ECO EMERGING

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Eco EMERGING

ECONOMIC RESEARCH DEPARTMENT

BNP PARIBAS

The bank for a changing world

Editorial

Monetary policy is back to the fore

Growth prospects for the emerging countries in 2020 (EC) have dimmed with the slowdown in export markets and the climate of uncertainty that reigns with the US-China trade war. This uncertainty has increased the volatility of portfolio investments since last summer, although external financing conditions are still favourable on the whole. The majority of countries have also eased monetary policy, and the pass-through of key policy rates to lending rates is functioning rather well. Yet private sector debt has risen sharply over the past decade, which could hamper monetary easing if credit risk were to rise.

Monetary policy to the rescue

For our selection of 26 emerging countries, real GDP growth hit a record low of only 4.1% year-on-year in Q2 2019, down from 5.2% one year ago. Excluding the financial crisis of 2008–2009, we must look back to 2001 to find such a weak performance. The main causes are the slowdown in export markets and the climate of uncertainty that prevails with the US-China trade war. Uncertainty has fuelled high volatility not only in EM exports, but also in portfolio foreign investments to EM. Yet external financing conditions have not tightened yet, with the exception of Argentina and Lebanon (for very specific reasons). Globally, spreads on sovereign external debt have tended to narrow since Q4 2018, while the ones for corporates have remained flat. Sluggish world growth is also straining commodity prices, which is helping to contain inflationary pressures. Against this backdrop, a large majority of central banks (16 out of 26) had initiated or continued to cut their policy rates at the end of September, compared to only 4 in 2018. The only exceptions are the central banks of the central and eastern European countries, where growth rates exceeded their long-term potential through H1 2018, triggering labour market pressures. Could monetary easing help buffer the impact of the slowdown in exports?

Limited manoeuvring room

Since year-end 2018, if we exclude mainland China (whose government sets the target for credit growth) and countries like Argentina, Brazil and Turkey, which have experienced volatile credit cycles, the growth of domestic bank lending has slowed in the emerging countries. For most countries, however, the effects of the current round of monetary easing have not been felt yet. This does not mean that the monetary policy transmission channel is functioning poorly or not at all. To the contrary, with the notable exception of India and Egypt, the apparent pass-through coefficient between the changes in policy rates and those of bank lending rates is rather elevated or very elevated, i.e. larger than 1 (see table).

Yet a bold monetary policy support, i.e. a decrease in the policy rate stronger than actual or anticipated disinflation, supposes that there exists some room of manoeuvre.

One way to measure the room of manoeuvre is to compare real interest rates with potential growth rate. Looking at key policy rates, few countries have very big differences (Mexico, Egypt and Russia). If we look at bank lending rates, in contrast, numerous countries have significant differences (South Africa, Brazil, Colombia, Turkey and, to a lesser extent, India and Indonesia). Yet a high real lending rate might also reflect a structurally high non-performing loan rate for certain types of credit, as is the case for cash loans and credit card loans in Latin America.

Monetary policy stance

	Policy rate evolution	Monetary easing pass-through (*)	Date de début	Date de fin
Brazil	↘	103%	19/10/2016	31/05/2019
Chile	↘	162%	17/10/2013	31/05/2019
Colombia	→	81%	16/12/2016	31/05/2019
Mexico	↘	58%	08/02/2017	31/05/2019
China	↘	72%	30/12/2014	31/05/2019
India	↘	39%	14/01/2015	31/05/2019
Indonesia	↘	n.s	-	-
Malaysia	↘	n.s	-	-
Taiwan	→	n.s	-	-
Thailand	↘	63%	16/10/2012	18/12/2018
Poland	→	111%	07/11/2012	31/05/2019
Hungary	→	110%	27/08/2012	31/05/2019
Czech Republic	↗	-	-	-
Romania	→	119%	01/07/2013	31/05/2019
Turkey	↘	n.s	-	-
Russia	↘	116%	31/12/2014	31/05/2019
Egypt	↘	45%	21/02/2018	31/05/2019
Morocco	→	138%	22/09/2014	31/05/2019
South Africa	↘	n.s	-	-

(*) Lending rate change divided by policy rate change during the specified period

Source: IMF, Central Banks, BNP Paribas Group Economic Research

Lastly, private sector debt might also hamper monetary easing if it leads to a deterioration in credit risk. This is obviously the case in China *(see our analysis below)*. But many emerging countries, mostly in Latin America, have reported an increase of more than 50% in their bank lending to GDP ratios since 2010. In Asia, ratios have not risen as strongly, but they stood initially at a higher level. Turkey is a good illustration of an intermediate profile (a rapid rise starting from a relatively moderate level): in case of an external shock, past experiences show that credit risk would rise more rapidly than in countries with relatively heavy debt loads but more moderate credit growth.

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China

Difficult policy choices

Since Q2 2018, Beijing has let the yuan depreciate against the dollar each time the US has raised its tariffs on imported goods from China. Yet, exchange rate policy as an instrument to support economic activity is expected to be used moderately in the short term. There is also little room to stimulate credit given the excessively high debt levels of the economy and the authorities' priority on pursuing efforts to clean up the financial system, the public sector and the housing market. Torn between stimulating economic growth and deleveraging, the authorities' dilemma could get worse if recent fiscal stimulus measures do not have the intended impact on domestic demand, or if the external environment were to deteriorate further.

Real GDP growth slowed to 6.2% year-on-year (y/y) in Q2 2019, down from 6.4% in the previous quarter and 6.6% in full-year 2018. Growth should continue to slow in the short term since the support provided by policy stimulus measures will only partially offset the impact of the slump in external demand. The authorities' room for manoeuvre to stimulate growth has narrowed sharply in recent years due to the erosion of external surpluses and rising internal imbalances (excessive debt, need to clean up the public and financial sectors).

Yuan depreciation should continue to be moderate

In the first eight months of 2019, export revenues stagnated compared to the same period in 2018 (-0.05%) because of higher US tariffs and the decline in world trade growth. Thanks to a 4.5% fall in imports, the trade surplus increased by 30% y/y to USD 262 billion over the same period. The export sector's troubles are expected to get worse in the months ahead, and the outlook for 2020 is still very uncertain since it hinges on the outcome of trade talks between Washington and Beijing.

Since Q2 2018, the weighted average tariff imposed by the United States on imported Chinese goods has increased from 6.5% to about 20% at the end of September 2019 (tariffs have so far been raised on more than two thirds of these imports). The weighted average tariff could exceed 25% by the end of the year if the recently renewed trade talks were to collapse and the new tariffs announced by the Trump administration last summer were effectively introduced. It threatened to apply tariffs to all US imports of Chinese goods (totalling USD 550bn). Between the end of March 2018 and the end of August 2019, the yuan lost nearly 13% against the dollar (including 3% in July-August). This decline more than offset the increase in the yuan reported in the previous fifteen months. With each new increase in US tariffs (announced or effective), the Chinese authorities have responded by letting the yuan depreciate to partially offset the impact on exporting companies (chart 2). In September, despite the introduction of new tariffs, the yuan levelled off against the dollar because Beijing and Washington had agreed to restart trade talks.

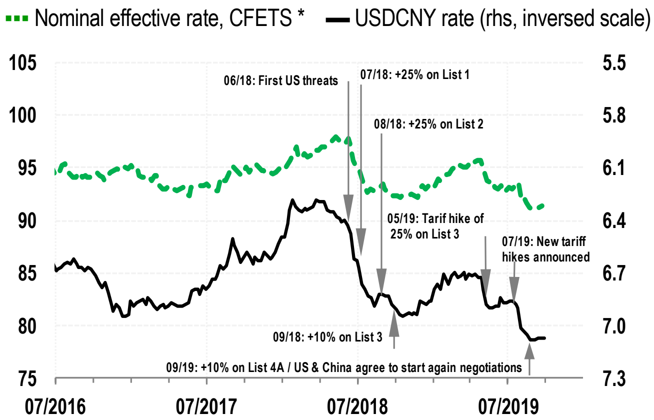
The authorities are expected to resort to the exchange rate policy moderately to stimulate economic activity in the short term. They fear the anticipation of currency depreciation could trigger a vicious circle of new capital outflows and yuan weakening. Yet this risk is limited given the existing controls on resident capital outflows (which have been reinforced since 2016, and then adjusted depending on balance-of-payment pressures). Moreover, the slight improvement in the current account surplus (it stood at 1.3% of GDP in H1 2019 and is projected 1.7% in full-year 2019, compared to 0.4% in 2018) and the expected increase in foreign portfolio investment inflows into China's financial markets (following recent market opening measures) might also help stabilise the exchange rate in the short term.

1- Forecasts

	2017	2018	2019e	2020e
Real GDP growth (%)	6.8	6.6	5.9	5.6
Inflation (CPI, year average, %)	1.6	2.1	2.4	2.8
Actual fiscal balance / GDP (%)	-3.7	-4.2	-4.5	-5.0
Central government debt / GDP (%)	16.4	16.6	19.6	22.0
Current account balance / GDP (%)	1.4	0.4	1.7	1.4
Total external debt / GDP (%)	14.4	14.5	14.1	13.5
Forex reserves (USD bn)	3 140	3 073	3 075	2 980
Forex reserves, in months of imports	17.0	14.5	14.9	14.8
Exchange rate USDCNY (year end)	6.5	6.9	7.3	7.2

e: BNP Paribas Group Economic Research estimates and forecasts

2- US tariffs and China's exchange rate policy



Source: China Foreign Exchange Trading Center, BNP Paribas.

** The CFETS index shows the yuan's weighted average exchange rate against the currencies of China's main trading partners.*

*** The lists of Chinese goods imported by the US and affected by tariff hikes are called "List 1" totalling USD 34 bn, "List 2" totalling USD 16 bn, "List 3" totalling USD 200 bn and "List 4A" of USD 125 bn (first slice of list 4).*

Credit is not responding much to monetary easing

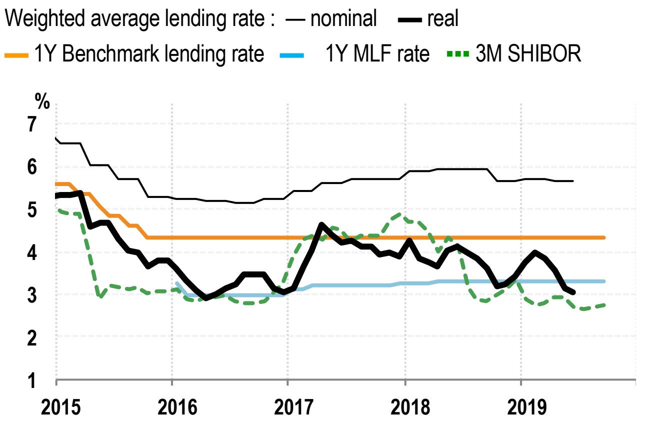
Investment and private consumption growth continued to falter in Q3 2019. In value terms, investment rose by only 5.5% y/y in the first eight months of 2019, compared to 5.8% in H1 2019. Growth in retail sales slowed to 7.5% y/y in July-August, compared to 8.4% in H1 2019. There are several downside factors: the troubles in the manufacturing sector are squeezing corporate profits and affecting the job market; food price inflation has surged (+10% y/y in August), and growth in bank loans to households has slowed (+16% y/y in August compared to +21% at year-end 2017). In this morose environment, it is interesting to note that the housing market has picked up a bit, with transaction volumes increasing slightly again in July-August, while average house price inflation continued to ease (+5.3% y/y in August). In the commercial and office real estate markets, in contrast, sales volumes continued to slump.

Monetary and fiscal policies have become increasingly expansionist since spring 2018 to counter the slowdown in domestic demand growth. Monetary and credit policy has been eased continuously and cautiously. Banks have been encouraged to increase lending to certain corporates, such as SMEs, the healthiest companies and the most buoyant sectors; liquidity conditions have been improved, thanks to successive reductions in reserve requirement ratios (the latest 50bp cut was in mid-September) and bank lending rates have been lowered slightly. To increase the effectiveness of its actions, the central bank announced a new interest rate reform in August 2019: the one-year loan prime rate will no longer be guided by the "benchmark lending rate", but by the "medium-term lending facility (MLF) rate". This change should improve the transmission of monetary policy and encourage the decline in interest rates on loans to the non-financial sector in the short term.

As a matter of fact, the weighted average lending rate on bank loans has not declined much since the beginning of monetary easing. From Q2 2018 to Q2 2019, it narrowed by 28 basis points (bp) in nominal terms and by 120bp in real terms (chart 3). Domestic credit growth has barely picked up. The rebound in bank lending (which accounts for two thirds of "total social financing") proved to be short lived: after accelerating between H2 2018 and Q1 2019, nominal loan growth slowed again from 13.8% y/y in March 2019 to 12.6% in August. Banks have remained very cautious in view of the economic slowdown, the excessively heavy debt burden of borrowers, and high risk of defaults. Credit from non-bank financial institutions (shadow banking) has continued to contract, illustrating the authorities' determination to continue cleaning up the financial sector. Bond issues were the only type of financing that has accelerated gradually over the past year (+11.3% y/y in August).

As a matter of fact, the authorities have little room for manoeuvre to boost credit. Beijing wants to stimulate domestic demand while also continuing to strengthen the financial sector's regulatory framework, encourage deleveraging of both financial institutions and the weakest state-owned companies, and cool the property market in order to improve housing affordability. Excessive debt in the corporate sector (which was estimated at about 135% of GDP at mid-2019, excluding local government financing vehicles) and the already high level of household debt (55% of GDP) are major

3- Interest rates on bank loans do not decline much



Source: PBOC

factors constraining the growth and efficiency of new loans. Interest rates are expected to decline slightly further in the short term, and the authorities could try to ease monetary policy further if economic growth were to deteriorate further. Even so, this risks having only a very mild impact on activity.

The impact of fiscal measures should start to be felt

Growth in public infrastructure investment is beginning to pick up. It should strengthen further in the short term given the recent rebound in bond issuance by local governments for project financing. Yet the authorities have limited room for manoeuvre to boost public investment as local governments and their financing vehicles are also strapped with high debt (estimated at about 50% of GDP).

A series of fiscal stimulus measures have been introduced since 2018. Household tax cuts aim to stimulate consumer spending by providing direct support for disposable income. These measures are geared especially towards low-income households. For example, changes introduced over the past year include raising the income tax brackets for the lowest income earners. The authorities initially estimated that tax cuts would boost total disposable income by as much as RMB 660 bn, which could increase private consumption by a total of 1.2 percentage points. The positive impact on household spending was not visible yet in August's economic indicators. However, the slight improvement in the "new orders" components of the PMIs for both the manufacturing and services sectors in September seems to suggest that a recovery in private consumption growth is possible in the very short term.

