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EDITORIAL

ECONOMIC RESEARCH

BNP PARIBAS

The bank for a changing world

DOUBLE WHAMMY

Excluding China, activity in emerging countries was stagnant in Q2 2022 and business and household confidence surveys indicate that the economic slowdown will continue. Inflation continues to rise and is being accompanied by new decisions of monetary tightening, including by central banks in Asia. The deterioration in external demand and tighter domestic financial conditions have combined with the monetary tightening in the United States and USD appreciation to trigger the slowdown in activity. This is a double whammy for emerging countries. But developing countries, which are also facing the food crisis and a situation of over-indebtedness, are in a more worrisome situation.

ECONOMIC GROWTH SLOWDOWN CONFIRMED

Signs of a slowdown or contraction in activity have been confirmed since the spring and have become more numerous over the summer. China started the ball rolling with a 2.6% fall in its GDP in Q2 compared to Q1. Excluding China, real GDP of our sample of the 26 main emerging countries stagnated. It even contracted in some of them (South Africa, India, Poland, Taiwan). Including China, real GDP fell by 1% in Q2 2022 compared to Q1. Over the course of the summer, the opinions of manufacturers about their order books continued to worsen, particularly for large exporter countries in Asia (China, South Korea, Taiwan) and in Central Europe (Hungary, Czech Republic). Global trade is slowing, oil and metal prices have turned around since mid-June and the Baltic Dry Index (benchmark price index for maritime transport and leading indicator for trade) has normalised after its rise in 2021.

In a number of countries, consumer confidence has fallen back to its spring 2020 level. The main reason is the acceleration in inflation. Inflation exceeds 15% year-on-year in most central European countries; it is between 8% and 14% in Latin America (excluding Argentina) and is now spreading in Asia (with the exception of China, Hong Kong and Taiwan) in a range between 4% to 8%. As a result, monetary policies are continuing to tighten, including in Asia.

DOUBLE WHAMMY

The deterioration in external demand and tighter domestic financial conditions (inflation and rise in key policy rates) have combined with the monetary tightening in the United States and the appreciation of the US dollar to trigger the slowdown of activity. Yet, according to the Institute for International Finance (IIF), bond portfolio investment flows to emerging countries excluding China have been rather resilient; they amounted to USD 75 bn over the nine first months of the year. In other words, sovereign debt yields in local currency have not suffered a double whammy (i.e. the effect of the rise of the US interest rates + the effect of investment withdrawals by non-residents).

However, emerging countries are inherently more sensitive than advanced countries to the tightening of US financial conditions. Firstly, the US dollar and commodity prices are generally negatively correlated and changes in the latter are often stronger than those in the US currency, with the result that commodity exporting countries suffer a loss of purchasing power. Secondly, the appreciation in the value of the US dollar increases the burden of external debt. Finally, financing costs in US dollars are rising, all the more so as risk premiums tend to widen.

According to IIF estimates, the share of non-bank sector debt (i.e. States + companies + households) denominated in dollars has risen sharply in Turkey and Latin America (Chile, Colombia, Mexico).

USD-DENOMINATED DEBT OF THE NON-BANK SECTOR

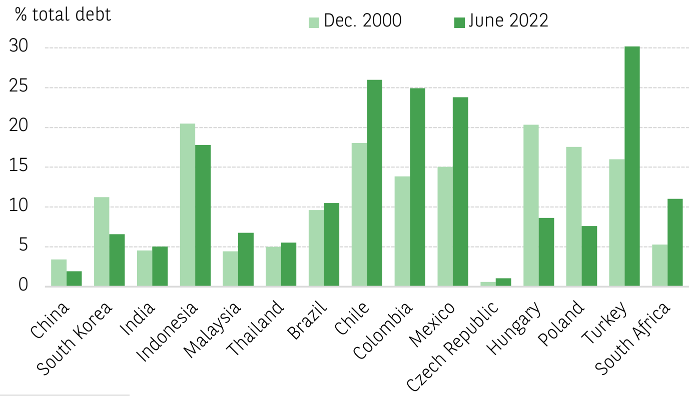

CHART 1 SOURCE: IIF, BNP PARIBAS

For the other emerging countries, this share has remained stable and moderate (chart 1). The dollar effect should therefore not be overestimated or generalised. Furthermore, the risk premiums on foreign-currency bond debt of sovereign borrowers classified as "investment grade" (mainly emerging countries) have remained stable since the beginning of the year.

However, many developing countries, which are much more fragile, have financed themselves on the international bond market and have obtained funding from China. The share of USD-denominated public debt in those countries has risen sharply over the past decade. They are also countries in the speculative grade category whose risk premiums have widened considerably.

Moreover, developing countries are also faced with another double whammy. According to the Global Report on food crisis, 45 countries totalling 180 million people are at risk of, or are already, facing a food crisis because of external or internal conflicts, weather conditions or economic shocks such as the Covid pandemic. According to the IIF, of 35 countries facing a food crisis, around half of these (mainly in Africa) are experiencing major difficulties in repaying their debt servicing costs (debt distress situation), which will amount to over USD 10 billion in 2023. In these circumstances, calls from countries to renegotiate their debt can only increase.

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CHINA

A WEAKER ECONOMY AHEAD OF THE PARTY CONGRESS

The recovery in activity since the end of the lockdowns imposed in Shanghai in the spring has been very gradual. It picked up in August, notably supported by public investment and tax measures, but it is likely to lose steam again in September. As exports begin to suffer from weaker global demand, the continuation of the zero-Covid strategy and the serious crisis in the property sector continue to weigh heavily on confidence, private consumption and investment. An easing of the health policy and more wide-ranging actions to support the property market seem to be the only measures capable of lifting the Chinese economy out of its current gloom. The 20th Congress of the Communist Party, which will open in Beijing on October 16th, will thus take place in a fragile economic environment.

A MARKED SLOWDOWN IN ECONOMIC GROWTH

Activity has recovered slowly since the end of May, when the lockdowns imposed in major economic centres such as Shanghai started to be relaxed. The rebound has been gradual in the industrial sector, and more sluggish in the services sector. However, the growth figures in August surprised on the positive side. The recovery strengthened both in industry (+4.2% year-on-year after +3.8% in July and +0.6% in Q2 2022) and the services sector (+1.8% y/y after +0.6% in July and -3.3% in Q2) despite numerous headwinds (new restrictions on mobility, drop in hydro-electric production and rationing in several provinces, slowdown in exports). Support policy measures by the authorities contributed significantly to this improvement. In particular they led to a rebound in car sales (driven by tax measures) and new public investment in infrastructure projects.

However, the upturn in activity is likely to be interrupted again in September: internal obstacles to growth remain significant and the external environment is deteriorating. The slowdown in export growth in August was substantial and widespread (+7% y/y after +17% on average over the previous three months). It is expected to continue in the short term given the expected weakening in global demand. As a matter of fact, the "new export order" sub-indices of the latest PMIs published at the end of September fell, highlighting the difficulties of the export sector. While exports of goods have been a key driver of Chinese economic growth over the past two years, activity driven by the domestic market will struggle to fill the gap.

Firstly, the zero-Covid policy continues to be very strict (although it was adjusted slightly at the beginning of July) and is likely to be maintained until at least the end of 2022. The number of new Covid cases rose over the summer and the average level of restrictions on mobility in the country increased again. Admittedly it is still far from its April-May level and disruptions as severe as occurred in Shanghai last spring are now unlikely. However, the continuing threat of new restrictions is weighing heavily on people's confidence. The lockdowns imposed in Chengdu and Shenzhen in the first half of September were in fact relatively short-lived but strict, and they hampered activity, particularly in the services sector. Retail sales, which recovered in August, may slow down again in September (in real terms, sales increased by around 3% y/y in August, after they stagnated in July and fell by 7% in Q2).

