking in terms of its scale and level. By comparison, it reached 27% in Côte d'Ivoire, where the growth rate is higher. In Senegal, a high proportion of investment seems to have been channelled into the construction sector, the effects of which on economic activity are short-lived. In addition, this investment effort has resulted in increased pressure on public finances (particularly debt), and hence a high degree of sensitivity to the various shocks since 2020. A large part of the Senegalese economy's underperformance in 2022-2023 is therefore due to the contraction in public investment in real terms, a situation that could recur given the fragility of the current macroeconomic situation.

PERSISTENT MACROECONOMIC IMBALANCES

In spite of strengthening exports on the back of the boom in the hydrocarbon sector, Senegal will continue to record current account deficits. According to the IMF, they are likely to remain close to 5% of GDP, after peaking at almost 14% of GDP on average between 2020 and 2023, due to the huge import requirements for capital goods associated with the initial phases of development of the oil and gas fields. The delay in launching hydrocarbon exports explains why the current account deficit is still expected to be 8% of GDP in 2024. At first sight, it would appear that future external financing needs (current account deficit and amortisation of external debt) would be well covered. But this assumes that Senegal continues to receive financial support from the international community. According to the IMF, just over half of total external capital flows over the next 3 to 4 years should be made up of FDI, which is significant but leaves a gap that is difficult to fill solely by issuing eurobond debt. Furthermore, the Senegalese economy is a net debtor in key areas of trade, particularly foodstuffs. It will therefore remain vulnerable to the vagaries of the international economic situation.

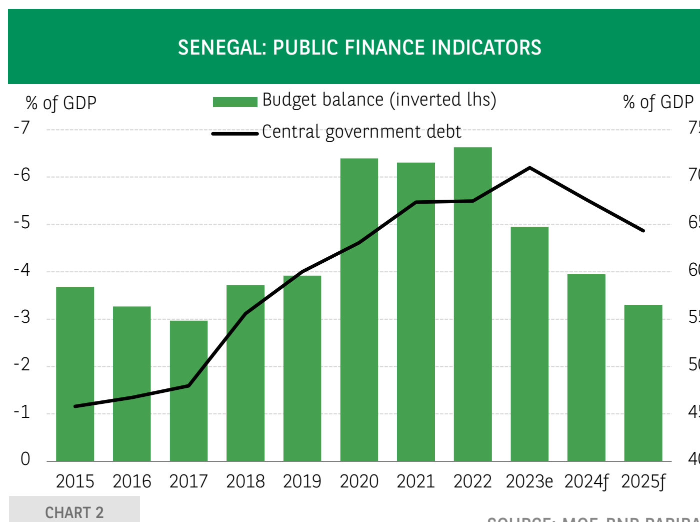

CHART 2

SOURCE: MOF, BNP PARIBAS

Public finances are not really any stronger. Major infrastructure projects carried out during President Sall's two terms in office and the various shocks recorded between 2020 and 2023 have resulted in a significant increase in debt. At 71% of GDP, Senegalese government debt is now 12 points higher than the average for WAEMU countries. On the positive side, its structure is favourable. Despite increased recourse to local/regional capital markets for financing in recent years, 40% of the stock of debt is still held by bi-multilateral creditors. As a result, the interest burden remains at a moderate level. Nevertheless, it is tending to increase rapidly (13.5% of government revenue compared with 10.7% in 2019 and 8.1% in 2014). Moreover, the increase in nominal GDP linked to the start-up of hydrocarbon production should improve the debt ratio, which will remain high (64% of GDP at the end of 2025, see chart 2). Continued fiscal consolidation therefore remains essential. The previous administration's objective was to reduce the budget deficit from 4.9% of GDP in 2023 to 3.9% in 2024, then 3% in 2025. To achieve this, it was counting largely on a gradual reduction in energy subsidies, whose surge in 2022 had prompted the authorities to make cuts in public investment. This reform of the subsidy system also features prominently in the IMF's support programme. However, there is nothing to suggest that the new authorities will continue along this path, in which case further adjustments will certainly be required, given that hydrocarbon revenues are not expected to exceed 1% of GDP. The IMF's next review is therefore likely to attract particular attention from investors.

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Head office: 16 boulevard des Italiens – 75009 Paris France / Phone : +33 (0) 1.42.98.12.34
Internet: www.group.bnpparibas - www.economic-research.bnpparibas.com

Head of publication : Jean Lemierre / Chief editor: William De Vijlder

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