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India

In need of investment

Economic activity slowed sharply in the first quarter of fiscal year 2019/2020 and second-half prospects are looking morose, even though the monetary authorities and the government have taken major stimulus measures. Monetary easing resulted in a mild decline in lending rates. The recently announced cut in the corporate tax rate should boost domestic and foreign investment in the medium term, although it will not impact growth much in the short term. Companies might decide to consolidate their position rather than to invest in the midst of a sluggish environment.

Economic growth slumps to record lows

India's GDP growth has slowed sharply since the second half of 2018. In the first quarter of fiscal year 2019/2020 (from April to June 2019), GDP rose only 5% year-on-year (y/y), the slowest pace in the past six years. The slowdown is mainly due to the sharp deceleration of domestic demand. Although Indian exports slowed (while exports from the other Asian countries contracted), the net contribution of exports swung into positive territory after making a negative contribution for the previous eight quarters.

Private consumption, the main growth engine, rose by only 3.1% y/y compared to a 2018 average of more than 8%. The slowdown can be attributed to a decline in household confidence combined with an increase in the unemployment rate, which rose to 8.2% in late August (vs. 6.5% in the year-earlier period). Moreover, the supply of non-bank lending slowed due to the financing difficulties encountered by non-banking financing companies (since the bankruptcy of IL&FS in September 2018). Total investment slowed sharply to 4% y/y (vs. 13.3% last year) at a time of high interest rates (9.8% for new rupee-denominated loans in July) even though the Reserve Bank of India (RBI) has been easing monetary policy since February 2019. Average interest rates on new loan production declined by only 29 basis points (bp) between February and August, despite the central bank's 110bp key rate cut over the same period.

Economic indicators for the second quarter of the current fiscal year do not suggest a rebound in the short term. Output of capital goods contracted in August for the seventh consecutive month, automobile sales declined sharply, confidence surveys continued to deteriorate and industrial activity, according to the latest PMI surveys, still did not rebound in August. Lastly, bank lending has been slowing since February and slumped even further in August.

The government and the central bank have undertaken numerous measures to boost economic activity, the biggest of which was the sharp cut in the corporate tax rate.

Corporate tax cut: a positive medium-term impact

In late September, the government announced that it was cutting the corporate tax rate from 30% to 22% (effective retroactively to 1 April 2019), with a preferential rate of only 15% for manufacturing companies created after 1 October 2019. Including all of the other taxes companies must pay (notably education taxes), this would bring the effective tax rate to 25.17% (17% for new manufacturing companies), which is close to the corporate tax rates applied in the other emerging markets of Asia (25% in Indonesia, 24% in Malaysia).

In the short term, the impact of the corporate tax cut is bound to be limited. The current slowdown is essentially due to household consumption. Moreover, Indian companies might decide to use the tax cut to slash debt rather than to invest in the midst of a sluggish economic environment.

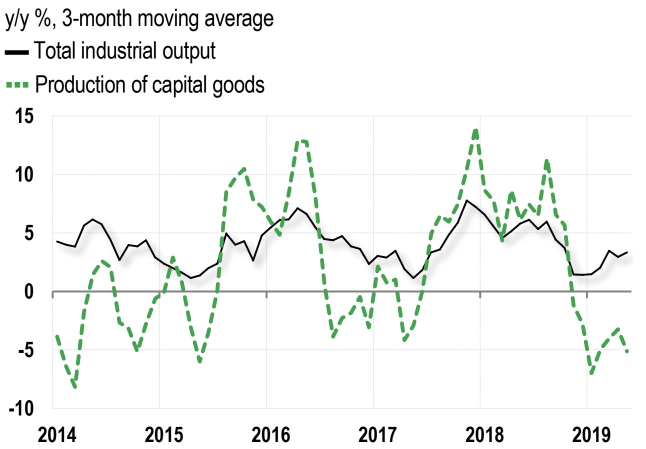
1-Forecasts

	2017	2018e	2019e	2020e
Real GDP growth[1] (%)	7.2	6.8	5.4	6.5
Inflation [1] (CPI, year average, %)	3.6	3.4	3.5	3.8
Central Gov. Balance[1] / GDP (%)	-3.5	-3.4	-3.6	-3.4
Central Gov. Debt[1]/ GDP (%)	45.6	44.6	44.4	44.1
Current account balance[1] / GDP (%)	-1.8	-2.1	-2.1	-2.2
External debt[1]/ GDP (%)	20.0	20.0	19.9	20.0
Forex reserves (USD bn)	409	393	435	460
Forex reserves, in months of imports	11.5	9.1	9.4	9.3
Exchange rate USDINR (year end)	63.9	71.0	71.2	73.5

(1): Fiscal year from April 1st of year n to March 31st of year n+1

e: BNP Paribas Group Economic Research estimates and forecasts

2- Industrial output



Source: CEIC

In the medium term, this measure should increase India's competitiveness, thereby favouring foreign direct investment (FDI). Yet the Modi government must take its reform efforts further. Restrictions on land acquisition and labour market rigidity continue to place a major damper on domestic and foreign investment.

Public finances: risk of fiscal slippage in 2019/2020

For the second consecutive year, the federal government may not meet its target of reducing the fiscal deficit to 3.3% of GDP in fiscal year 2019/2020 (compared to 3.4% of GDP in 2018/2019). In the first 5 months of the fiscal year, the fiscal deficit was already equivalent to 78.7% of its full-year target.

This poor performance can be blamed on revenues, which fell far short of estimates. In the first 5 months of the current fiscal year, spending amounted to 42.2% of the full-year target, but revenues – though on the rise – accounted for just 29.8% of the full-year target of 9.9% of GDP (vs. 8.8% of GDP in 2018/19). Taxes revenue was the main component that fell short of the government's forecast. It amounted to only 24.5% of the full-year target due to the downturn in domestic demand and foreign trade.

According to government estimates, the cut in the corporate tax rate will generate a revenue shortfall of 0.7% of GDP (including 0.46% of GDP for the central government). Part of this shortfall will be offset by a bigger-than-expected transfer of the central bank's surplus: in late August RBI announced that the transfer of "capital surplus" (in relation to its needs) to the government would be equivalent to 0.8% of GDP (vs. 0.5% of GDP in the finance ministry's initial fiscal forecast). If the government does not significantly reduce spending during the rest of the year, the deficit for the general government could increase by 0.4 pp to 6.7% of GDP. Consequently, the government seems to be very far from meeting its target of reducing the public debt ratio to 60% of GDP by 2025 (from 67.3% of GDP in 2018/2019).

For an emerging country, India's public debt is still high[1] although its structure is not very risky. Exchange rate risk is low because debt denominated in foreign currency accounted for only 2.8% of GDP in June 2019. Refinancing risk is also limited since the average maturity on the debt is 10.4 years. Only 4.3% of its debt will reach maturity over the next twelve months. With residents holding 93% of its debt, the government is not very dependent on foreign investors for debt financing.

Less pressure on external accounts

India's external accounts deteriorated in 2018. A wider current account deficit combined with a decline in foreign direct investment and portfolio investment resulted in a USD 15 billion decline in foreign exchange reserves and a 9% depreciation of the rupee against the dollar.

This movement has since been reversed. In the first 9 months of 2019, the average exchange rate has been stable and foreign exchange reserves have increased by USD 33.5 billion to a record high of USD 401.6 billion at the end of September. Reserves cover 1.4 times the country's short-term financing needs (USD 297 billion). At the same time, FDI and portfolio investment have increased (to 1.9% of GDP and 1.4% of GDP, respectively, in H1 2019). The big increase in FDI following the re-election of N. Modi is particularly good news, because 1) it covers the current account deficit, and 2) it reduces the country's dependence on volatile capital inflows. Although the current account deficit is likely to widen in the second half of 2019 (after reaching 1.3% of GDP in H1 2019, compared to 2% in the year-earlier period) it should continue to hold at about 2.5% of GDP.

Lastly, external debt is still mild, although it has increased slightly (+8.7 in Q2 2019 y/y). At the end of June 2019, it amounted to only 19.8% of GDP. Commercial borrowing is the largest debt category (38.4% of the total), followed by non-resident deposits (24%) and short-term trade credit (18.7%).

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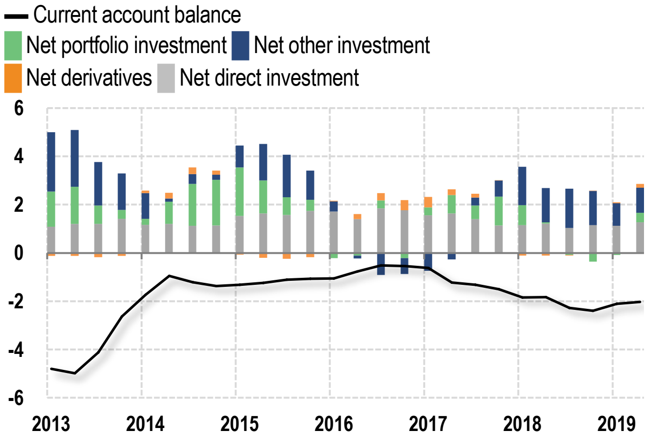
3 – Balance of payments

4-quarter sum, of GDP



Source: RBI

[1] In comparison, Indonesia's government debt accounted for only 30.1% of GDP in 2018.

Brazil

In the spotlight

The world's projectors have descended on Brazil following raging fires in the Amazon forest. President Jair Bolsonaro has come under pressure for his lack of engagement and commitment to protecting the environment. The pace of economic growth is still struggling to accelerate. Confidence indicators are ambivalent while investment remains weak. In the wake of a much less buoyant external environment and low inflation risk, the Central Bank has lowered its policy rate by a cumulative 100 basis points since August. The pension reform was approved in the Senate (first round) but was subject to revisions. Throughout the fall, a number of major reforms should be deployed and privatizations and concessions should accelerate.

Downplaying environmental concerns

In recent months, President Jair Bolsonaro has attracted attention for his management of the Amazon rainforest fires, his noted absence from the United Nations Climate Action Summit as well as his lively exchanges with French President Emmanuel Macron. In keeping with environmental concerns, Germany and Norway have meanwhile suspended their donations (USD 30 million each) to the Amazon Fund, citing the Brazilian government's lack of engagement and goodwill in fighting deforestation.

These diplomatic spats as well as financial sanctions have cast new doubts regarding the future endorsement and ratification of the already contested free trade agreement between the European Union and Mercosur. If ratified, countries party to the agreement will have to comply with international standards and treaties regarding environmental protection (including compliance with the Paris Agreement). The Amazon crisis and Brazil's shortcomings in terms of environmental protection have also sparked a reaction from multinational companies, asset management firms, pension funds and insurance companies. To that effect, a group of 230 institutional investors totalling USD 1620 bn in assets under management published a joint statement demanding that companies ensure that their supply chains exclude any activity that contribute to deforestation in the Amazon. In response to these pressures, Brazil has launched a campaign to improve its image abroad. First, through social media but also by mobilizing several ministers, sent on assignments – primarily to the United States and Europe – to convince businesses and foreign investors that in order to protect the rainforest, fight against the activities that threaten it (illegal farming, grazing, logging etc.), and reduce poverty, it is necessary to leverage the region's natural resources and foster its economic development.

A (still) fragile recovery

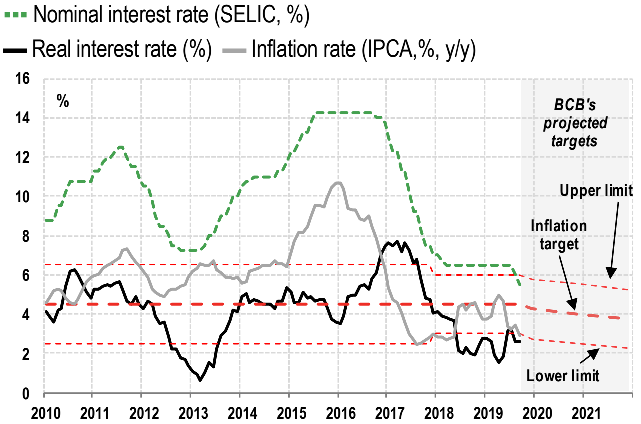
The economy is still struggling to find solid growth drivers. On a positive note, fears of recession through the first semester were dispelled as GDP growth in Q2 proved to be stronger than expected (0.4% q/q). The year-on-year print was even stronger at 0.9%, however it reflected in large part a significant base effect resulting from the impact on economic activity of the truckers' strike in Q2 2018. On the supply side, growth took advantage of a relative bounce back in activity in the industrial sector (notably in manufacturing and construction) which overall contributed 0.14 percentage points (pp) to quarterly GDP growth following two quarters of negative contributions.

1- Forecasts

	2017	2018	2019e	2020e
Real GDP growth (%)	1.1	1.1	0.5	2.0
Inflation (CPI, year average, %)	3.0	3.7	3.1	3.5
Fiscal balance / GDP (%)	-7.8	-7.1	-6.7	-6.8
Gross public debt / GDP (%)	74	77	82	82
Current account balance / GDP (%)	-0.5	-0.8	-1.1	-1.7
External debt / GDP (%)	27	33	35	38
Forex reserves (USD bn)	373	374	365	360
Forex reserves, in months of imports	20	18	18	18
Exchange rate USDBRL (year end)	3.3	3.9	3.8	3.4

e: BNP Paribas Group Economic Research estimates and forecasts

2- Rates dynamics



Source: IBGE, BCB

So far, the indicators available through Q3 point to relatively weak growth. The Central Bank's IBC-BR leading indicator of economic activity fell 0.2% m/m in July, despite better performances in services (0.8% m/m, seasonally adjusted) and stronger retail sales (1% m/m and 4.3% y/y). Industrial production could be losing steam as year-on-year figures show a fall of -3.3% for July-August on average with a sharp decline in the production of intermediate goods. Growth prospects in the industrial sector remain fragile due to the global slowdown and the recession in Argentina. These concerns appear to be corroborated by confidence indicators (FGV and CNI indices) which all around showed no improvement in September. On another note, Petrobras announced in September a 3.5% increase in gasoline prices as well as a 4.2% increase in diesel prices. Besides weighing on household consumption, these changes could fuel social discontent. Truck drivers have not yet reacted to the increases for the moment.

In the short term, the economy is unlikely to find an engine of growth in public spending. The 2020 draft budget calls for public investment to contract by about BRL 7 bn compared to 2019. Total planned capital expenditure is estimated at BRL 19.4 bn (0.3% of GDP), the lowest figure in ten years. In contrast, private consumption and residential investment should benefit from a temporary measure allowing for the release of funds from FGTS[1] accounts totalling around BRL 42 bn over the next two years. Such funds will also be allowed to qualify as collateral for mortgages. This move along with other measures is expected to help jump start growth in mortgage loans which has remained stagnant since the end of the recession.