A PROPERTY SECTOR IN CRISIS

Secondly, the crisis in the property and construction sectors continues. Property sales, construction projects and construction starts continued to fall rapidly in August (chart 1). The average house price (in the 70 largest cities) has fallen by 3.4% over the past year, a surprisingly moderate drop given the collapse in the volume of activity.

FORECASTS

	2019	2020	2021	2022e	2023e
Real GDP growth, %	6.0	2.2	8.1	3.0	5.3
Inflation, CPI, year average, %	2.9	2.5	0.9	2.3	3.1
Official budget balance / GDP, %	-2.8	-3.7	-3.1	-2.8	-3.2
Official general government debt / GDP, %	38.6	45.9	46.9	50.5	51.5
Current account balance / GDP, %	0.7	1.7	1.8	1.9	1.7
External debt / GDP, %	14.5	16.3	15.5	16.4	16.9
Forex reserves, USD bn	3 108	3 217	3 250	3 220	3 200
Forex reserves, in months of imports	14.9	16.2	12.6	11.5	10.7

E: ESTIMATIONS ET PRÉVISIONS

TABLE 1 SOURCE : BNP PARIBAS RECHERCHE ECONOMIQUE GROUPE

CHINA: PERSISTING CRISIS IN THE REAL ESTATE SECTOR

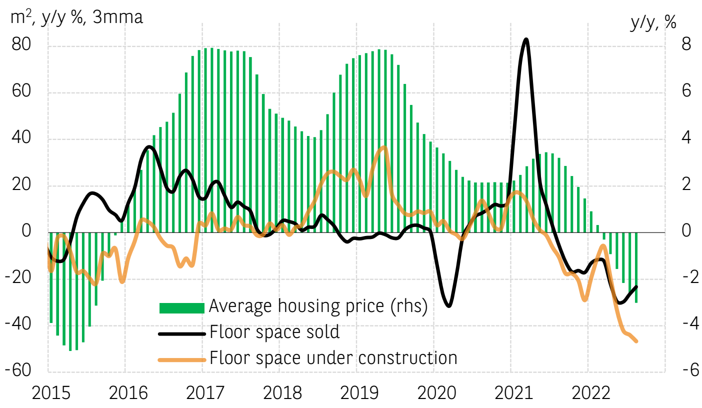

CHART 1 SOURCE: NBS, REFINITIV, BNP PARIBAS

In recent weeks, the authorities have stepped up their efforts to contain the property crisis. Firstly, some measures have been aimed at encouraging mortgage lending and housing demand (lower interest rates, especially on mortgage loans ; easing of prudential rules with, in particular, an increase in the maximum loan/value ratio in certain provinces). Secondly, the authorities have sought to improve the cash flow of property developers and to complete housing construction projects that are still ongoing. One of the main objectives is to reassure buyers who have prepaid their homes, but have not yet received them and, in some cases, have stopped repaying their loans.

The main local banks have therefore been asked to meet "reasonable" financing needs of property developers, and the public company China Bond Insurance Co. Ltd has provided guarantees to a few private developers issuing bonds in the local market. In addition, local governments have set up rescue funds and taken administrative measures to help accelerate the completion of housing construction projects. State policy banks also have to provide new funding to help developers complete certain unfinished projects.

Effects of these support measures have so far been very limited. After three years of slowdown, growth in bank loans to property developers has only recovered slightly and remains low (+1.5% y/y in Q2 2022 compared to 0.8% at the end of 2021). Developers continue to be financially strangled due to both the lack of financing and falling sales. Growth in mortgage loans to households continued to slow in H1 2022 (+5.6% y/y in Q2 compared to 6.6% at the end of 2021). More generally, China's monetary policy easing over the past few months has been cautious and has not led to an acceleration in domestic credit: growth in "total social financing" to the economy remained almost stable at 10.5% y/y in August 2022, compared to 10.3% at the end of 2021 (mostly driven by local governments' bond issues), and growth in total bank loans declined from 11.6% y/y at the end of 2021 to 10.8% in August (chart 2).

Activity in the property and construction sectors shows no sign of recovery. The confidence of investors, creditors and households has been undermined by the decline in property prices, delays in the delivery of prepaid housing and the rise in the number of payment defaults by developers on bank and bond loans. The effects of the property market crisis on the rest of the economy are exacerbated by this significant, and probably lasting, loss of confidence.

CHOICES TO BE MADE

A more wide-ranging support plan could become essential to help take the property market (and the economy) out of the current gloom – at the cost of an interruption in the process of deleveraging developers. At the same time, however, the authorities' room for manoeuvre is constrained, principally due to the already excessive debt of the economy and the increasing fragility of local government finances.

Local governments, which already have large debt, have been hit hard by the drop in their budgetary revenues (-6.5% year-on-year over the first eight months of 2022) due to the economic growth slowdown and, most importantly, by the fall in their land sales proceeds (-28.5% y/y).

The central bank's actions are also being hampered by the rise in the differential between US and Chinese interest rates – while inflationary pressures remain moderate in China. Consumer price inflation reached 2.5% y/y in August 2022, compared to 1.5% in March.

The 20th Congress of the Chinese Communist Party, which will be held in Beijing from 16 to 22 October, will therefore take place in a fragile and complex economic environment. The Congress will appoint the 25 new members of the Party's Politburo and the 7 members of its Standing Committee, and Xi Jinping is expected to be appointed General Secretary of the Party for a third term of five years. The 20th Congress is also expected to provide new insight on the development strategy and the direction of economic policies for the next five years – even though the economy's new leaders will only be appointed at the National People's Congress in March 2023.

CHINA: MONETARY EASING HAS LITTLE EFFECT ON CREDIT ACTIVITY

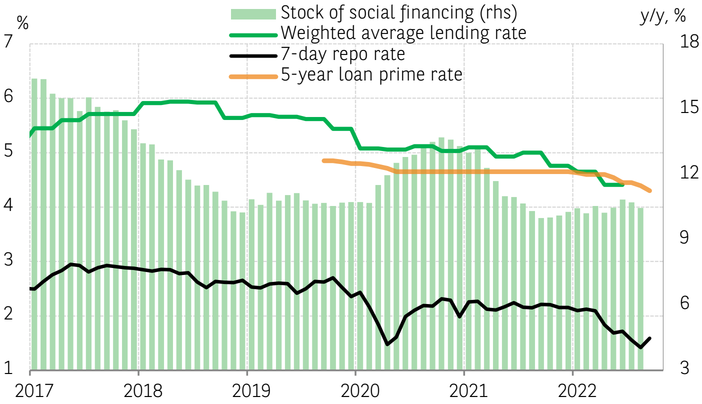

CHART 2

SOURCE: PBOC, CEIC, REFINITIV, BNP PARIBAS

Given the scale of the economic growth slowdown since the beginning of the year, the weakness of domestic demand and the recent weakening in external trade, the country's economic development is likely to be put back at the top of the agenda for China's leaders. An easing of the zero Covid policy and further measures to support the property market are likely to be implemented by the beginning of 2023. In addition, Xi Jinping could revive his strategy aimed at promoting: (i) the concept of "dual-circulation": the domestic market and private consumption should be strengthened as much as export-oriented activities, and "national security" must be ensured (access to essential resources, self-sufficiency of the technological sectors); and (ii) "Common Prosperity", with particular focus on improving social protection and reducing inequalities.

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INDIA

FIRM RESISTANCE AGAINST STRONG PRESSURES

Although it remains dynamic, economic growth slowed in the first quarter of the current fiscal year. Monetary policy tightening, a very mixed monsoon season and disruption to global value chains are expected to weigh on activity during the next two quarters. The central bank has revised its economic growth forecasts downwards for the current fiscal year as a whole. At the same time, pressures on external accounts and the rupee are set to remain strong. Despite this rather unfavourable environment, enterprises and banks are holding up well.

SLOWER ECONOMIC GROWTH

In the first quarter of the fiscal year 2022/2023 (April to June 2022), real GDP increased by 13.5% compared to the same period the previous year, but contracted by 3.3% in seasonally-adjusted terms compared to the previous quarter. All GDP growth components fell back slightly compared to the previous quarter (with the exception of imports). The contribution of net exports to growth deteriorated further; it had already been negative for six quarters.

The latest leading indicators reveal that the slowdown in activity continued in the second quarter of the fiscal year 2022/2023 in industry (electricity, cement and coal) and services. Disruption to global value chains and rising production costs are worsening the outlook for industry. Higher prices and a tighter monetary policy are likely to affect the consumption of urban households. In August, the inflation rate again reached 7% year-on-year, whereas the target set by the monetary authorities is 4% +/-2 percentage points. Furthermore, the core inflation (excluding food and energy prices) remains very high, even though it slowed to 5.8% year-on-year in August (from a peak of 7% in April 2022).

The agricultural sector has also experienced a very variable monsoon. Sales of tractors already fell in July and August. Throughout the country, the monsoon should be slightly better than the average recorded between 1970–2020. On the other hand, while the northeast and east of the country seem to have a water shortage, rainfalls in central and western regions were heavier than usual. The water deficit in four states (Uttar Pradesh, Bihar, Jharkhand and West Bengal) is estimated at between 18% and 46%, and these states produce almost a third of the country's cereals. Anomalies weighed on the cotton and soybean harvests in the west of the country, but should also reduce rice harvests, particularly in the main producer states such as West Bengal, Bihar and Uttar Pradesh. In September, against this backdrop, the government announced a ban on broken rice exports and imposed a customs duty of 20% on sales of other categories of rice (excluding basmati rice). As a result of these measures, the country's rice exports are expected to fall by 25% during the fiscal year 2022/2023.

For the whole fiscal year 2022/2023, real GDP growth is not expected to exceed 7.0%, according to the latest forecasts from the Reserve Bank of India (RBI).

FORECASTS

	2019	2020	2021	2022e	2023e
Real GDP growth, % (1)	4.2	-6.6	8.7	7.1	6.1
Inflation, CPI, year average, % (1)	4.8	6.1	5.5	6.7	5.5
General Gov. Balance / GDP, % (1)	-7.3	-13.7	-11.0	-9.1	-8.6
General Gov. Debt / GDP, % (1)	74.7	84.0	82.3	81.1	81.0
Current account balance / GDP, % (1)	-0.9	0.9	-1.2	-4.2	-3.1
External debt / GDP, % (1)	19.9	21.6	19.7	19.4	18.7
Forex reserves, USD bn	457	580	633	520	535
Forex reserves, in months of imports	7.7	11.0	9.1	7.5	8.0

TABLEAU 1

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

INDIA: INDUSTRIAL PRODUCTION

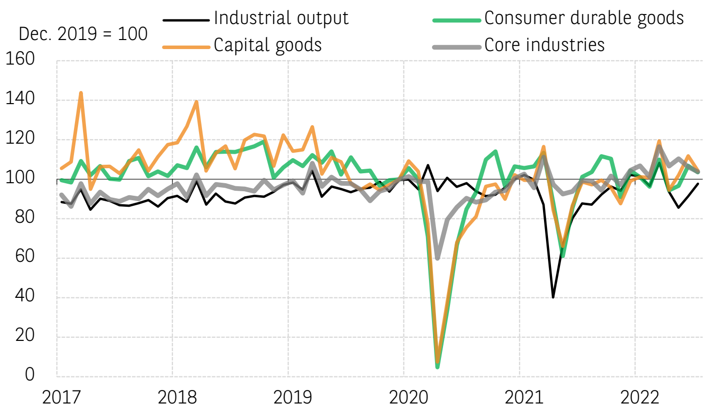

CHART 1

SOURCE: CEIC, RBI, BNP PARIBAS

THE RUPEE UNDER PRESSURE

Between January and September 2022, the sharp widening of the trade deficit and capital outflows caused the rupee to fall by 8.9% against the dollar, and a drop in foreign exchange reserves of over 15% (to USD 537 billion at the end of September 2022).

The trade deficit reached 7.9% of GDP over the first eight months of 2022 (compared to 4.6% last year), and net portfolio investments posted a deficit of 1.7% of GDP over the first half of the year. The central bank's interventions to support the currency have gathered pace since the summer. Between January and July 2022, the RBI sold USD 38.8 bn in foreign exchange reserves (including almost USD 20 bn for July 2022 alone). By way of a comparison, it sold USD 14 bn between June and September 2013 during the 'Taper Tantrum' episode.

In the short term, the rupee looks set to remain under pressure. Although the drop in international commodity prices should help reduce the energy bill, the global economic slowdown is likely to have a negative impact on exports. These had already fallen by 11.6% in July and August compared to the first half of the year. The trade deficit is therefore expected to remain particularly high. Over the entire fiscal year 2022/2023, the current account deficit could reach 4.2% of GDP (compared to 1.2% of GDP in 2021/2022).

Regarding investment flows, the country could benefit from the increase in India's weighting in the MSCI Emerging Markets Index (up from 12.45% to 14.483%). However, the decision to include the Indian government debt securities in global bond indices, originally scheduled for October, was delayed to 2023.

Pressures on external accounts are expected to remain strong during the fourth quarter and throughout 2023, but foreign exchange reserves remain sufficient. They covered 1.8 times the country's short-term financing needs at end-September 2022.

A MORE SOLID BANKING SECTOR

The latest financial stability report published by the RBI describes a consolidation of the banking sector during the fiscal year 2021/2022. Although public banks remain much more fragile than private banks, their financial situation has continued to strengthen, and they should all be able to cope with monetary tightening and the deterioration of the economic environment.

Banking asset quality has improved: across the entire banking sector, the non-performing loan (NPL) ratio fell by 1.6 points during the past 12 months, to 5.9% in March 2022. The NPL ratio for public banks remains higher but yet recorded a fall from 9.5% to 7.6% over the same period. The construction sector remains the most fragile of all. Its non-performing loan ratio was still as high as 19.4% in March 2022. Nevertheless, the risks for the banking sector remain under control, since loans to the construction sector only represent 3.7% of total credit granted by the banking sector as a whole.

Furthermore, although provisions are still insufficient across the banking sector as a whole, they improved slightly, covering 70.9% of risky assets in March 2022 compared with 68.9% a year earlier.

Solvency ratios have continued to strengthen, reaching 16.5% for the entire banking sector (14.7% for public banks). Lastly, banks' profits have continued to grow, though at a more modest rate than in the previous six months. Their return on assets and return on equity stood at 0.9% and 9.7% respectively in March 2022.

Supported by their more comfortable financial situation, banks have been more inclined to respond to rising credit demand. Credit growth, which has been up since April 2021, continued to accelerate and reached 14.5% year-on-year in July 2022 (compared to +5% a year earlier). This growth spans all categories of borrowing, including loans to households and companies, and all sectors of activity. However, this upward momentum is expected to be affected by the rise in key rates (up 140 basis points since April 2022). Average interest rates for new loans only rose by 70 bps in nominal terms between April and July 2022, but the rise in real terms is much greater given the slowdown in inflationary pressures over the same period. Deflated by the consumer price index excluding energy and food ("core inflation"), interest rates rose by 190 bps. Yet they remain at relatively low levels (the average real rate for new loans was 2.4% in July).