External accounts : jostled but no major risks

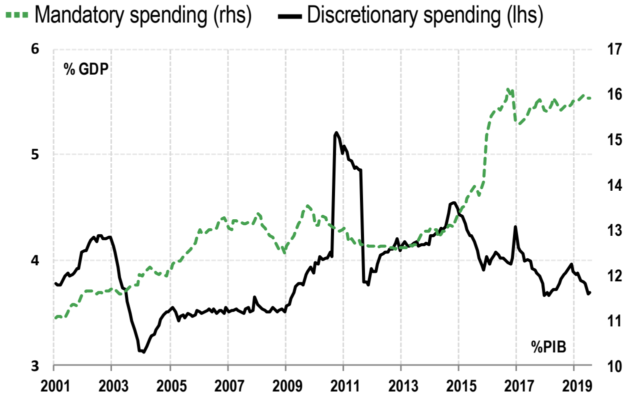
The current account deficit has widened but remains moderate at 1.8% of GDP in August (over 12 months) compared to -0.8% at end 2018. The persistent weakness of sugar and coffee prices (of which Brazil is respectively the 1st and 2nd global exporter) have adversely weighed on exports in value. While exports to Argentina continue to suffer from the country's economic adjustment, current account receipts have on the flipside benefitted from an upsurge in beef exports to China (up 15% yoy over the January-August period due in large part to the swine fever epidemic affecting the Asian giant). So far, the current account deficit remains largely covered by net foreign direct investment (2.8% of GDP over 12 months) and, in general, capital flows largely cover the country's external financing needs. Foreign exchange reserves have continued to increase over the first 8 months of the year (USD 386 billion at the end of August against 374 billion at the end of 2018) but fell in September to USD 376 billion following the Central Bank's intervention in the spot market following a recent policy change.

After gaining some ground against the dollar between May and July, the BRL plunged sharply in August (-9%) and has hovered north of BRL 4 to the dollar ever since. Despite a large surplus basic balance, the BRL's weakness is a good reminder of Brazil's sensitivity to net outflows of portfolio investment (USD 5.1 billion in August over 12 months), even though the country is not the most vulnerable emerging economy in this respect. Monetary policy easing is currently accentuating this sensitivity.

Low interest rates: the new normal?

The Central Bank of Brazil (BCB) has lowered its key policy rate (SELIC) by 50 basis points (bps) twice since August, bringing the rate down to 5.5%, after holding it at 6.5% since March 2018. For the moment, inflation remains contained below the BCB's target for 2019 (2.9% y/y in September vs 4.25%). According to BCB's monthly survey, the market consensus anticipates a SELIC rate of 4.75% by year end before rising back to 5% by the end of 2020.

3- Central government : evolution of spending (% of GDP)



Source: National Treasury

The current low interest rate environment is generating new market dynamics. Local investors accustomed to high bond yields are shifting asset allocations which are particularly beneficial to the equity market. Interest rate cuts in recent years coupled with the stripping of Brazil's investment grade rating in 2015 also triggered a sharp drop in non-resident holdings of government bond in the local debt market (from 21% in 2015 to 12% in 2019). The fall in the SELIC has also reduced the attractiveness of carry trades strategies for some international investors. Conversely, lower domestic rates are encouraging some Brazilian companies to exchange foreign currency debt for BRL denominated debt.

Some progress on the reform agenda

The Senate has approved the pension reform bill through a first round of voting (a second vote is expected by the end of the month). The fiscal savings achieved through the reform should ultimately amount to about BRL 800 bn over 10 years versus BRL 910 bn following the vote at the Chamber of Deputies in August. Over the course of the fall, the government is expected to present its fiscal reform as well as roll out its privatizations and concessions programme. A third of the 130 state-owned enterprises (SOEs) could be affected. According to a Supreme Court decision in June, subsidiaries (half of the SOEs) will not require Congressional approval to be sold. New measures have also been adopted to help liberalize the economy and support entrepreneurship: i/ improved access to credit for small and micro enterprises[2], ii/ new regulatory framework in the telecommunication sector, iii/ reduced tariffs on 2300 products. In the next 4 years, the authorities hope to increase trade openness to 30% of GDP from 22% currently.

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[1] Fondo de Garantia do Tempo de Serviço is a workers severance fund account funded by employer contributions equivalent to about 8% of wages that protects against the risk of unemployment among other factors. The funds are deposited in an account at Caixa Federal, a government-owned bank.

[2] A new law voted in April 2019 allows for the creation of *Empresas simples de credito* (ESC), a structure analogous to a microfinance company which provides small and micro enterprises access to credit at very low interest rates and require less red tape. Since April, 350 ESCs have already been created.

Russia

Resilience but no growth

In August, the rating agency Fitch upgraded Russia's sovereign rating based on its greater resilience to the external environment. The timing might seem surprising considering that Russian GDP growth slowed sharply in H1 2019 and the central bank had to revise its outlook for 2019-2021 downwards again. Even so, the consolidation of Russian fundamentals is undeniable. Currently the main sources of concern are the sharp increase in household lending and the delays in implementing public spending programmes, which should stimulate growth in the medium term.

Economic growth slowed sharply in H1 2019

In first-half 2019, GDP growth slowed sharply to 0.7% year-on-year (y/y), compared to 2% in H1 2018. This slowdown can be attributed to the decline in domestic and foreign demand. Exports contracted due to the decline in global demand and the adoption of new oil output quotas as part of the OPEC agreements. Household consumption slowed sharply following a 2-point increase in the VAT rate as of 1 January. Investment also slowed. Public investment projects announced for 2019 were postponed, and by August they still had not been implemented. Moreover, the monetary environment is not favourable for an upturn in private investment, although the decline in interest rates since June should reverse this trend.

The Central Bank of Russia (CBR) proceeded with three 25bp rate cuts between June and September. Monetary easing was facilitated by price inflation that was not quite as high as the monetary authorities expected, and close to the target rate of 4% (prices rose 4.3% y/y in August). By the end of July, more than 80% of this monetary easing had carried over to corporate lending rates.

Even so, growth prospects are still sluggish. The central bank has revised its outlook for 2019, 2020 and 2021 downwards again. Growth is only expected to accelerate by 2% to 3% in 2022 if the government manages to remove some of the structural impediments to growth (notably by increasing expenditure on education, healthcare and infrastructure as planned in the national spending programme of May 2018).

Banking sector: increase in household loans is a new source of risk

The banking sector continues to consolidate but the economic slowdown could undermine the quality of assets. The sharp increase in household lending is a new source of risk, even though the central bank tightened its prudential regulations again on 1 October.

The monetary authorities have continued to clean up the banking system over the past twelve months. In September 2019, there were 454 banks, down from 1,344 in 2000.

The quality of bank assets has also improved since mid-2018, even though it is still fragile. In July 2019, the doubtful loan ratio was 9.9% of all loans, while the share of risky assets (non-performing and restructured loans) declined to 17.9%, from 19.1% the previous year. This consolidation reflects the deleveraging of non-financial companies on the one hand, and on the other, the transfer of the risky assets of three private banks (Otkritie, B&N and Promsvyazbank) to Trust Bank, a defeasance structure, as part of the rescue package set up by the central bank. At the same time, the capital adequacy ratio improved slightly to 12.3% in July.

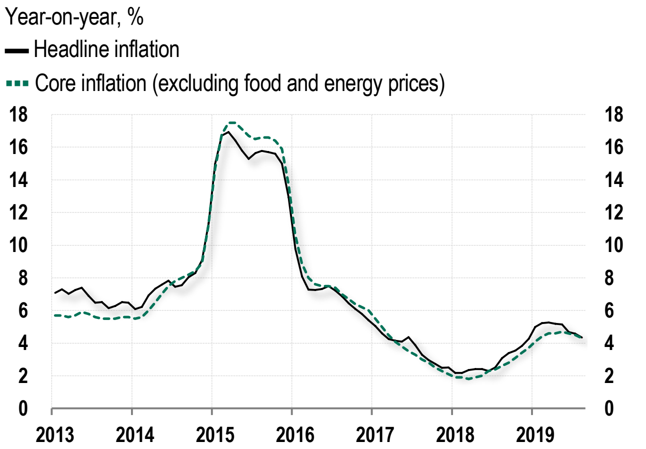
The dollarization of the banking sector continued to decline. In July 2019, 20% of loans and 25% of deposits were denominated in foreign currencies, compared to 35% and 42%, respectively, in 2015. Moreover, at the end of March 2019, the external position of all

1-Forecasts

	2017	2018	2019e	2020e
Real GDP growth (%)	1.6	2.3	0.9	1.5
Inflation (CPI, year average, %)	3.7	2.9	4.7	3.8
Central Gov. balance / GDP (%)	-1.5	2.9	1.7	1.0
Public debt / GDP (%)	15.5	14.3	14.8	15.1
Current account balance / GDP (%)	2.1	6.9	5.3	3.0
External debt / GDP (%)	32.8	27.2	26.6	23.8
Forex reserves (USD bn)	356	375	424	440
Forex reserves, in months of imports	10.3	12.8	13.0	13.2
Exchange rate USDRUB (year end)	58.3	69.4	67.0	66.0

e: BNP Paribas Group Economic Research estimates and forecasts

2- Price inflation is close to target



Sources: CBR, CEIC

banks was still largely positive, with external assets covering 1.5 times external commitments. The external debt of banks was down by 61.5% compared to 2014 and accounted for only 4.9% of GDP in Q2 2019. Payments due by March 2020 were limited to USD 18.1 bn.

The banking sector's profitability has picked up with a 50% y/y increase in profits in August 2019. The return on equity (ROE) and assets (ROA) were 17.3% and 1.9%, respectively, in July 2019 (compared to 6.8% and 0.8%, respectively, in the year-earlier period).

Although the banking sector is generally more solid than it was a year ago, the sharp increase in household loans is a new source of concern. Up 21.9% y/y in July 2019, household loans grew at a much faster pace than wage growth (+9% y/y). Moreover, interest rates on household loans are still high (13% on loans maturing in more than one year in July 2019). Contrary to corporate rates, they have only declined by 17bp since the beginning of the year.

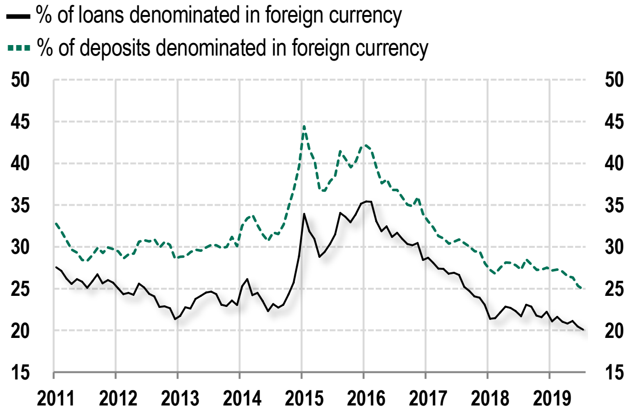
So far, household debt has only increased by 3 percentage points to 16.3% of GDP in Q2 2019. According to the central bank, the debt ratio is still moderate at 25% of revenues at end-2018. Household loans as a share of bank portfolios is also moderate (26% of total loans) and the doubtful loan ratio was limited to 5% at the end of July. The situation nonetheless needs to be watched, especially for loans without collateral (50.4% of household loans), which have a doubtful loan ratio of 8.4%. To encourage banks to reduce this type of household lending, the central bank has increased the weighting of loans without collateral in the calculation of risky assets on four occasions since 1 March 2017. Moreover, as of 1 October 2019, a new weighting will be introduced for loans whose debt servicing exceeds 50% of revenue.

US Congress tightens sanctions

On 2 August 2019, the US government adopted new sanctions against Russia in application of the 1991 Chemical and Biological Weapons Control and Warfare Elimination Act, but they are unlikely to have much of an impact. The main measure forbids American banks from participating in foreign currency bond issues by the Russian government and to grant foreign currency loans to any Russian public organisation. The new sanctions do not cover local currency government bonds (OFZ) and do not prevent American banks from purchasing foreign currency bonds in the secondary market.

In September 2019, the stock of Eurobonds held by foreign investors amounted to only USD 22.5 bn (11.5% of Russian bonds, i.e. 1.4% of GDP) and all external public debt amounted to only USD 49 bn, the equivalent of 11.7% of foreign exchange reserves. Moreover, in full-year 2019, the government only issued USD 5.5 bn and EUR 750 m in Eurobonds. It had no trouble placing the bonds at high yields (5.1% for USD bonds maturing in 2035). Even if new sanctions were implemented against the Russian state, the government still has the capacity to face up to the situation given its low debt level (14.6% of GDP) and mild financing needs (equivalent to an annual average of 0.8% of GDP over the next 5 years).

3 – The dollarization of the banking sector has declined



Source: CBR

External vulnerability declines

Russia has consolidated its external position through the accumulation of foreign reserves (USD 423.1 bn at the end of September 2019, a USD 39 bn increase from the previous year), the decline in the external debt (29.5% of GDP in Q2 2019 vs. 41% in 2016) and the partial uncoupling of oil prices and the rouble's exchange rate. The external position amounted to USD 370 bn in Q1 2019, the equivalent of 22% of GDP.

Debt payments due over the next twelve months, estimated at USD 50 bn by the central bank, should be covered by the current account surplus, which reached an annualised rate of USD 91 bn in H1 2019. It is expected to remain solid, even though it has declined somewhat compared to 2018.

Foreign exchange reserves should continue to swell, buoyed by the current account surplus on the one hand and by the central bank's foreign currency purchases on behalf of the ministry of finance on the other. In the first 8 months of the year, they amounted to USD 32.8 bn.

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Poland

Loss of momentum

In the first half of 2019, Poland's economic growth held up well to the deterioration of international conditions. Its economic prospects remain relatively positive in the short term despite the downturn in the cycle. The economic model of competitiveness and low labour costs – the foundation of the economic transition of which Poland is a successful example – will be altered by the more generous social policies introduced by the current government. Cyclical and structural factors argue for a slowdown in investment growth over the short and medium term. Of the factors weighing on medium and long-term growth potential, the demographic decline seems the most potent.