INDIA: BALANCE OF PAYMENTS

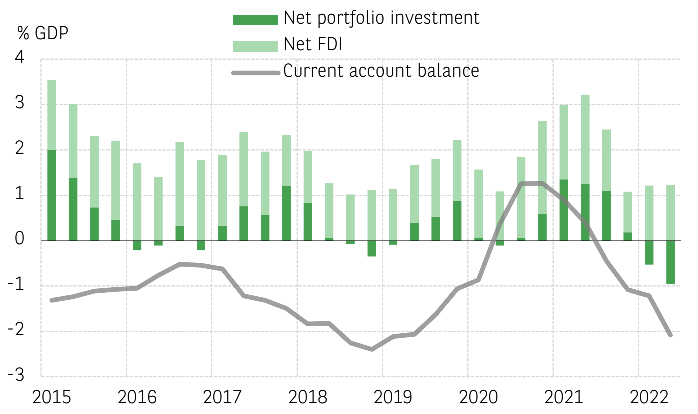

CHART 2 SOURCE: CEIC, RBI, BNP PARIBAS

Despite the expected slowdown in activity in the next few quarters, credit risks should remain contained, according to the RBI. In its baseline[1] scenario, the central bank foresees a strengthening of the quality of bank assets by the end of the 2022/2023 fiscal year. The non-performing loan ratio should fall to 5.3%. However, it also predicts a drop in solvency ratios from 16.5% in March 2022 to 15% in March 2023. In the event of an extreme shock (contraction of economic activity), the NPL ratio would increase to 8.3% and the average solvency ratio would drop to 13.3%. Nevertheless, the 46 banks tested would not need to be recapitalised in order to comply with solvency ratios.

ENTERPRISES IN A GOOD POSITION

Despite the increase in production costs (up by 45% year-on-year in Q2 2022) and, to a lesser extent, in debt interest payments (up by 9.4% in Q2 2022), the financial situation of enterprises remains comfortable overall. They have passed the increase in their costs on to their sales prices, as can be seen by their profit growth. Their profits continued to grow compared to the same period last year, albeit at a more modest rate (net profits increased by a rate of 24.6% year-on-year in Q2 2022). The level of corporate debt decreased: the ratio of debt to equity stood at 35% in Q2 2022 compared to 45.8% two years earlier. Furthermore, in June 2022, pre-tax profits were still enough to cover 4.9 times the amount of debt interest payments.

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1 In its baseline scenario produced in June 2022, the RBI forecast growth of 7.2% and average inflation of 6.6% over the year 2022/2023.

INDONESIA

A LESS FAVOURABLE OUTLOOK

During the first six months of 2022, the economy proved to be quite resilient to the consequences of the conflict in Ukraine and China's zero-Covid policy. In particular, it benefited from the higher prices of exported commodities (mainly coal and palm oil). Its public finances and external accounts consolidated despite rising subsidies and net capital outflows. However, the situation could deteriorate in the fourth quarter and the medium-term outlook is less favourable. Although the fiscal deficit and government debt remain modest, refinancing risks will increase in 2023 in conjunction with the end of purchases by the central bank of government's bonds, which have been in place since 2020. Moreover, pressures on the rupiah will intensify with the fall in commodity prices.

EXPECTED SLOWDOWN

In the first half of 2022 economic growth was +5.2% compared to the same period last year. Household consumption and net exports picked up pace significantly. The return of tourists supported the demand for services. The increase in the consumer price index (CPI) remained relatively modest over the first six months of the year (+3% year-on-year), thanks in particular to the maintenance of regulated petrol prices and the ban in May on exporting palm oil in order to limit the rise in domestic vegetable oil prices.

However, activity will slow down over the second half of the year and inflationary pressures will intensify. The increase in the consumer price index reached 5% year-on-year between June and September 2022, and so exceeded the 4% target set by the monetary authorities. Domestic demand is expected to slow down (particularly in the last quarter), mainly due to the rise in food prices (already +9.2% on average over the past three months), the increase in regulated petrol prices and the tightening of monetary policy.

Indeed, in order to limit the rise in public spending, at the beginning of September the government announced a rise in the controlled petrol and diesel prices, for the first time since 2016. They have been raised by an average of over 30%. In anticipation of the impact of this increase on transport prices and, more generally, in response to the rise in inflationary pressures, the central bank (Bank Indonesia, BI) tightened its monetary policy by 50 basis points (bps) at the monetary policy committee in September, having previously raised its rates by 25 bps in August. Further rate hikes can be expected.

Furthermore, the economic slowdown in China and the United States, Indonesia's two main trading partners, will weigh on its exports.

Against this backdrop consumer confidence indices fell slightly over the summer and the pace of growth in retail sales began to slow. While entrepreneurs remained confident in August, there is every indication that this optimism won't last.

The government has less room for manoeuvre for supporting its economy than in 2019. Moreover, the prospect of having to finance its entire deficit without direct support from the central bank means it has to be cautious. This explains the recent increase in regulated petrol prices following several months of support for the population.

PUBLIC FINANCES REMAIN STRONG

However, the public finances consolidated over the first eight months of 2022. The government's fiscal balance recorded a surplus equivalent to 0.6% of GDP, compared to a deficit of 2.3% of GDP in the same period last year.

FORECASTS

	2019	2020	2021	2022e	2023e
Real GDP growth (%)	5.0	-2.1	3.7	5.5	4.9
Inflation (CPI, year average, %)	2.6	2.0	1.6	4.3	4.7
Gen. Gov. balance / GDP (%)	-2.2	-6.1	-4.6	-3.9	-2.9
Gen. Gov. debt / GDP (%)	30.7	39.8	41.1	41.3	40.9
Current account balance / GDP (%)	-2.7	-0.4	0.3	0.3	-0.2
External debt / GDP (%)	36.0	39.4	35.1	31.8	30.9
Forex reserves (USD bn)	122	129	131	115	110
Forex reserves, in months of imports	7.1	7.3	7.4	6.0	6.9

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

INDONESIA: INFLATIONARY PRESSURES HAVE ACCELERATED SINCE JUNE

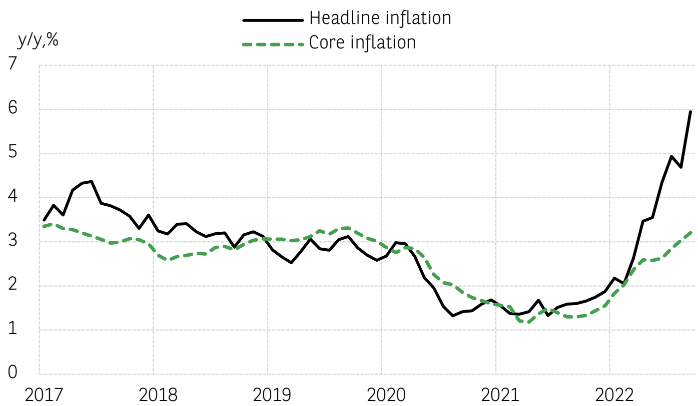

CHART 1

SOURCE: CEIC, BI, BNP PARIBAS

This strong performance was made possible by the very significant increase in budget revenues. These increased by almost 50% year-on-year over the first eight months of 2022 to reach the equivalent of 14% of GDP, fostered by the dynamism in domestic demand, the rise in VAT in April, and the sharp increase in company profits excluding oil and gas.