A controlled slowdown

We have upgraded our growth forecast for 2019 from 4% to 4.3% and downgraded our 2020 forecast from 3.5% to 3.3%. Despite pressure on international trade, slowing growth in the euro zone and the contraction of Germany's GDP in Q2 2019, Polish economic activity again surprised positively over the first part of the year. First half GDP growth was a vigorous 4.4% year-on-year (y/y). Although this was slower than the 5% seen in 2017 and 2018, it was nevertheless stronger than the five-year average of 4%. The quarterly variation shows a steeper slowing (from 1.4% q/q adjusted for seasonal variations and working days in Q1, to 0.8% in Q2), and this will continue. International conditions suggest that exports, production and private investment will all lose speed over the next few quarters and ultimately feeding through into consumption, the main engine of growth.

Having disappointed in Q1, household consumption (61% of GDP) bounced back in Q2 (1.2% q/q adjusted and 4% y/y). Labour market tensions, symbolised by the historically low unemployment rate (3.3% in August according to harmonised Eurostat statistics), have maintained strong upward pressure on nominal wages (7% y/y in H1). Retail sales remained on a positive trend in August, as did consumer confidence in September. Domestic demand was also boosted by an expansionist policy mix, made possible by a degree of room for manoeuvre on the budget. Having won legislative elections, the conservative PiS Party, which has been in power since 2015, has promised increases in the minimum wage of 78% by 2023.

Total investment rose by 10.6% y/y in H1, under the continued influences of business investment and public infrastructure investment. The capacity utilisation rate has held at an historically high level of above 80% for more than a year. Exports of goods and services remained strong in year-on-year terms (up 4.9% in H1 by volume and 8.5% by value over the first seven months of the year), contributing to the robust performance of external accounts despite strong growth in imports.

However, exports slowed on a quarterly basis over the first half (down 0.4% q/q wdsa in Q1, and up 1% in Q2), whilst industrial production, notably in manufacturing, stood still in August (down 1.3% y/y in August, giving a three-month moving average of 0.6% y/y). This slowdown can be seen in the latest confidence surveys of companies in the manufacturing sector (September), which were more pessimistic about the overall economic position, the domestic & export order books, production and employment. The Manufacturing PMI supports this view of deteriorating prospects in the short term.

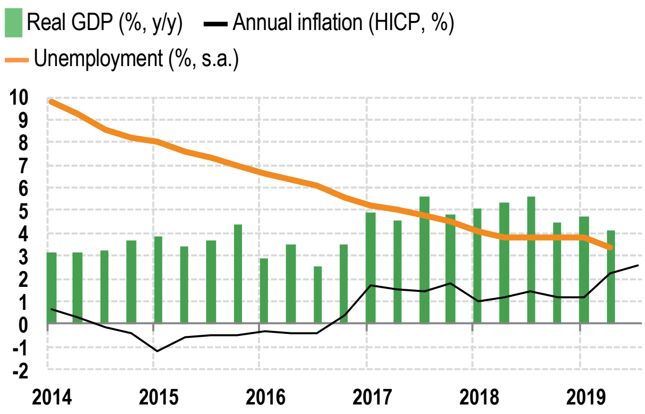
The risk of an economic slowdown in the second half led the National Bank of Poland to hold interest rates steady at the beginning of October (at 1.5%, unchanged since 2015). The NBP reiterated the transitory nature of inflation above the 2.5% target, which has been due mainly to an increase in food prices. Core inflation hit 2.4% in September whilst headline CPI inflation dropped from 2.9% y/y in August to 2.6% in September.

1- Forecasts

	2017	2018	2019e	2020e
Real GDP growth (%)	4.6	5.2	4.3	3.3
Inflation (CPI, year average, %)	2.0	1.7	2.3	3.2
Gen. Gov. balance / GDP (%)	-1.5	-0.4	-1.5	-1.4
Gen. Gov. debt / GDP (%)	50.6	48.9	47.4	46.0
Current account balance / GDP (%)	0.2	-0.6	-0.5	-2.0
External debt / GDP (%)	72.2	61.3	58.5	57.0
Forex reserves (EUR bn)	94.5	102.3	103.8	105.2
Forex reserves, in months of imports	4.8	4.8	4.5	4.3
Exchange rate EURPLN (year end)	4.2	4.3	4.3	4.3

e: BNP Paribas Group Economic Research estimates and forecasts

2- Growth, inflation and unemployment



Source: GUS, Eurostat

A review of a successful economic transition

Since the beginning of the 1990s, Poland has conducted a policy of economic liberalisation, which, combined with institutional reforms and political stability, has generated uninterrupted economic growth since 1992, at an average annual rate of 4.2%. According to the World Bank's classification, Poland is an example of a successful transition from a low- to medium-income planned economy (USD6,600 per capita in purchasing power parity terms in 1992) to a market economy highly integrated within the European Union (EU) and global value chains and, since 2009, classified as high-income (USD32,000 per capita since 2018).

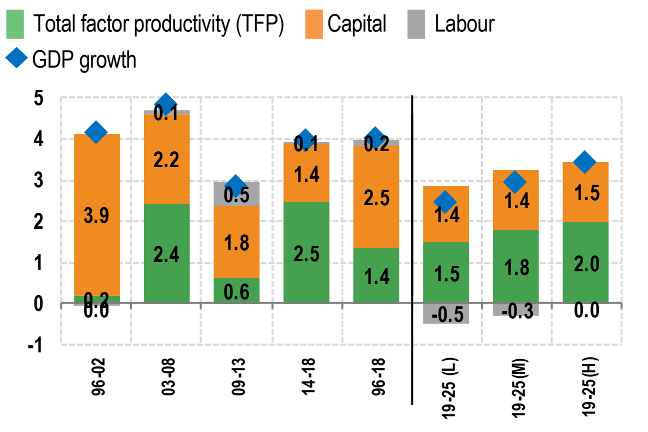
Under the classical approach of breaking down growth into factors of production (capital and labour) and changes in total factor productivity (TFP), our estimates indicate that the accumulation of capital contributed 61% of GDP growth between 1996 and 2018. Efficiency gains, measured by the contribution to growth of TFP, contributed 34% to growth, the remainder coming from an increase in the labour factor. To borrow Paul Krugman's phrase, the "perspiration" behind growth, that is the contribution of factors of production, came almost exclusively from the accumulation of physical capital. Meanwhile, the "inspiration" came both from technical progress, and improvements in the institutional framework, business environment and human capital.

According to Marc Schiffbauer and Gonzalo Varela ("Macro and micro features of successful economic convergence: the case of Poland", World Bank, January 2019), "the progressive integration into the EU bloc boosted growth and productivity because of three key factors: (i) increased openness to trade, investment and talent, (ii) increased domestic competition and regulatory harmonisation with the EU and (iii) increased certainty in reforms, through a commitment to EU institutions." Alongside private domestic and foreign investment, public investment benefited from European co-financing, particularly in infrastructure projects, as Poland has been the leading recipient of European structural funds.

At the same time, demographic decline has limited growth in the active population and employment: the fertility rate has fallen (1.4 children per woman in 2018, from 2 in 1990), the migratory balance is structurally negative, the natural balance (births less deaths) has been negative since 2013, the population is ageing (17% were aged over 65 in 2018, from 9% in 1990) and the activity rate is below the European average (70%, compared to 74% in the EU in 2018 according to Eurostat), particularly amongst women.

In the absence of any increase in the quantity of labour, its quality has improved through better standards of education and skills in the labour force that has accompanied the increasing sophistication of production and exports. The share of the active population (aged 15 to 64) educated to degree level or above rose from 10% in 1997 to 27% in 2018 (Eurostat figures), bringing it close to the EU average of 29%.

3- Contributions to GDP growth and potential GDP growth



Source: AMECO, World Bank, BNP Paribas calculations

Impediments to potential growth

Some structural factors will hold back potential growth over the medium to long term (see Eco Emerging, "Poland: Trees don't grow to the sky", April 2019). With a central scenario (M) estimating potential growth of 2.9% through to 2025, we have a low-range estimate (L) of 2.4% and a high-range figure (H) of 3.4%.

The main differentiating factor between these three scenarios is the demographic constraint. Demographic projections established by the Polish Office of Statistics, Eurostat, the United Nations and the US Census Bureau agree on an acceleration of the decline in the Polish population that began in 2014 over the next few decades (-0.3% per year between now and 2030). Despite family policy measures (family benefits, childcare, etc.) and scope for increases in the activity rate (notably amongst women), only massive immigration can offset the demographic decline and avoid a negative contribution from the labour factor to economic growth by 2025.

Moreover, there are cyclical and structural factors that argue for a slowing of investment and thus the accumulation of the capital factor over the short and medium term. The rates of growth in investment seen over the past two years are not sustainable at the same level, given the expected downturn in the private investment cycle in machinery & equipment and construction and the expected reduction in disbursements from European structural funds for 2021-27 (public investment).

Lastly, the quality of the business environment, the improvement in human capital and the quest for productivity gains through innovation and the shift up-market of Polish products will be essential to underpin economic growth in Poland over the medium and long term.

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South Korea

Double whammy

Korea's economic growth prospects have continued to deteriorate. Recent trade tensions with Japan have come on top of the slowdown of the Chinese economy and in global demand as well as the conflict between the United States and China, hitting exports and investment. The authorities have some scope to stimulate domestic demand. As has been the case for several years now, fiscal policy will remain expansionary in 2020, whilst the central bank could cut its policy rate in the short term. Stimulus measures will nevertheless not be enough to boost economic growth significantly in 2020.

A further slowing of growth

Having grown by 2.7% in 2018, real GDP growth slowed significantly in the first half of 2019 (1.9% y/y). Non-construction investment fell by an average of 6.5% over the first two quarters of 2019 and spending on capital goods fell by more than 17% over the same period, a direct consequence of the difficulties experienced in the semiconductor sector and the trade war between China and the United States. In addition, the macro-prudential rules introduced by the government at the end of 2017 (intended notably to control the growth in household debt) have held back investment in construction. In total, investment fell for the fifth consecutive quarter, dropping by 3.4% (y/y) in Q2 (Chart 2). At the same time, private consumption stabilised at 1.0% in the first half of 2019, having slowed throughout 2018. All the available figures for the third quarter (retail sales, industrial production and the PMI) suggest a further slowing in the third quarter.

Most importantly, exports collapsed, dropping 11.7% y/y in September, after a 13.8% fall in August. Over the last nine months of the year they fell by nearly 10% y/y, having grown by 6% in 2018. Exports to China fell particularly sharply, reflecting both the weakness of global demand – China remains at the centre of the Asian value chain even though its structure is changing – and the slowing of the Chinese economy, which is becoming an increasingly important source of final demand. The worst affected sectors were exports of semiconductors and electronic goods, which saw heavy falls. Nor are prospects particularly favourable: Chinese growth is likely to slow further, and trade tensions between China and the United States persist. In addition, the Korean export sector will be further put to the test over the coming quarters: since the beginning of the summer, the diplomatic conflict between Japan and Korea has heated up, leading to restrictive trade measures between the two countries.

Tensions with Japan

The tensions between Korea and Japan flow from an historical and political conflict that has rumbled on for many decades[1]. Recently, the re-emergence of disagreements relating to colonial reparations have revived tensions between the two countries.

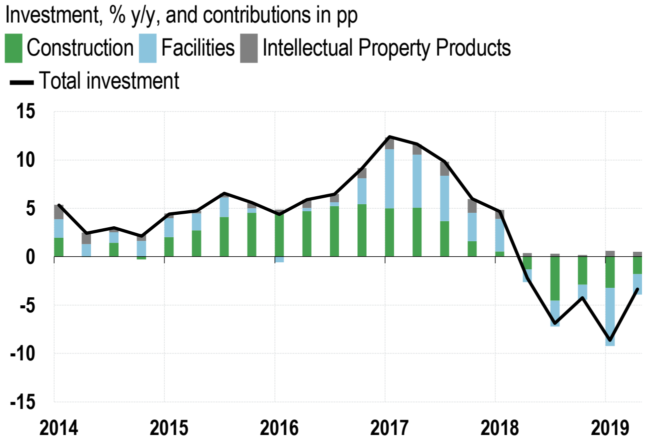
[1] Korea was colonized by Japan between 1910 and 1945. In 1965, after 14 years and 7 cycles of negotiation, the two countries signed a treaty normalizing their relationship, particularly on the economic front. Since then, the relationship between the two countries has nevertheless been strained.

1-Forecasts

	2017	2018	2019e	2020e
Real GDP growth (%)	3.2	2.7	1.9	2.1
Inflation, CPI, year average (%)	1.9	1.5	0.9	1.5
Gen. gov. balance / GDP (%)	1.4	1.4	0.3	-1.6
Gen. gov. debt / GDP (%)	40.4	39.5	37.1	39.8
Current account balance / GDP (%)	5.1	4.8	4.3	4.1
External debt / GDP (%)	27.7	28.3	28.6	28.6
Forex reserves (USD bn)	384	404	405	405
Forex reserves, in months of imports	7.9	7.3	7.5	7.5
Exchange rate USDKWR (year end)	1 130	1 122	1 200	1 100

e: BNP Paribas Group Economic Research estimates and forecasts

2- Investment



Source: National Accounts

On 1 July 2019, the Japanese Prime Minister announced restrictions on the export to Korea of a range of products, including three chemical products that are required for the production of semiconductors, smartphone screens and TVs, which are key industries in Korea. Then on 2 August, the Japanese government announced that Korea had been removed from the list of countries with which Japan has favoured trade relations. The countries on this list are considered as "reliable" trade partners and, amongst other things, enjoy facilities relating to the import of "strategic" products (military material, sensitive chemical products). Conversely, countries not on the list must request special authorisation for each product every 6 months, and the delay in this authorisation being granted can be up to 90 days. Korea will have to seek authorisations for more than 1,000 products, and the Japanese government could expand the list of products requiring special authorisation at any time.

In mid-September, the Korean government took a similar decision, removing Japan from the list of "friendly" trading partners. This decision comes a month after Korea decided not to renew an agreement on the sharing of military intelligence that had existed since 2016.

Repercussions for the export sector

At first sight, the consequences for the Korean economy are likely to be relatively limited: imports from Japan were less than 10% of the total in 2018 (with those from the United States and China representing 12% and 21% respectively), whilst exports to Japan account for 5% of the total (with 25% going to China and 12% to the US). In addition, in terms of value added, the move up market of Korean industry over the past decade has translated into a marked reduction in the share of Japanese inputs into the Korean production process.

This said, in 2018, 90% of imports from Japan were intermediate goods and capital goods. The vast majority of these imports consisted of chemical products, which represent intermediate goods for the semiconductor and base metals sectors and are precisely the products targeted by restrictions. Lastly, the Japanese companies supplying all these goods have dominant positions in the global market, making alternative supplies difficult to access for Korean companies.

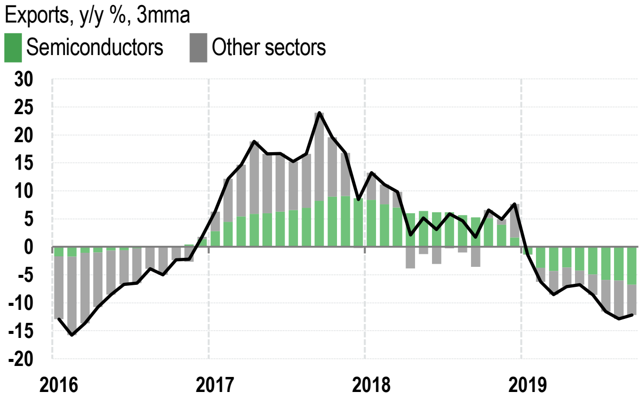
According to the Korean Ministry of Trade, at the beginning of October, that is to say three months after the measures were announced, authorisation requests for numerous products used in the semiconductor production chain had not been successful. The semiconductor sector in particular (but potentially a much broader segment of Korean industry) could find itself structurally weakened if delays in supply (or shortages in a more extreme scenario) persisted. More generally, given the high level of integration of the various economies in the region, the whole of the Asian value chain could be hit by delays in supply. Lastly, investor concern could mount, further holding back investment over the coming quarters.

Sources of support for investment

South Korea has solid macroeconomic fundamentals and the scope to support the economy. Falling inflation gives the central bank the option of cutting interest rates (currently at 1.25%) over the next few quarters.

Most notably, public debt is modest, at around 40% of GDP. When it presented its budget for 2020, the Korean government included a range of measures intended to support growth, particularly in investment. Under its 'growth through innovation' programme, the government plans to reduce dependence on imports, increase local competitiveness and accelerate Korean industry's move up the value chain. The three industries targeted by the programme

3- Exports



Source: Ministry of Trade, Energy and Industry

(semiconductors, biochemicals & healthcare and innovative vehicles) will receive additional support. In addition, research and development spending is likely to rise by nearly 20%, and spending relating to the manufacturing sector and SMEs set to increase by nearly 30% compared to 2019. Fiscal policy has been expansionary for several years now. According to government forecasts, if we take account of the social security surplus, the public finances are likely to be in deficit in 2020 (at 1.6% of GDP, compared to a surplus of 0.3% of 2019) for the first time since 2015. Without the social security surplus, the deficit would be 3.6% of GDP (from 2.0% in 2019).

All in all, given the frankly negative prospects for the export sector, stimulus measures are unlikely to be enough to offset the slowdown in growth in 2019 and 2020. Real GDP growth is unlikely to be significantly above 2.0% in 2019 and 2020.

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Argentina

Up against the wall

The Macri government faces an emergency situation in the run up to October's general elections. Confronted with the erosion of foreign reserves and its failure to roll over short-term bonds, the government was forced to 1) delay payment of Treasury bonds held by local institutional investors, 2) announce debt "re-profiling" and 3) tighten capital controls. After this summer's primary election, the opposition is largely expected to take power. The future government will have to manage numerous priorities and will probably roll back certain economic liberalisation measures. Yet, it has very little manoeuvring room since it cannot risk breaking off relations with the IMF, which is now its main creditor.

With the approach of the first round of presidential and legislative elections on 27 October[1], Argentina's economy continues to sink into recession. Faced with the erosion of BCRA's foreign reserves and the failure to roll over short-term bonds, the government was forced to 1) delay payment of treasury bills held by local institutional investors through the end of the year, 2) announce bond restructuring and 3) tighten capital controls (see box). The IMF supported these emergency measures and is exploring rescheduling proposals. Mauricio Macri's chances of getting re-elected are very low, and his main challenger, Alberto Fernandez, will have to manage an emergency situation with IMF support.

Pre-election financial crisis

In the primary elections, known as PASO, Alberto Fernandez and his vice-presidential running mate Cristina Kirchner reported a big lead over Mauricio Macri, triggering a wave of distrust between foreign and resident investors alike. The official exchange rate plunged to a low of ARG 60 to the dollar before stabilising in early September once new capital controls were introduced. Stabilisation of the currency is obviously very fragile, since the peso has already depreciated by 35% against the dollar since the beginning of the year. The *blue chip swap,* which had disappeared with the elimination of currency controls in 2016, widened again to 15%. To limit capital flight, BCRA had to raise its key benchmark rate (LELIQ) from 60% to 86% before the implementation of capital controls, but it has since eased to 73% (with a floor set at 68% for the end of October). The BCRA had to temporarily postpone its target of a stable monetary base. Lastly, while awaiting the details of the government's bond re-profiling proposal, the risk premium on USD-denominated international debt has culminated at more than 2000 basis points (bp).

Monetary tightening and capital controls slowed the haemorrhaging of foreign reserves, which were down by USD 20 bn compared to the mid-July level, but they continued to erode by USD 120 million a day through early October, to USD 48 bn. After deducting the USD-denominated deposits of commercial banks, IMF loans to BCRA, and the currency swap agreement with China, net reserves had dwindled to only USD 13 bn in mid-September. According to the BCRA's monthly balance of payments statistics, net purchases of external assets (the vast majority of which are net dollar purchases) were buoyant through August (averaging USD 2.8 bn between March and August, with a peak of USD 5.1 bn in August) and will probably continue going strong. Indeed, USD deposits, which had tripled to USD 32 bn between year-end 2015 and end-July 2019, declined by a third until early October, even after the tightening of capital controls (although for households, the ceiling on withdrawals is rather high). All in all, delayed payment of USD-denominated Treasury bills (LETES) - to preserve the banks' USD liquidity - combined with capital controls, failed to reassure deposit holders, although it did prevent a run on deposits. If USD liquidity reserves were to dry up, the banks would still have access to BCRA swap lines.

1- Forecasts

	2017	2018e	2019e	2020e
Real GDP growth (%)	2.7	-2.5	-3.0	-1.5
Inflation (official, annual average, %)	25.2	34.3	56.3	50.0
Fiscal balance/ GDP (%)	-6.0	-5.0	-4.0	-4.0
Public debt/ GDP (%)	52.5	86.0	95.0	84.0
Current account balance / GDP (%)	-4.9	-5.4	-2.5	-1.5
External debt / GDP (%)	36.9	54.2	60.4	61.8
Forex reserves (USD bn)	53	64	45	50
Forex reserves, in months of imports	7.2	8.9	7.0	8.2
Exchange rate USDARS (year end)	18.6	38.3	65.0	80.0

e: BNP Paribas Group Economic Research estimates and forecasts

An alarming economic and social situation

Financial pressures since August can only make an already deteriorated macroeconomic situation worse. In Q2 2019, GDP continued to contract for the fifth consecutive quarter (down 1.3% year-on-year). The cumulative decline since Q2 2018 is 7%, with domestic demand making a negative contribution of 14 percentage points. All of the components of domestic demand are in decline, including public consumption at a time of budget austerity. Despite the recession, the federal government's primary surplus was trimmed to only 1% of GDP in August 2019. Unsurprisingly, foreign trade made a very strong positive contribution (a cumulative total of 7 pp since Q2 2018), but this was due to a sharp contraction in imports, and not to the dynamic momentum of exports. The international cyclical environment has not helped either. Soybean prices have picked up after bottoming out in early May, but wheat and corn prices are still depressed.

[1] The elections cover half of the 257 seats of the Chamber of Deputies and a third of the 72 Senate seats. Gubernatorial elections for five provinces, including Buenos Aires and Grand Buenos Aires, will also be held on 27 October.

The social situation is alarming. Inflation dropped back to a monthly rate of 2% in July, but accelerated again to 4% in August, and should hold within a range of 4-6% through the end of the year. This would boost year-on-year price inflation to close to 60% in December. Since early 2018, the cumulative loss of real wages had already hit 15% at the end of July. Over the same period, social welfare benefits were slashed by 12% in real terms as well. The official unemployment rate rose to 10.6% in Q2 2019, from an average of 8.5% in 2017. A large portion of the middle class was impoverished over the course of the past year.

Even if debt restructuring is carried out smoothly and the IMF shows some flexibility in the face of the gravity of the economic and social crisis, Argentina's economy seems to be headed for a second consecutive year of recession.

Managing priorities

The state's debt load has become excessive despite a restrictive fiscal policy. Major fiscal efforts were taken in recent years to address the situation (the primary deficit was still at 4.2% of GDP at year-end 2016), but they failed to stabilise the federal government's debt ratio, which should reach about 95% at end-2019, up from 52.6% at end-2015. Granted, net interest charges have doubled from 1.3% of GDP at end-2015 to 2.7% at end-2018, but the sin is an excessive foreign currency debt (80% of federal government debt is in foreign currency). Until now, the authorities have tried to avoid asking for a debt haircut, which would open the door to litigation with potential holdouts. Thus, although debt restructuring should provide some respite, it will not solve the problem of stabilising the debt.

In the short term, the most urgent need is to ease the debt burden in USD and to stabilise inflation. Yet this creates conflicting monetary policy targets. Legally, the government has the option to repay its USD debt under Argentine law in pesos, and, for that, it could be tempted (or forced) to resort to monetary financing. Even if the IMF were to agree to ease its quantitative control of the monetary base, it is unlikely to accept such a potentially inflationary solution.

Moreover, the social crisis will probably force Alberto Fernandez to roll back a number of liberalisation measures introduced by the Macri government. At the least, this would entail freezing energy and transport prices, and possibly even the reintroduction of subsidies for low-income households. At the same time, to contain the inflationary effects of currency depreciation and to preserve USD liquidity, we can expect to see higher export taxes, import restrictions and even some price control measures.

The more immediate risk is that the future government might decide to distance itself from the IMF, as E. Duhalde and N. Kirchner did in 2002-2007. This seems very unlikely, especially since Argentina owes the IMF USD 44 bn. Moreover, the current situation is very different and much less favourable than the one in 2002-2007.

The emergency measures introduced on August, the 28th and September, the 1st

Mandatory delay/extension of the maturity of Treasury bills

The payment of Treasury bills (mainly LETES in pesos and LECAP in dollars) held by local institutional investors has been delayed for 6 months for those reaching maturity before the end of 2019, and for 3 months for those maturing in 2020. Interests will continue to be paid.

Bond debt re-profiling

The government will ask parliament to approve a project to reschedule the 2020-2023 calendar of principal repayments of the bond debt issued under the Argentina law and held by local institutional investors. As to the international bonds hold by private creditors (USD 66 bn), the government will propose to reschedule repayments as well. In both cases, there would be no haircut. The government has also asked the IMF to reprofile the repayment of credit lines already disbursed.

Capital controls

The BCRA has imposed time limits on the repatriation of export revenues. Companies will need an agreement of the BRSA for i) the payment of imports of more than USD 2 mn ii) payment of services to foreign companies (except those linked to tourism), and iii) dividend payments.

Companies are not allowed to purchase dollars for savings purposes. Resident individuals are allowed to buy up to USD 10,000 per month and 9/10ths would have to be held in an account with a local bank.

Limitations to new USD obligations are introduced; bonds issued in international bond markets would have to be transferred and converted into pesos. Residents are not allowed to access the official FX market to honour new debt obligations in foreign currency if that debt is between residents.

Lastly, forex arbitrage operations between the official and informal markets would be limited as well.

Source: Global Source Partners, BNP Paribas

The government currently has very little fiscal space. At a little more than 20% of GDP, primary spending is double the 2003 figure, and the pension shortfall amounts to 4% of GDP, compared to 2.5% in 2003. It will be hard to reduce structural inflation due to the legal obligation to index social welfare and pension benefits to past inflation. Lastly, the external environment is much less buoyant: the upward phase of the commodity price cycle in 2003-2007 will not be repeated.

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Egypt

Mixed trade performance

Although still showing a significant deficit, the trade balance has improved substantially since 2017. It has benefited from a recovery in hydrocarbon exports, whilst the steep depreciation of the pound has had only limited consequences on trade in non-hydrocarbon goods. A substantial share of imports is incompressible, whilst structural constraints weigh on the country's export potential. Moreover, the moderate appreciation of the pound over the past year has not helped price competitiveness. Measures have been introduced to support exports, but we remain cautious on the prospects for a significant improvement in international trade over the medium term.

In 2016, the Egyptian economy found itself at a serious dead end. On top of a significant deterioration in the public finances, the widening of the current account deficit and the absence of capital inflows suffocated the economy due to a lack of available foreign currency. The accelerated expansion of gas production and renewed investor confidence as a result of the IMF-backed reform programme have produced a spectacular improvement in external balances. The current account deficit has shrunk considerably and foreign currency liquidity has returned to an acceptable level.

However, the international trade performances in 2017/18 and 2018/19 were disappointing. Despite the fact that the pound depreciated by half following the liberalisation of the foreign exchange market in November 2016, the trade balance remains in sizeable deficit: USD 37.3 bn in 2017/18 and USD 38 bn in 2018/19.

A lacklustre improvement

There has been a marked improvement in the international balances in the hydrocarbons sector over the past two years. From a deficit of USD 5.4 bn in 2016/17, provisional figures for 2018/19 show a symbolic surplus of USD 8 million. The balance on the trade in gas became positive in October 2018. Exports of LNG have recovered thanks to the Zohr gas field coming into production and, according to JODI[1], reached a monthly average of 500 million cubic metres in H1 2019, after a complete stop in 2014 and 2015. Meanwhile, imports of LNG have stopped since November 2018, having reached an average of 740 million cubic metres in 2017. Although the country remains a substantial net importer of oil products, the imbalance has narrowed over the past two years. Exports have tripled since 2016, to an average of 0.127 million barrels per day (mb per day) in the first half of 2019, whilst imports fell by 9% on average over the same period (0.293 mb per day in H1 2019). It seems that the increase in oil prices over the course of the 2018/19 fiscal year (8% for Brent crude) has had positive consequences given the increase in the volume of oil exports.

For the time being, the balance sheet is much less flattering when it comes to the non-hydrocarbon sector. Here the deficit reached the record level of USD 38 bn in 2018/19, equivalent to 12.7% of GDP. Exports were practically stable in value terms in 2018/19, having risen 10% over the previous two years. Taking account of the sharp increase in hydrocarbon exports in volume (10% for oil and oil derivatives and 240% for LNG) and the growth of 11% in total exports in volume as calculated by the IMF[2], we would estimate that the volume of non-oil exports declined in 2018/19. Meanwhile, imports have continued to grow steadily since 2017. These are largely incompressible, both for capital goods and consumer goods. They increased by 9% in value in 2017/18 and 2018/19.