The increase in expenditure was relatively modest (+8.3%) despite the increase in interest payments and subsidies (+10.1% and +16.8% respectively over the first eight months of the year). Nevertheless, the government expects a sharp rise in costs in the fourth quarter of 2022 because of the conflict in Ukraine, despite the increase in regulated oil prices in September. Subsidies are therefore expected to amount to 1.8% of GDP over the full year 2022 (compared to 1.4% of GDP in 2021), plus income transfers (for the lowest income households) which will amount to 1.6% of GDP in 2022 (they were almost zero in 2021).

Over 2022 as a whole, the deficit should reduce to 3.9% of GDP (compared to 4.6% of GDP in 2021). In its budget projection for 2023 the government envisages reducing the deficit to 2.9% of GDP, below the «legal» threshold of 3% of GDP (temporarily suspended between 2020 and 2022 and restored for 2023). This consolidation will in particular be supported by the reduction in expenses (-4%), including subsidies and transfers to households. The growth in revenues is likely to be marginal. The one-point rise in VAT (set at 12%) should help to compensate for the expected drop in corporate income taxes resulting from the expected normalisation in commodity prices.

On the other hand, debt interest payments are expected to increase (in conjunction with the rise in debt and the yields on government bonds) and account for more than 18% of government revenues in 2023 (compared to 14.1% in 2019), further restricting the government's budgetary room for manoeuvre.

In 2023 the deficit will be wholly financed by the issuing of bonds on the domestic market. However, unlike the last three years, the central bank will not purchase government's bonds on the primary market (439 trillion rupiah in bonds were purchased by the BI in 2021 and 2022, equivalent to 2.6% of the 2021 GDP).

In 2022, government debt is expected to continue increasing, to 41.3% of GDP, before falling slightly from 2023. However, refinancing risks will increase with the end of the central bank's debt purchasing programme and the rise in US interest rates.

While government debt remains modest, the refinancing risks are greater than in other countries (such as Malaysia and India where the debt-to-GDP ratio is, however, much higher) as Indonesia remains structurally dependent on foreign investors to meet its financing needs. Prior to the BI's debt purchasing programmes in 2020, the proportion of tradable domestic debt (91% of the total debt) held by foreign investors stood at 38.6% in 2019. It was only 15.2% in June 2022.

EXTERNAL ACCOUNTS SHOW RESILIENCE

Indonesia's external accounts have proved far more resilient to the external environment than might have been feared in view of previous episodes of rising oil prices and US monetary policy tightening. Furthermore, although foreign exchange reserves fell over the first eight months of the year they are still sufficient to cover the country's overall short-term external financing needs by a factor of 1.9. The rupiah depreciated by only 6.3% against the dollar in the first nine months of 2022. Nonetheless, external account pressures are expected to grow in the coming quarters and volatility in the rupiah is expected to increase.

The country's external debt fell below pre-Covid-19 levels to stand at just 31.8% of GDP in June 2022 compared to 36% of GDP in 2019. This reduction mainly reflects the decrease in government debt purchases by foreign investors and, to a lesser extent, the slight fall in Indonesian corporate debt, while banks' external debt increased slightly. In addition, while external debt still accounts for almost 1.8 times the country's export revenues, the refinancing risks are modest. External debt repayments in the next twelve months remain low, especially in relation to foreign exchange reserves. At the end of June they stood at only 66 billion US dollars, equivalent to 0.5 times the country's foreign exchange reserves.

INDONESIA: CURRENT ACCOUNT SURPLUS IN H1 2022

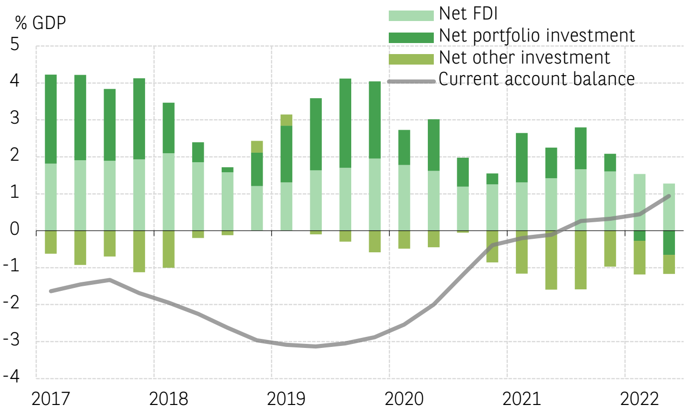

CHART 2 SOURCE: CEIC, BI, BNP PARIBAS

As a net exporter of commodities, particularly coal and palm oil (each of which accounted for 11.6% of the country's total exports in 2021), Indonesia has benefited from the sharp rise in commodity prices in the first half of 2022. Although oil and gas imports increased by 83% compared to the same period last year, the effect on the trade balance was largely offset by the rise in exports. The current account therefore recorded a surplus of around 0.7% of GDP over the first six months of 2022 while it showed a deficit of 1.4% of GDP a year ago.

Furthermore, although the country has continued to post net portfolio investment outflows, these have fallen significantly in comparison to Q4 2021. They were only 0.5% of GDP in the first half of 2022.

However, foreign direct investment (FDI), which was already structurally modest (1.6% on average over the past five years), declined in the first half-year compared to the same period in 2021, at just 1.1% of GDP. Investments remained concentrated in the metallurgy industry, the transport sector and telecommunications, the food industry and the mining sector. This drop in FDI flows could be explained by the uncertainty surrounding President Joko Widodo's succession. If foreign investment remains as modest in 2023 this could become a concern as the current account could show a (slight) deficit again, and the government's external financing needs would be expected to increase to compensate for the lack of bond repurchasing by the central bank. The downward pressures on the rupiah could intensify next year.

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THAILAND

CAUTIOUS OPTIMISM

The recovery is continuing in Thailand. The rebound in private consumption and the gradual return of tourists should help, at least in the short term, to compensate for the slowdown in exports. However, the risks to growth remain on the downside, due to rising inflation, monetary tightening, the weakness in global demand and the absence of Chinese tourists. In the run-up to the elections in May 2023 political tensions could increase again. However, medium-term strategic investments, including the Eastern Economic Corridor programme, should not be jeopardised.

EXPORTS SLOW

The upturn in economic activity continues to be evident in Thailand. GDP grew by 2.3% and 2.5% respectively year-on-year in the first two quarters of 2022. This dynamic should accelerate in the second half of the year, supported by strong private consumption; this is being boosted by the removal of all lockdown measures and the recent increase in the minimum wage by 5%, as well as by a budgetary policy that continues to be accommodative. The agricultural sector (which still represents 30% of total jobs) should also benefit (in terms of volume and market share) from the new restrictions on Indian exports (last September the Indian government banned exports of broken rice and imposed a customs duty of 20% on sales of other categories of rice).

At the same time, the number of tourists arriving in the country continues to rise. It has been increasing since May, following the partial reopening of borders. All restrictions have since been lifted. However, the recovery is likely to be very gradual due to the almost complete lack of Chinese visitors. While they accounted for over 30% of total arrivals in 2019, Chinese tourists have been fewer than 3% of the total since the start of 2022. It will probably take several years to get back to the previous level – around 40 million visitors registered in 2019 (chart 1).

Overall, real GDP is expected to grow by 4% in 2022 after 1.5% growth in 2021. That said, the risks to growth remain on the downside. The rapid deterioration in regional trade (in the context of a slowdown in global demand) is hampering the recovery and contrasts with the momentum in private consumption.

Exports of goods slowed in July and August (to 8% year-on-year, after having risen by more than 15% on average in the first six months of the year), and the PMI index of new export orders also declined over the last two months. The gradual normalisation of production in the automotive sector (globally) has helped to prevent an even more marked slowdown in exports. However, this respite is likely to be short-lived, as the consumption of automotive products is particularly sensitive to the current environment of rising interest rates.