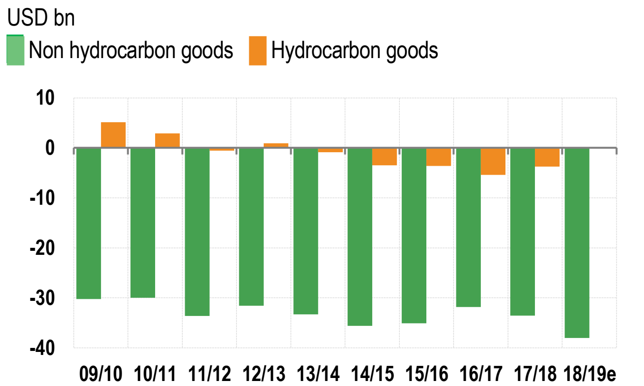
1-Forecasts

	2017	2018	2019e	2020e
Real GDP growth (%)	4.2	5.3	5.6	5.8
Inflation (CPI, year average, %)	23.3	21.5	13.4	10.4
Central. Gov. balance / GDP (%)	-17	-9.5	-8.6	-6.7
Central. Gov. debt / GDP (%)	103	93	89	88
Current account balance / GDP (%)	-6.1	-2.4	-2.7	-3.0
External debt / GDP (%)	41	37	33	31
Forex reserves (USD bn)	31	44	44	43
Forex reserves, in months of imports	5.5	7.2	6.8	6.2
Exchange rate USDEGP (year end)	18.1	17.9	16.7	17.4

Fiscal years from July 1st of year n to June 30th of year n+1

e: BNP Paribas Group Economic Research estimates and forecasts

2- Trade balance



Source: CBE, BNP Paribas

Multiple constraints

The most obvious reason for the disappointing performance of non-oil exports relates to the increase in production costs following the floating of the pound. The sharp rise in import costs and widespread

[1] Joint Oil Data Initiative

[2] World Economic Outlook, October 2019

wage increases, against a background of high inflation, prevented exporters from benefiting from gains in price competitiveness.

More generally, even though we know that the positive effects on exports of significant currency depreciation are limited in time, an international comparison carried out by the World Bank[3] underlined the limited elasticity of Egyptian exports to a sharp depreciation in the exchange rate. According to this study, the positioning of exported goods, in terms of characteristics and geographical destination, does not help their integration into world trade. Around 25% of goods exports go to Arab countries whose international trade is amongst the least dynamic. On average, the growth in imports to Arab countries was 1.6% between 2014 and 2018, compared to a global average of 3.3%. Political upheaval in North Africa, notably in Libya and the weak economic trends in the Gulf states, have affected Egyptian exporters. Conversely, the fastest growing region, Asia (4.2% growth), takes only 10% of Egypt's exports.

Moreover, the main exports have limited technological content. They are mainly unsophisticated extracted goods (hydrocarbons, minerals, agricultural products) or manufactured goods with little technological content (textiles, food). Egypt's comparative advantages [4] are focused on poorly performing markets (cotton, fertilisers, tobacco and oil seeds). Only its exports of electrical equipment, essential oils and fruit and vegetables are in markets seeing growth on the global level. These represent only just over 15% of Egyptian exports.

According to the World Bank, non-tariff barriers, such as administrative constraints, technical and health requirements and the lack of infrastructure, affect the whole of Egypt's international trade and are therefore also a constraint on the performance of exports.

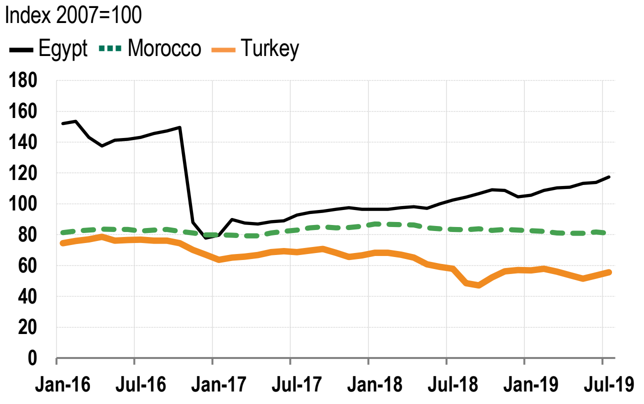
The government has recently relaunched its export support policy, adopting a number of measures implemented by the export development fund: direct financial support, tax benefits and the provision of services such as training and communication. In total, this support package could be worth as much as 10% of total exports, and would be linked to certain criteria in order to favour SMEs or exports to the rest of Africa.

Mixed prospects

The balance of trade in hydrocarbons will continue to improve in the short term, with further growth in LNG exports. However, given the continued rise in domestic energy demand, only the bringing on stream of a substantial new gas field will prevent the energy balance moving back into deficit within two or three years.

Meanwhile prospects remain mixed for the trade balance in the non-hydrocarbons sector of the economy and we do not foresee any significant improvement. In the short term, the stronger pound coupled with the downward trend in inflation is likely to make Egyptian exports less competitive.

3- Real exchange rate against USD



Source: BNP Paribas

The pound's real exchange rate has risen by 47% since the end of 2016, whilst the Turkish lira has fallen by 12% and the Moroccan dirham has remained more or less stable. Given the slightly less favourable trend in external balances over the coming year and despite the central bank's willingness to control inflation, the pound should slightly depreciate over the short term. Against this background, prospects for global trade are negative in the short term.

Foreign direct investment (FDI) could provide the means to tackle the structural constraints holding back Egyptian exports, most notably by allowing the country to move up international value chains. Indeed, a few multinationals have recently set up in the country. Even so, for the time being inflows of non-hydrocarbon FDI have been well below the levels hoped for.

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[3] Egypt Economic Monitor, July 2019

[4] Defined as the case where exports of a product as a share of a country's total exports is greater than that product's share of global trade.

Qatar

The limits of diversification

The Qatari economy is struggling to find new sources of growth beyond the hydrocarbon sector. Given the stability of hydrocarbon production and the ending of the infrastructure investment cycle, economic growth is likely to hit a record low in 2019. Over the medium term, the introduction of new LNG production capacity is likely to bolster the economy. Against the background of a sluggish economy, inflation is likely to be dragged into negative territory by the on-going fall in real estate prices. This said, the public finances and external accounts remain solid and are likely to improve further as the gas rent increases over the medium term.

The economic slowdown continues

Despite attempts to diversify, economic growth remains dependent on the hydrocarbon sector. The rest of the economy has not managed to generate sustainable and significant growth. Over the past decade the Qatari economy has seen three phases of growth. Real GDP growth was above 15% per year between 2007 and 2011 thanks to the steady increase in hydrocarbon production, mainly LNG. Over the following four years, the non-hydrocarbon sectors of the economy, particularly construction and services, were the main growth engine. Between 2012 and 2015 growth averaged 4.2% per year. Since 2016, growth has dropped by a further notch, and averaged 1.7% per year between 2016 and 2018. These mediocre performances were due to a number of factors: the stagnation of hydrocarbon GDP, the end of the project cycle with the completion of the main infrastructure projects, the consequences of the embargo and the weakness of the real estate sector.

The latest economic data confirm the weak performance of the Qatari economy. GDP in the hydrocarbon sector, representing 48% of total GDP, fell by 1.9% in Q2 2019, taking its average fall over the previous 12 months to 0.4%. This reflects the dependence of this segment of the economy on gas production; since 2015, gas production has been stable whilst, in the absence of any new discoveries, oil production has been in steady decline. Non-hydrocarbon GDP fell 1.1% y/y in Q2 2019. The construction and real estate sectors (accounting for around 15% of GDP) shrank by 2.1%. This reflected the regional depression in the real estate sector. Throughout the Gulf, abundant supply of real estate faced with soft demand has resulted in a decline in activity in this sector. At the same time, the end of the project cycle, and in particular the completion of the bulk of the infrastructure planned for the football World Cup in 2022, has naturally resulted in a slowdown in the construction sector. Reflecting the mediocre performances of the construction industry and the non-hydrocarbon segment in general, growth in Qatar's total population has slowed significantly since 2015. The expatriate population, which accounts for more than 80% of the Emirate's total population, increased by an average of only 2.5% per year between 2016 and 2018, compared to a figure of over 10% in previous years.

Although its economic importance is more symbolic than real, the tourism sector has struggled to expand since mid-2017 and is facing a steep decline in tourists from other Gulf states. Although visitor numbers appear to have recovered since the beginning of the year, the number of arrivals to the country in the year to the end of Q1 2019, at 12 million, was well below the figures of more than 19 million seen up to 2016. Symbolising of this steady slowing of the non-hydrocarbon economy, growth in the financial services sector has fallen steadily since 2015. This sector saw growth of only 3.4% y/y in Q1 2019, from an average of over 10% prior to 2016.

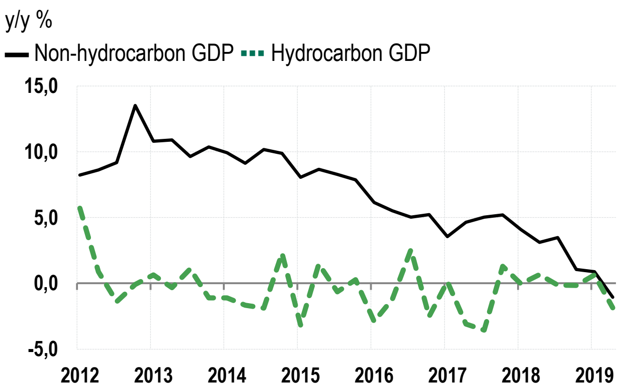
In the short term, prospects are mixed, and are likely to confirm the regime of much slower growth that began in 2016. The hydrocarbons sector is unlikely to see any significant changes given that no new production is coming on stream. Moreover, Qatar left OPEC at the beginning of the year and therefore does not follow

1- Forecasts

	2017	2018	2019e	2020e
Real GDP growth (%)	1.7	1.4	1.0	2.3
Inflation (CPI, year average, %)	0.3	0.2	-0.5	1.5
Gen. Gov. balance / GDP (%)	-5.8	0.5	1.0	2.3
Gen. Gov. debt / GDP (%)	50	48	47	46
Current account balance / GDP (%)	3.8	8.7	5.1	3.9
External debt / GDP (%)	100	101	107	98
Forex reserves (USD bn)	14	26	28	29
Forex reserves, in months of imports	2.3	4.4	4.4	4.5
Exchange rate USDQAR (year end)	3.64	3.64	3.64	3.64

e: BNP Paribas Group Economic Research estimates and forecasts

1 - Real GDP Growth



Sources: Qatar Planning and Statistics Authority, BNP Paribas anymore its policy of regulating oil production. We expect hydrocarbon sector GDP to grow very slightly – by 0.5% in 2019 and 2% in 2020, with the coming on stream of the Barzan gas project, intended to meet rising domestic energy demand. The performance of the rest of the economy is likely to remain modest. The bulk of activity is likely to be related to growth in government spending, particularly investment spending. We would note, however, that at the regional level, the positive effects of public spending on the whole economy have diminished. It seems that after years of sustained growth in government investment, the economy's ability to absorb it has been reduced. Growth in the non-hydrocarbon economy looks set to slow further, to 1.5% in 2019 (from 3.0% in 2018), before climbing to 2.5% in 2020.

All in all, we expect total GDP growth of 1.0% in 2019, its weakest level for twenty years, followed by a slight recovery to 2.3% in 2020.

Support from the hydrocarbons sector over the medium term

Over the medium term there are two factors that will support economy activity. The World Cup will bring a temporary economic boost, at least in the services sector, although its impact on non-hydrocarbon GDP growth should not be overestimated. The main risk is at the geopolitical level. The Gulf region is currently a nexus of significant regional tensions, and any increase in political risk in the area has an unfavourable effect on economic activity, particularly in the services sector. The construction sector meanwhile should benefit from the additional activity created by the Qatar National Vision 2030 plan. This covers investment in infrastructure and real estate equivalent to USD 16 bn in order to boost economic activity from 2022 onwards. This raises the question of the match-up between investment and the needs of the local market.

The second source of economic support will come from increased investment in the LNG sector, with the aim of increasing Qatar's export capacity by 40% by 2023-24. The economic rationale of the project is strong given the medium-term growth prospects in this market (notably in Asia).

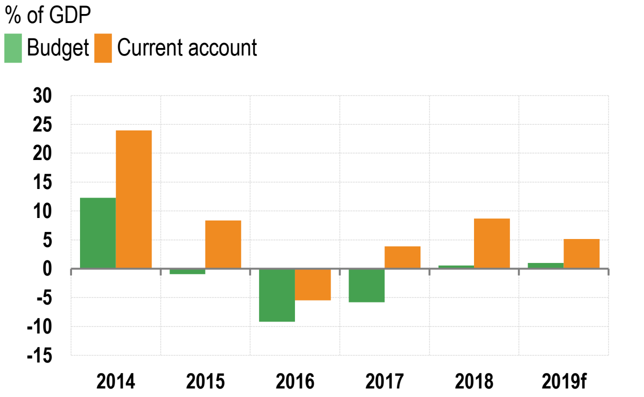
Negative inflation

In common with other Gulf states, consumer price inflation has fallen sharply due to the on-going fall in real estate prices. The housing component of the price index (22% of the total) has fallen steadily since the end of 2016 (dropping an average of 2.1% since the beginning of the year). We expect an average inflation rate of -0.4% in 2019. There could be a return to positive territory next year with the possible introduction of VAT. However, if we look at regional precedents, its rate and scope are likely to be limited, thus reducing its effect on the general level of prices. In 2020, average inflation is likely to be 1.5%.

Solid fundamentals

Despite these depressed economic conditions and the unfavourable regional political climate, Qatar remains financially solid. After three years of deficits linked to falling oil prices, the government moved

3- Back to surpluses



Source: BNP Paribas

back into surplus in 2018 (0.5% of GDP). Control of public spending is likely to produce further surpluses in 2019 and 2020 (1.0% and 2.3% of GDP respectively). The solvency of public finances remains comfortable, given modest government debt (41% of GDP in 2018, though 78% if one includes public companies), access to capital markets on favourable terms (the risk premium on foreign currency bonds is currently 53bp, one of the lowest in the region) and the government's foreign currency assets, which are estimated at more than 1.6 times GDP. Similarly, external balances are solid, with recurrent current account surpluses (8.7% of GDP in 2018).

In the banking sector, the negative consequences of the embargo that began in 2017 have been compensated by the substantial public support (deposits from the central bank and the government) and then the return of foreign depositors, particularly from Asia. However, the rapid growth in the banks' net external liabilities should be noted. Given the rapid increase in lending to the public and private sectors (17% and 9% y/y respectively in June 2019 according to the IMF) and the decline in deposits (-1.9% y/y), a growing share of resources comes from abroad. The country's banks thus had a net external liabilities position of USD 73 bn (39% of GDP) in June 2019.

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Morocco

Satisfactory performance

Between difficulties in Europe and a poor agricultural harvest, Morocco faces numerous headwinds. Growth slowed in 2019 for the second consecutive year. Yet domestic demand remains robust, bolstered among other factors by low inflation and an accommodating monetary policy. The authorities are also counting on major privatisation proceeds to soften fiscal consolidation without worsening public debt. Above all, the ongoing development of the automobile industry raises hopes for a rebound in GDP growth in 2020, while lower oil imports should help to reduce the current account deficit.

Growth slows but is still robust

The economic slowdown continues. GDP growth dropped to 3% in 2018 from 4.2% in 2017, and according to the latest HCP figures, will reach 2.7% at best this year. Between difficulties in Europe and a poor agricultural harvest, the Moroccan economy faces numerous headwinds. Yet the overall picture is much more nuanced than it might seem, raising hopes for a rebound in activity as of 2020.

The slowing down in the economic activity during the first six months of the year can be attributed primarily to the 3% contraction in agricultural value added, which accounts for a significant share of GDP (11%). For the rest of the economy, the dynamics is rather encouraging. Non-agricultural GDP growth also slowed to 3.2% y/y in Q2, compared to 3.6% in Q1. But this is still robust compared to the 2016-2018 average of 2.9%. Most of the sectors vulnerable to the European cycle, including tourism and manufacturing, have proven to be fairly resilient so far. Moreover, two new major projects have just been completed, the Tangier port expansion and the start-up of the Peugeot plant in Kénitra. As the plant is ramped up in 2020, the increase in automobile production should provide a new impulse to what has become a strategic industry, although its pace has been slowing recently. Automobile exports increased only 2.2% since the beginning of the year, after more than doubling between 2013 and 2018.

Robust domestic demand will also be a key supportive factor. Household consumption is buoyant (+3.8% y/y in the first 6 months of the year) and should continue going strong thanks to extremely low inflation – less than 1% since end-2018 – and the boost from the 10% increase in the private sector minimum wage. Low inflationary pressures also give the central bank some extra manoeuvring room. With a key policy rate of only 2.25% and a mandatory reserve rate recently cut to 2%, monetary policy is already accommodating. The status quo is likely to persist even though with the real interest rate at a positive 1.5%, there is still room for further cuts if necessary. In any case, financial conditions will remain favourable for households and corporates. The weighted average interest rate on lending to the economy hit a low of 4.98% in Q2. Budgetary execution during the first 8 months of the year also demonstrates the authorities' determination to stimulate the economy.

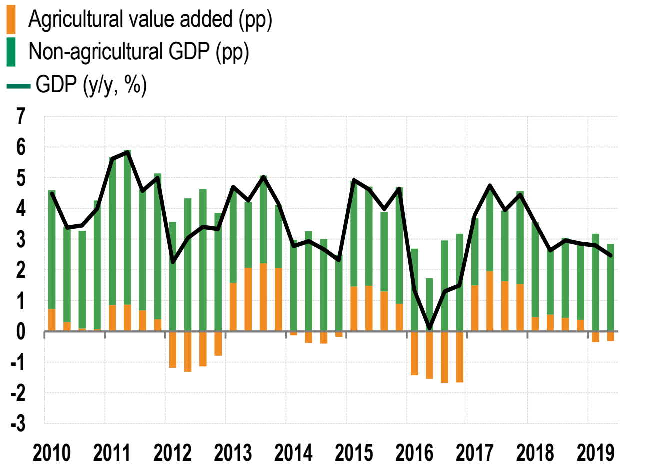
With non-agricultural GDP growth of 3.4% and assuming a normal agricultural harvest, economic growth could reach 3.5% in 2020. *

1-Forecasts

	2017	2018	2019e	2020e
Real GDP growth (%)	4.2	3.0	2.7	3.5
Inflation (CPI, year average, %)	0.7	1.8	0.6	1.1
Central. Gov. balance / GDP (%)	-3.6	-3.7	-4.0	-3.8
Central. Gov. debt / GDP (%)	65.1	65.3	65.9	65.5
Current account balance / GDP (%)	-3.6	-5.5	-5.1	-4.1
External debt / GDP (%)	47.1	44.4	46.5	46.7
Forex reserves (USD bn)	26.2	24.5	25.0	26.1
Forex reserves, in months of imports	6.4	5.3	5.3	5.4
Exchange rate USDMAD (year end)	9.4	9.6	9.6	9.5

e: BNP Paribas Group Economic Research estimates and forecasts

2- Sector contribution to growth



Source: HCP, BNP Paribas

This would make the Moroccan economy one of the top performers in the region. Given the country's development needs, however, this is still not enough. At 8.5%, the unemployment rate is chronically high, as is the proportion of the population excluded from the labour market (the employment rate is only 42%). Yet the economy continued to create jobs in H1 2019 despite the massive destruction of farm sector jobs, which highlights again the solidity of Morocco's economic performances despite a deteriorating international environment.

Softer fiscal consolidation

After the major budget overruns reported in 2018, public finances deteriorated further in 2019. From January to August, the main budget components continued to rise, whether operating expenses (+5.5%) or capital investment (+4.9%). Despite the rather good dynamisms of fiscal revenues excluding privatisation (+3.4%), the budget deficit widened again. It is expected to reach 4% of GDP in 2019, up from 3.7% in 2018 (and an initial target of 3%), before gradually narrowing again as of 2020.

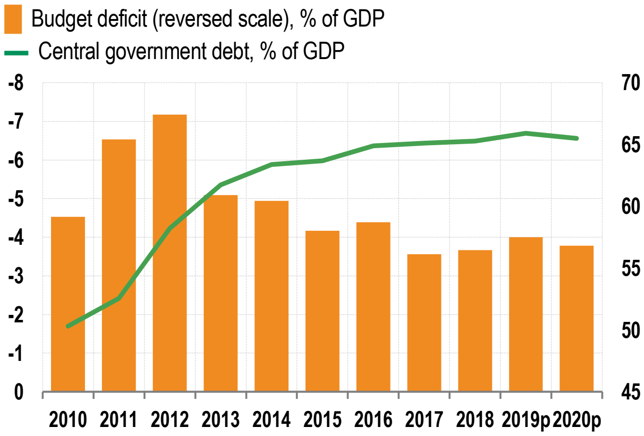
While the government has opted for a smoother fiscal consolidation programme, the situation generally seems to be under control. In terms of both revenues and spending, the main risk factors behind the 2018 budgetary slippages have since dissipated. Financial assistance from the Gulf countries is expected to be modest and the authorities have put in place a hedging strategy to insulate the budget against the volatility of oil prices: last year's surge in oil prices resulted in a 26% overrun in the budget allocation for energy subsidies. The government is also planning to increase recourse on public-private partnerships to ease the pressure on the public accounts. Public investment, the second largest spending item behind public sector wages, is high at about 6% of GDP. Above all, the authorities are counting on privatisation proceeds of about 0.4% of GDP a year through 2021 to stabilize government debt at 65% of GDP. With the partial disposal of the government's stake in Maroc Télécom in July, its 2019 target has already been met, and other privatisation operations have been identified.

In any case, government debt does not seem to be a major source of risk. Unlike many emerging countries, Morocco has hardly called on the international financial markets. Two Eurobond issues are expected to be made in the short term. With a risk premium of 150 basis points, they should be completed under good conditions, especially since the S&P rating agency has just revised outlook for Moroccan sovereign risk from negative to stable. Moreover, the debt profile will not change fundamentally, with 80% denominated in the local currency, and the government's financing conditions have rarely been so advantageous, both in terms of interest rates and maturity. With an apparent cost of debt of only 4%, the government has comfortable manoeuvring room.

Solid external position

The deterioration of the economic situation in Europe could strain the dynamics of Morocco's external accounts, albeit without threatening its stability. With the exception of remittances from the Moroccan diaspora (-1.3% y/y), the main sources of hard currency were still on the rise in the first 8 months of the year, with exports and tourist revenues up 3.7% and 4.5%, respectively. Imports grew at a similar pace, however, so the trade deficit widened slightly, but the situation could improve in the months ahead thanks to an upturn in automobile sales. Automobiles already account for a quarter of Moroccan exports. In an unstable external environment, and while commodities (phosphates) still account for a large share of trade, the move towards higher value added exports strengthens the economy's resilience. Downward pressure on oil prices (15-20% of imports) could also help improve the external accounts.

3- Public finance indicators



Source: Ministry of Finance, BNP Paribas

With the current account deficit estimated at 5.1% of GDP in 2019 and 4.1% in 2020, compared to 5.5% in 2018, Morocco should easily cover its financing needs. Net flows of foreign direct investment (FDI) are robust at about 1.5-2.5% of GDP, and external debt is moderate at 44% of GDP. Buffers are also adequate. Foreign reserves cover more than 5 months of imports of goods and services, and Morocco benefits from a USD 3 billion precautionary credit line with the IMF through end-2020 to protect the economy against any balance of payment shocks. As with previous IMF programmes, the authorities are unlikely to draw on these funds.

Lastly, after the dirham's fluctuation band was widened in January 2018 to +/-2.5% on either side of reference parity (vs. +/-0.3% previously), the central bank almost never has to intervene in the forex exchange market, which reduces the pressure on external liquidity. MAD volatility has been extremely mild and is expected to remain so as the authorities proceed as cautiously as ever to introduce greater flexibility in the exchange rate regime.

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Angola

Under the IMF supervision

The country has renewed relationship with the IMF and obtained its financial support in late 2018. Under the Fund supervision, a mild recovery is expected in the near term but outlook remains weak due to a still tight foreign currency liquidity, a troubled banking system and a poor external environment. Amid higher oil price volatility, Angola continues to rely on the oil sector as a source of economic growth, fiscal income and foreign exchange earnings. Despite supportive measures to attract international investors, important deficiencies keep FDI weak. Some fiscal reforms are also ongoing, but governement room for maneuver remains slim.

Angola is successfully undergoing business-friendly reforms aiming to improve governance and transparency, diversify the economy and reduce its reliance on bilateral loans. Beyond political transition, hydrocarbon sector reshaping and new fx exchange policy, the government has restored relations with the IMF resulting in a three-year extended agreement for about USD 3.7 billion in December 2018, with disbursements until 2021. Nevertheless, the promising IMF's program starts in the context of a weakened near-term outlook due to higher oil price volatility, more restrictive external financial conditions and trade tensions between the US and China, which is Angola's major trading partner.

A mild growth recovery is possible

After recession for the third consecutive year in 2018, Angola GDP seems to struggle to recover and remained in negative territory in the first quarter of 2019. According to the National Statistical Institute (INE) data, the economy contracted by 0.4% on an annual basis in Q1, contrasting with the previous quarter's expansion of 2.6%. Q1 2019 contraction mainly comes from oil sector (-6.9%) which continues to play a very dominant role in Angola's economy[1], alongside with a contraction in the telecommunications (-6.8%) and financial services (-4.8%). The negative oil growth is largely the result of a falling oil production[2] along withan uptick in crude prices, due to a combination of maturing fields that are producing less oil, maintenance stoppages and a lack of new exploration opportunities into Angola's deepwaters' explorations.

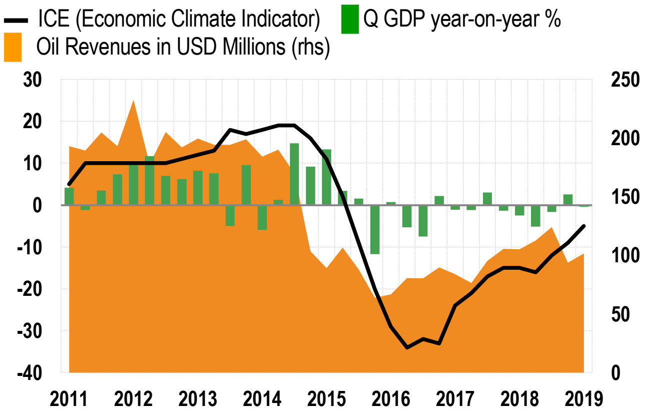
Overall economic sentiment improved in Q1 despite remaining firmly entrenched in negative territory. Indeed, the economic climate indicator (ICE: Indicador de Clima Económico) published by the Statistical Institute, that increased from -12 points in Q4 2018 to -9 points in Q1 2019. In 2019, GDP growth is likely to post a mere 0.3% with still contracting oil growth (despite the ramping up of Total South Kaombo field). The tepid recovery should also be driven by modest non-oil growth benefiting from the implementation of the IMF programme. In June 2019, the government has successfully completed the first review of the Extended Fund Facility with the release of the second tranche of financing (USD 248 mn), thus bringing to around USD 1.24 billion the total disbursement obtained so far. The government continues its efforts to improve the business environment and sustain the private-sector-led growth[3], but the still-ailing banking system and constraints on FX access for banking activity keep on straining the overall economic dynamics.

1- Forecasts

	2017	2018	2019e	2020e
Real GDP growth (%)	-0.2	-1.7	0.3	2.8
Inflation (CPI, year average, %)	29.8	19.6	17.4	11.1
Gen. Gov. balance / GDP (%)	-6.3	2.1	-0.1	0.3
Gen. Gov. debt / GDP (%)	69.3	87.8	90.6	83.6
Current account balance / GDP (%)	-0.5	6.6	-2.0	0.4
External debt / GDP (%)	38.2	56.0	58.5	54.9
Forex reserves (USD bn)	18.6	16.1	15.2	16.5
Forex reserves, in months of imports	8.7	7.3	6.6	7.2
Exchange rate USDAOA (year end)	166	310	368	380

e: BNP Paribas Group Economic Research estimates and forecasts

2- A difficult start to the year



Source: INE, Reuters, EIA, BNP Paribas

[1] It contributes to about 30% of GDP, 95% of exports, and over 60% of fiscal revenues at end 2018.

[2] According to the OPEC data, Angola's crude oil production was reported at 1,394.000 Barrel/Day in August 2019, which represents a record low over the last decade.

[3] Such as, for example, raw diamonds commerce liberalization, or establish a Regulatory Authority for Competition and privatization resolution, with a list of 32 state-owned enterprises earmarked to be sold on the country's stock exchange, the Bolsa de Dívida e Valores de Angola (BODIVA) by 2022.