FORECASTS					
	2019	**2020**	**2021**	**2022e**	**2023e**
Real GDP growth (%)	2.2	-6.2	1.5	4.0	4.7
Inflation (CPI, year average, %)	0.9	-0.3	2.2	6.4	4.2
Gen. Gov. balance / GDP (%)	-0.8	-4.5	-7.9	-3.9	-3.8
Gen. Gov. debt / GDP (%)	41.1	49.4	58.4	60.6	59.6
Current account balance / GDP (%)	7.0	4.2	-2.2	-2.9	2.3
External debt / GDP (%)	31.5	38.1	39.0	40.9	39.6
Forex reserves (USD bn)	224	258	246	205	218
Forex reserves, in months of imports	9.0	15.0	11.0	9.0	9.3

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

THAILAND: INFLATION AND POLICY RATE

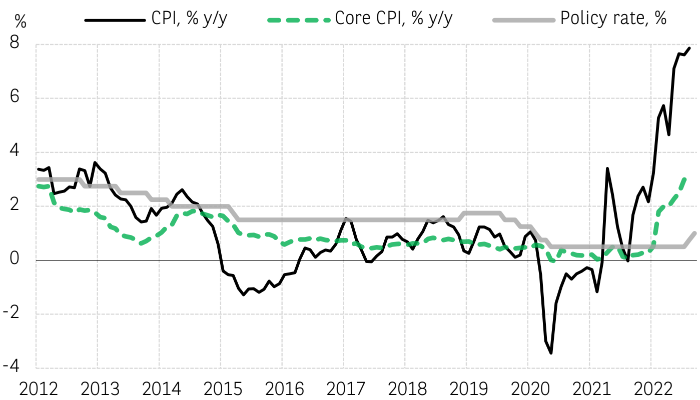

CHART 1

SOURCE: BANK OF THAILAND, BNP PARIBAS

MORE RATE HIKES CAN BE EXPECTED

Furthermore, the high rate of inflation continues to weigh on the outlook for growth. Inflation has continued to rise steadily since the last quarter of 2021. It has been above the central bank's target (between 1 and 3%) since the beginning of 2022, due to rising energy and food prices. The inflation rate stood at 7.9% year-on-year in August, after 7.6% in July, and is likely to remain high in the short term given the series of adjustments expected (20% increase in the price of electricity, 5% increase in the minimum wage, increase in taxi fares, etc.).

For the first time since May 2020 the central bank raised its key interest rate by 25 basis points (to 0.75%) at its monetary policy meeting on 10 August. Another rate hike was announced at the meeting on 30 September, bringing the key rate to 1%. This is now 25 basis points (bps) below its pre-Covid level. In its latest statement the central bank has indicated that further short-term rate increases are likely, given the context of strengthening domestic demand and tightening of international monetary conditions.

However, the statement indicates that the central bank intends to establish its key interest rate at a level that is *"compatible with sustainable long-term growth"*. Given the structural weaknesses affecting Thai growth (ageing population, relatively high household debt, relatively weak net FDI inflows), the end of the tightening cycle could occur before inflation has been fully stabilised.

FISCAL POLICY REMAINS ACCOMMODATIVE

Since 2020 the government has been making full use of the room for manoeuvre that it has to support the economy. Numerous measures were implemented in 2020-2021, deepening the public deficit (to 4.5% and 7.9% of GDP respectively, after an average of 3% in 2015-2019). The government is also planning a very gradual consolidation, with priority given to supporting growth.

The various subsidies designed to mitigate the rise in energy and food prices have gradually replaced the measures put in place during the Covid-19 crisis, and the deficit is expected to be around 4% of GDP in 2022 and 2023. Public debt should remain well below the regulatory ceiling of 70% of GDP.

POLITICAL TENSIONS ON THE RISE AS THE ELECTIONS APPROACH

The biggest risk to growth, and the country's main structural weakness, remains the political climate. Following several years of apparent calm, political tensions have been increasing since 2020. The political climate could become even more difficult in the run-up to the legislative elections[1], scheduled for May 2023.

In the very short term political tensions could increase after the decision of the Constitutional Court to keep the Thai Prime Minister in office. Last August several opposition parties had asked the Court to rule on the legitimacy of the latter remaining in his post, as the constitutional limit of eight consecutive years for the exercise of power had been reached. However, the Court ruled that the number of years that Prayuth Chan-ocha had been in power should be counted from 2017 (the year of the referendum and the year when the constitution came into effect) and not from 2014 (the year of the coup d'état which enabled Prayuth Chan-ocha to take power, as commander of the armed forces).

On the basis of the judgment the Prime Minister could therefore remain in power until 2025, two years after the elections. If he were to be elected again to the position of Prime Minister, he would therefore be required to resign mid-term and new elections would have to be organised. In these circumstances it is unlikely that he would be selected by his party to be a candidate for his own succession.

In addition, the election of the former Minister of Transport (a member of Pheu Thai, the party ousted by the 2014 coup d'état) to the position of Governor of Bangkok last May, the internal dissensions of the governmental party as well as the absence of a natural (and agreed) successor to the current Prime Minister have weakened the government coalition, leading some parties to form new coalitions, and strengthened the opposition parties.

NUMBER OF TOURISTS IN THAILAND

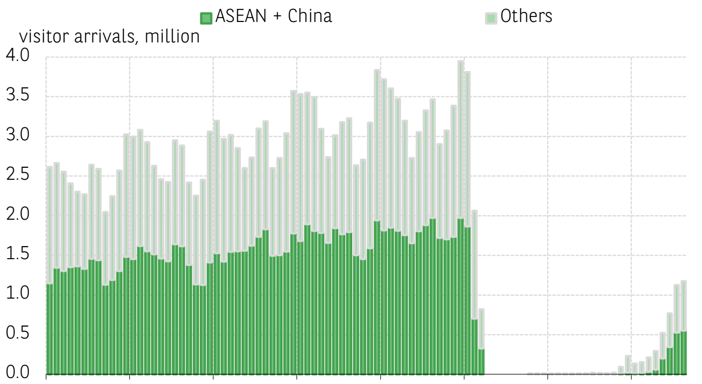

CHART 2 SOURCE: MINISTRY OF TOURISM

That said, the political noise around the elections should not affect Thai investment strategy over the next five years. For the time being, all parties seem to be intent on implementing the policies undertaken by the current government, particularly with regard to the second phase of the EEC (Eastern Economic Corridor) project. This is a wide-ranging investment plan primarily aimed at facilitating investment in the technology sectors and improving the country's infrastructure through public-private partnerships. This project, which was launched in 2017, has slowed considerably since 2020 due to the health crisis. The second phase is expected to be completed in 2026.

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1 As a reminder, since the constitution came into effect in 2017, the lower house of representatives has consisted of 500 seats: 350 members are elected via a one-round first-past-the-post ballot and the other 150 are elected via a proportional representation list system. The term of office is four years. The Prime Minister is then elected (also for a period of four years) following a vote organised in the House of Representatives (consisting of the lower chamber and the Senate, whose 250 members are appointed by the National Council for Peace and Order, a military institution created in 2014 following the coup d'état).

LOSING STEAM

The economic slowdown is likely to continue in the coming quarters. Poland is facing several challenges. Firstly, the country is highly dependent on coal imports, and the price of this commodity has soared since the end of 2021. The Central Bank has moved towards a less restrictive monetary policy despite high inflationary pressures. Finally, the moratorium on mortgage repayments in 2022 and 2023 will have a negative impact on banks' balance sheets in the short term. However, the Polish economy does have numerous strengths and should show resilience.