Still hard access to foreign currencies

Despite the abandon of currency peg in January 2018, access to foreign currency remains difficult. The Central Bank continues to keep a local currency trading band and prioritise currency access for specifically selected activities (food, health, and petroleum), which have triggered a restriction on 54 imported-substitution goods. Most of dollar denominated contracts are paid in euros because of the loss in the US dollar correspondent banking[4]. Authorities are trying to resume sales of dollars within local commercial banks but the correspondent banking in dollars would be restored once efficient reforms to combat money laundering and reduce the institutional corruption will be implemented.

Meanwhile, the country continues to rely on the oil sector as a source of fx earnings. But a persistent declining oil production, albeit oil prices partial revival, affects export growth while maintaining an acute shortage of fx reserves. Indeed, the country does not have oil refineries and must use hard currency to import refined oil[5]; moreover, fx earnings from energy are used to service debt payments (both external and domestic), which accounted for more than 16% of GDP at end 2018.

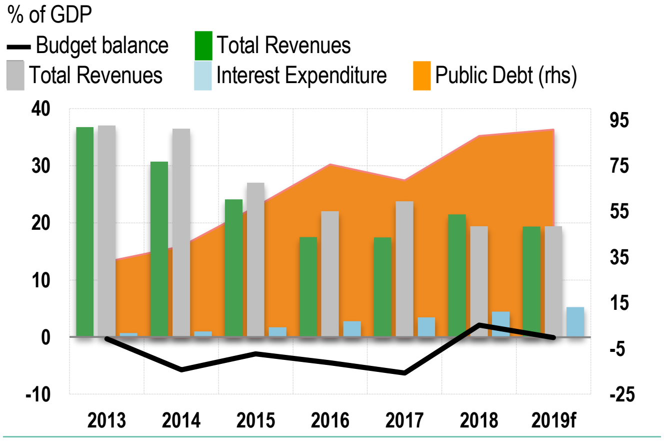
Exports have declined by 10% yoy in Q1 2019 while imports have risen by more than 40% in the same framework. Fx reserves erosion continues further (they have declined by 5% since January 2019). The current account balance is expected to swing back to a 2% deficit in 2019, after the strong surplus in 2018. Therefore, although FDI inflow has resumed in the first quarter of the year, external financing requirements are expected to increase further this year. The IMF support (USD 0.5 bn in 2019 and USD 1.1 bn per year in 2020-2021) would allow official fx reserves to recover in 2020 only.

At the same time, after having lost more than 40% in 2018, the kwanza registered a further 15% fall since the beginning of the year and it is now traded at AOA 365 per USD at the official rate. If the partial fx regime liberalisation has helped to reduce the kwanza overvaluation, the local currency continues to trade considerably higher in the parallel market (at above AOA 500 per USD in September). Even if the likelihood of a large exchange rate shock has been lessened by the transition to a more flexible exchange rate regime, further devaluations remain very likely in the medium term.

Fiscal reforms but worsening debt metrics

Ongoing fiscal reforms are mainly related to the ending of fuel subsidies, improving SOEs accountability and arrears clearance. Last year, budget execution was beyond expectations, with a fiscal balance moving back into a strong surplus thanks to contained government spending (below 20% of GDP), oil prices rebound and the kwanza depreciation. Fiscal consolidation is expected to continue in 2019, as evidenced by the supplementary budget presented end of May 2019, which recalibrates expenditure envelope to lower oil prices and identifies new non-oil revenue measures[6] to offset the expected revenue loss (around 3.8% of GDP according to the IMF). Nevertheless, revenues projections would suffer from postponed value added tax (VAT) introduction, with expected fiscal balance likely to go back to deficit this year.

3- Fiscal adjustements but increasing interest costs



Source: IMF, BNPParibas

But the room for maneuver is very slim. Indeed, the debt-to-GDP ratio has more than doubled in the last four years to reach 88% in 2018 and the debt burden (interest-to-revenue ratio) has soared up to 21% in 2018. The Government is committed to pursuing a prudent debt management strategy by decreasing public debt issuing and by developing the primary domestic debt market in local currency with increasingly longer maturities (instead of fx currency which increases its exposure to exchange risk). It will also enforce prudent SOE borrowing by moderating issuance of sovereign guarantees. A large privatization program[7] has also been considered. Albeit public debt-to-GDP ratio may be able to be reduced, it remains highly vulnerable to further local currency depreciation and further declining oil price.

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[4] The USD Correspondent Baking was closed in 2016 by the FED owing to concerns about weak anti-money laundering/combating the financing of terrorism.

[5] A severe fuel shortage occurred in March 2019 due to difficulties in accessing USD.

[6] Such as adjusting excise rates on energy, soda drinks and real estate, removing some personal income tax exemptions, widening the stamp tax base to include self-employed professionals and transactions that are not subject to VAT.

[7] Amongst the 190 major privatizations there are Sonangol, Endiama, TAAG, Bancos de Comércio e Indústria (BCI), Banco Angolano de Investimentos (BAI), Bolsa da Dívida e Valores de Angola (Bodiva), and some major telecom companies.

South Africa

Engine failure

Economic growth is forecast at only 0.4% in 2019, after averaging 1% a year in 2015-2018. The Ramaphosa government has little manoeuvring room to implement reforms, and strong structural headwinds continue to hamper economic activity. Illustrating the country's enormous lack of infrastructure, major power outages disrupted activity in the first months of the year. To address the severe financial troubles at Eskom, the state-owned company behind the power outages, the government had to unblock additional funds to come to its rescue. The latest rescue package will accelerate fiscal deficit slippage and further weaken sovereign solvency in the medium term.

South Africa's real GDP growth averaged 1% a year between 2015 and 2018, far short of what the country needs to boost per capita income; population increased by 1.7% a year over the same period. Economic growth has been weak since the beginning of the year and is unlikely to improve much in the very short term. The central bank eased monetary policy slightly last summer, but the government has no choice but to maintain a restrictive fiscal policy. Yet this will not prevent the public deficit and debt from increasing rapidly this year.

Very slow economic growth

After hitting another air pocket in Q1 2019, real GDP growth picked up slightly in Q2, reaching 3.1% q/q sa (vs. -3.1% in the previous quarter) and 0.9% y/y (vs. 0% in Q1). Leading indicators and recent activity data point to another slowdown in Q3. We are projecting full-year real GDP growth of only 0.4% in 2019.

The power outages arising from the troubles at the state-owned company Eskom hit the primary and secondary sectors particularly hard, especially in the first months of the year. A strike also blocked a major gold mine from November 2018 until a wage agreement was signed in April. Mining sector activity (7% of total GDP) contracted by 4.6% y/y in Q1 2019 and then by 2.1% in Q2. Growth in the manufacturing sector (which accounts for only 12% of GDP) slowed to 0.5% y/y in H1; it probably slipped into negative territory in July-August according to the industrial output index. The agricultural sector was hit by another sharp decline in production (down 12.7% in Q1 and 6.7% in Q2), while the troubles in the construction sector persisted (-2.4% in H1). The services sector reported growth of 1.5% in H1, roughly in line with the average for the past four years. The finance and real estate sector (18% of GDP) continued to report the most buoyant performance.

From the demand standpoint (chart 2), real GDP growth was undermined by the negative contribution of net foreign trade in Q2 2019. This decline is likely to continue in the short term in a weak international environment. Private consumption (60% of GDP) rebounded in Q2 (+1.4% y/y) after slowing for several quarters, in part thanks to a slight acceleration in household lending. It could drop off again in the short term given the deterioration in the labour market and the feeble increase in real revenues. Employment declined slightly in Q1 and the unemployment rate rose to an all-time high of 29% in mid-2019.

1- Forecasts

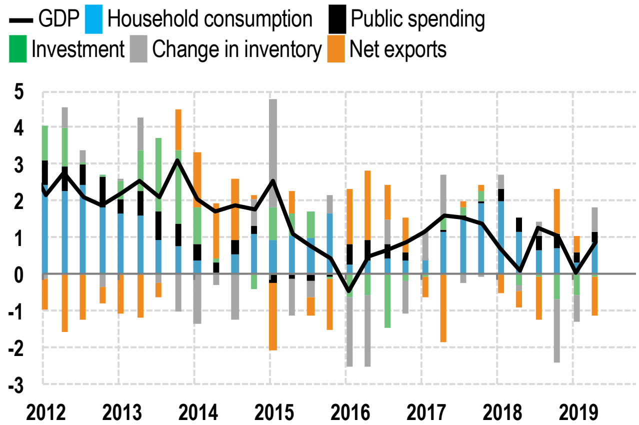
	2017	2018	2019e	2020e
Real GDP growth (%)	1.4	0.8	0.4	0.8
Inflation (CPI, year average, %)	5.3	4.6	4.2	4.5
Gov. balance / GDP (%) [1]	-4.4	-4.2	-6.1	-5.8
Gen. Gov. debt / GDP (%) [1]	52.7	56.5	60.0	65.0
Current account balance / GDP (%)	-2.4	-3.6	-3.3	-3.6
External debt / GDP (%)	45.8	51.1	52.0	54.0
Forex reserves (USD bn)	45.5	46.5	43.5	45.0
Forex reserves, in months of imports	4.7	4.4	4.0	4.0
Exchange rate USDZAR (year end)	12.4	14.3	14.5	13.7

(1): Fiscal year from April 1st of year n to March 31st of year n+1

e: BNP Paribas Group Economic Research estimates and forecasts

2- Sluggish growth

Real GDP (y/y, %), and contribution (in percentage points) *



Source: Statistics South Africa ** The residual component is not shown.*

One alarming signal is very weak investment, which has declined continuously since Q1 2018. The investment ratio fell below 18% of GDP, down from a 2011-2015 average of 20.5% of GDP. This trend could continue in the short term given the weak prospects for external and domestic demand, and due to the further erosion in investor sentiment.

No manoeuvring room

The confidence that was restored following the inauguration of President Ramaphosa in February 2018 proved to be short lived. The high hopes that were raised with the announcement of reforms (notably to improve public finances, fight corruption and raise the potential growth rate) and the implementation of the first measures have been dashed and replaced by fears of paralysis. As a matter of fact, the government's manoeuvring room for implementing reforms is severely constrained by low economic growth, a very tense social climate and deep-running divisions within the ruling party. The significant structural headwinds that are hampering investment and GDP growth (lack of infrastructure, lack of skilled labour, labour market rigidity, corruption and uncertainty over future changes in the legal framework in certain sectors) are bound to persist. The authorities also have very little manoeuvring room to stimulate activity in the short term.

The central bank lowered its key repo rate by 25 basis points (bp) to 6.5% in July 2019; its previous action was a rate increase by a similar amount in November 2018. Monetary policy could be eased slightly further in Q4 2019, since consumer price inflation is holding comfortably within the target range of 3-6%. Inflation averaged 4.3% y/y in the first eight months of the year, compared to 5% in H2 2018. The central bank will nonetheless remain cautious. The financial markets have enjoyed a relative calm since the beginning of the year and the rand has depreciated by less than 3% against the US dollar. However, new episodes of capital flight and pressures on the rand are possible in the short term in case of an external shock, bigger-than-expected fiscal deficit slippage and/or if Moody's were to downgrade its sovereign rating (the next review is scheduled for early November). If South Africa's sovereign rating were downgraded to speculative grade, it could trigger a large sell-off of public debt bonds by investors.

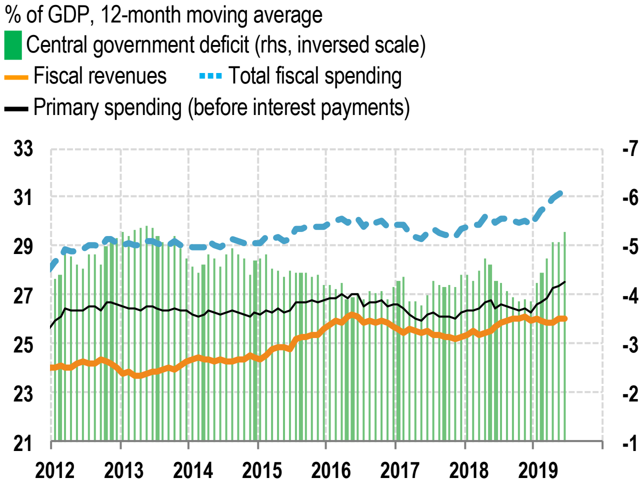
Accelerated deterioration in public finances

Public finances have deteriorated gradually over the past decade due to insufficient fiscal revenues, rising debt and interest payments, and recurrent losses reported by state-owned companies. The situation has deteriorated even faster this year.

From fiscal year 2014-15 to fiscal year 2018-19 (FY, starting April 1st and ending March 31st), the central government deficit held between 4% and 4.5% of GDP, and debt swelled from 47% of GDP to 57%. Although efforts to contain spending increases and to boost revenues helped reduce the primary deficit to less than 1% of GDP last year, compared to 2.7% in FY2012-13, the nominal deficit did not improve due to the increase in debt interest payments. These accounted for 3.7% of GDP in FY2018-19, and 14.3% of fiscal revenue.

In FY2019-20, the nominal deficit should deteriorate significantly, rising above 6% of GDP (overshooting the government's initial target of 4.5%). While interest charges continue to rise (to an estimated 4.5% for the full fiscal year), the primary deficit is also deteriorating rapidly (chart 3). It could reach 1.6% of GDP in FY2019-20. The much bigger increase in spending can be attributed to the government's additional support to rescue the state-owned company Eskom.

3- The fiscal deficit is deteriorating rapidly



Source: Statistics South Africa

Initially, Eskom was to receive support of ZAR 23 bn a year over ten years starting in 2019. This figure was raised to ZAR 49 bn for FY2019-20 and ZAR 56 bn for FY2020-21 (or about 1% of GDP a year), with part of the funding being early payments of the financial support plan previously scheduled for the longer term. This support package must be accompanied by a corporate restructuring plan and debt rescheduling for Eskom, and part of the debt guaranteed by the central government will probably be transferred to its balance sheet. There is a high risk that other state-owned companies may need direct government support going forward. Moreover, the government has almost no capacity to reduce other expenditures or to boost revenues given the sluggish pace of economic growth, fierce social tensions at a time of high unemployment and poverty, and very poor-quality public services.

Government debt is likely to reach at least 60% of GDP by the end of FY2019-20 and 65% at the end of FY2020-21. While South Africa's medium-term solvency continues to deteriorate, the liquidity and refinancing risk of government debt in the short term has also increased. Nonetheless, it remains moderate thanks to a still favourable government debt profile and the existence of a large local-currency bond market. The average maturity on central government debt is long (at 15 years) and it is mainly denominated in rand (about 90% of total debt). Yet, with 40% of domestic debt held by non-residents, the government is vulnerable to changes in the sentiment of international investors. This sentiment could erode in the coming months in response to the rapid widening in fiscal deficits.

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