The quarterly accounts for the second quarter of 2022 confirm a slowdown in economic activity in all of the Central European Countries (CEC). It has been more pronounced in Poland, with a GDP contraction of 2.1% q/q after +2.5% in Q1 2022 and +1.8% in Q4 2021. Household consumption and net exports made a positive contribution to growth, of 0.9 and 0.6 points respectively, but this contribution was insufficient to compensate for the marked decline in investment. Companies also seem to have de-stocked during the second quarter.

DETERIORATION IN ECONOMIC INDICATORS

Confidence in the manufacturing industry deteriorated significantly in the past six months. PMI indices and most sub-indices fell below the 50 threshold, but still remain higher than in 2020. The introduction of a tax on windfall profits, particularly in the energy sector, could further erode the confidence of businesses and cause them to defer investment projects. Households were also more pessimistic in recent months according to surveys by Ipsos, the European Commission and the Polish Institute of Statistics.

Retail sales grew more slowly year-on-year, but are still going in the right direction. They stand at 16.3% above the pre-Covid-19 level. The good performance in consumption can be explained by several supportive measures in favour of households, as well as strong wages growth in the first half of the year. This was close to the rate of inflation, meaning that losses in purchasing power were limited. The labour market remained dynamic, with a record low unemployment rate of 2.6% in August. The second half of the year will better reflect the effects of inflation on retail sales, as wages have risen more slowly since August while price increases continue to pick up.

Industrial production is resisting well for now. It is 21.2% above its pre-Covid level, but has risen more slowly over the past four months year-on-year. There is also some divergence between sectors. Energy-intensive industries are particularly affected due to rising energy costs. Some fertiliser, chemical and steel manufacturers have been forced to temporarily suspend some of their activities. Production of durable consumer goods is also falling. By contrast, activity in the automotive sector continues to move in the right direction. In the coming months, we expect a significant downturn in overall production activity in view of the signals coming out of recent industry surveys and due to the expected slowdown in demand from European countries.

MAJOR BUT MANAGEABLE CHALLENGES

The energy crisis will weigh on the economy. In fact, Poland is dependent on imports of coal from Russia for heating, even though the country is one of the world's leading producers of this commodity. Russian coal has been subject to an embargo by Poland since April. As a result, the country has to source from other suppliers in a context where prices have soared.

FORECASTS

	2019	2020	2021	2022e	2023e
Real GDP growth, %	4.7	-2.1	5.8	3.5	1.0
Inflation, CPI, year average, %	2.1	3.4	5.1	14.0	13.0
Gen. Gov. balance / GDP, %	-0.7	-6.9	-1.9	-5.0	-4.9
Gen. Gov. debt / GDP, %	45.6	57.1	53.8	51.4	49.9
Current account balance / GDP, %	0.5	2.9	-0.7	-4.1	-2.0
External debt / GDP, %	58.8	60.3	56.5	52.0	50.0
Forex reserves, EUR bn	114.5	125.6	146.9	148.0	150.0
Forex reserves, in months of imports	5.1	5.9	6.0	5.8	5.6

e: ESTIMATE & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

POLAND: INDUSTRIAL PRODUCTION

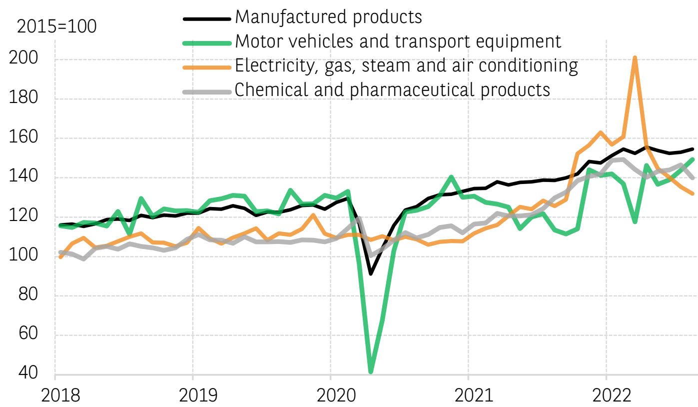

CHART 1 SOURCE: EUROSTAT, BNP PARIBAS

Poland would find it difficult to increase coal production in the short term, given high extraction costs. Also, the country's commitments to reducing CO_2 emissions have held back investment in this sector.

However, it should be noted that Poland is one of the Central European Countries that is best prepared for the energy crisis, owing to an investment strategy that has been in place for several years to diversify gas supply sources. Poland has terminals for importing liquefied natural gas, in Świnoujście. Similarly, the Baltic Pipe gas pipeline linking Norway and Poland via Denmark has been operational since 1st October 2022 and will be operating at full capacity by 2023. Poland is also supplied via Germany. Since April the country has no longer been importing Russian gas. Regarding stocks of gas, the tanks were 98% full at the end of September.

Challenges also concern the banking sector. The moratorium on mortgages, which has been in effect since July, will have a negative impact on banks' balance sheets. According to the authorities, the cost is estimated at 20 billion zlotys for banks, or EUR 4.2 bn, if all households were to decide to exercise this option.

The moratorium allows households to suspend their repayments on loans contracted in zlotys for four payment dates in 2022 and four others in 2023. As this measure is not conditional on household income it could be very widely used, particularly as almost all mortgage loans are taken out on a variable rate basis. The tightening of monetary policy since 2021, through hikes in the key interest rate, has in fact been reflected in the cost of mortgage lending.

The banking system should be able to cope with this measure. Its prudential ratios are strong. For example, the solvency ratio of the banking system as a whole was at 15.6% in Q1 2022, well above the required threshold. The non performing loan ratio remains very low, at 2.8% in Q1 2022.

POLAND: POLICY RATE AND INFLATION

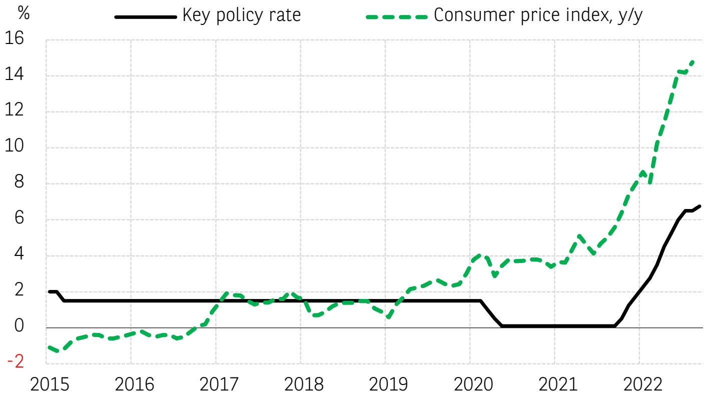

CHART 2 SOURCE: EUROSTAT, NBP, BNP PARIBAS

TOWARDS A LESS RESTRICTIVE MONETARY POLICY

Inflation has continued to accelerate. It reached 14.8% year-on-year in August, far in excess of the central bank's 2.5% inflation target. Since the end of 2021, it has been driven higher mainly by the cost of food, rents and energy bills. As for inflation excluding food and energy, it has risen sharply since the end of 2021 and stood at 10.7% year-on-year in August, driven by high wage growth (+13.8% year-on-year on average over the past three months). In the short term, inflationary pressures will remain high.

Despite inflationary pressures, the Central Bank has slowed its pace of monetary tightening since July. The increase was 25 basis points (bps) to 6.75% in September, after 50 bps in July, 75 bps in June and 100 bps in April. These actions are in line with the Central Bank's recent communications on the risks to growth. However, it still has plenty of room for manoeuvre, judging by real interest rates which are still broadly negative.

AN ECONOMY RESILIENT TO SHOCKS

Despite the expected slowdown in the coming months, the Polish economy could grow by an average of 3.5% in 2022 due to significant carry-over effects in 2021 and Q1 2022. A more pronounced slowdown is expected in 2023, but Poland should still stand out from other Central European Countries with a better economic performance. This resilience can be explained by several factors.

Firstly, the authorities have implemented several series of support measures since end 2021 to deal with inflationary risks. They represent around 3 to 4% of GDP in 2022 and have taken the shape of reductions in the rate of income tax, VAT on certain food and energy products, and excise duties. Households have also benefited from direct payments to support their purchasing power. Recently, an amount of 3,000 zlotys (640 euros) was allocated to those relying on coal for their heating. In September, the authorities also announced a freeze on household electricity tariffs in 2023.

Secondly, Poland is an economy that is somewhat less exposed to the deterioration in the international environment than its neighbours. Exports account for 50% of GDP, compared to 90% and 80% in Slovakia and the Czech Republic respectively.

Finally, twin deficits (budgetary and current) are no longer a cause for concern. Financing the current account deficit is not a major problem. FDI flows will most likely cover much of the gap in 2022 and 2023. External liquidity and solvency indicators are solid. The ratio of debt servicing to exports of goods and services was moderate at 17% in 2021. External debt was also moderate, at 56.5% of GDP.

Public accounts are also sound. The numerous support measures put in place this year are estimated at around 3 to 4% of GDP and the public deficit is expected to reach 5% of GDP in 2022. Revenues remain strong in 2022, being almost comparable to those of last year over the first 7 months of the year. In addition, the recently announced taxation on super-profits will also provide support if this measure is implemented quickly. Furthermore, the proportion of government debt denominated in foreign currencies is moderate. The increase in the cost of financing on the bond markets remains manageable with a very low ratio of interest charges in relation to tax revenues.

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SLOVAKIA

ENERGY DEPENDENCY

All growth drivers weakened in the second quarter of 2022. With a high exposure to Russia for its oil and gas supplies, Slovakia could be amongst the most affected Central European countries by the consequences of the war in Ukraine. The steep rise in energy costs, as well as supply disruptions, will have an adverse impact on industrial activity, which has not yet returned to its pre-Covid level. Moreover, inflation has increased rapidly but is still more moderate compared to other countries in the region. Finally, public and external accounts will deteriorate in the short term, but this situation remains manageable.

The Covid pandemic led to a GDP contraction of 4.4% in 2020. The rebound in activity of 3% in 2021 has not yet enabled the economy to return to its pre-crisis level. The catching-up will not happen before 2023 given diminished growth outlook for the next two years.

GROWTH IS SLOWING DOWN

Economic activity weakened in Q2 2022, with a GDP print of 1.8% year-on-year compared with 3.1% in the first quarter. Growth was dragged down by net exports and by government consumption, which resulted in negative contributions of -0.3 and -1.3 points respectively. Exports suffered from supply disruptions in industry, particularly in the electronics sector. The contribution made by investment was practically nil. Consumption slowed down, but was still the main driver of growth. Households have drawn on their savings to maintain their purchasing power to some extent. The partial freeze on electricity tariffs for households since the beginning of the year has also helped.

The soft patch in investment reflects the deterioration in the business climate. The uncertainties related to the war in Ukraine, alongside with the squeeze on margins due to soaring production costs, and labour shortage have undoubtedly resulted in the postponement of investment projects.

In terms of economic indicators, retail sales are struggling to exceed their pre-Covid level. They have slowed in recent months, to +1.2% year-on-year in July after +1.5% in June and +7.8% in May. Another point to note is that registrations of new vehicles continue to record very sharp declines (-20.3% year-on-year in July, -29.5% in June and -15.9% in May). The slowdown in domestic demand is likely to continue in the short term.

STRONG DEPENDENCE ON RUSSIAN OIL AND GAS

Of the Central European countries, Slovakia, the Czech Republic and Hungary are amongst the most vulnerable to the consequences of the conflict in Ukraine, given their dependence on Russia for energy. Thus, the Slovak economy is likely to be hit harder than Poland or Romania in the short term. This fragility is due to the country's high exposure to Russia for its supplies of gas and oil (85% of gas imports and 100% of oil imports). The reduction in gas deliveries via Nordstream 1 pipeline, followed by its shutdown since September, reinforces this vulnerability. The Slovakian government has sought to diversify its sources of gas supply since the war began in Ukraine. Agreements have been signed with Norway and the United States to supply liquefied natural gas. A new pipeline between Poland and Slovakia also became operational at the end of August. This will allow Slovakia to source supplies from Norway or the Baltic Sea. The country's gas reserves were 87% of maximum capacity at the end of September. Furthermore, Slovakia along with Hungary and the Czech Republic have obtained an exemption from the EU to continue importing Russian oil until the end of 2023.

FORECASTS

	2019	2020	2021	2022e	2023e
Real GDP growth, %	2.6	-4.4	3.0	1.0	0.3
Inflation, CPI, year average, %	2.6	1.9	3.2	11.6	7.3
Gen. Gov. balance / GDP, %	-1.3	-5.5	-6.2	-5.5	-3.6
Gen. Gov. debt / GDP, %	48.1	59.7	63.1	61.5	60.7
Current account balance / GDP, %	-3.4	0.4	-2.0	-5.5	-6.0
External debt / GDP, %	112.2	120.5	137.0	130.5	129.8
Forex reserves, EUR bn	6.4	7.7	8.5	9.9	10.2
Forex reserves, in months of imports	1.0	1.3	1.2	1.2	1.1

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

SLOVAKIA: INDUSTRIAL PRODUCTION AND RETAIL SALES

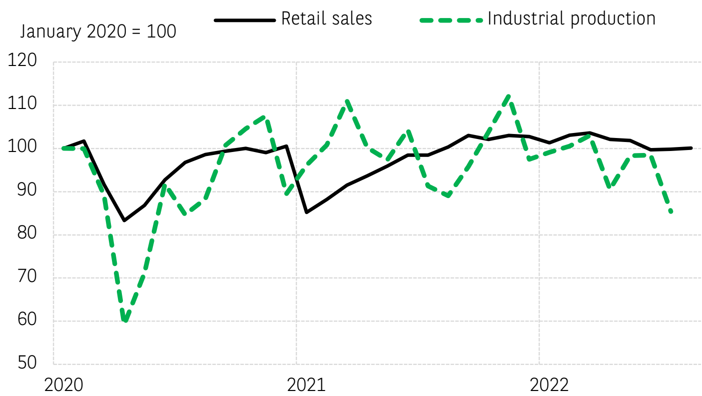

CHART 1

SOURCE: STATISTICAL OFFICE OF SLOVAKIA, EUROSTAT, BNP PARIBAS

While these efforts provide some respite, the industry is still being hit hard. Industrial production fell by 6.4% year-on-year in July compared to -4.8% on average over the past three months. It is still a long way from pre-Covid levels. The latest figures confirm that all sectors have been affected, including power, electronics, transport equipment and machinery. Energy-intensive industries are on the front line, as their energy bills are soaring. Under these circumstances, production at some aluminium plants has been temporarily suspended.

The country is also very dependent on the automotive sector, which represents 48% of its industrial production. This sector was particularly badly affected by supply disruptions in 2021. The war in Ukraine is likely to exacerbate these issues this year. Increases in production costs and energy bills will also hurt this sector. In order to support its industrial sector, the authorities announced at the start of September that they were considering extending the freeze on electricity and gas tariffs to companies.

INFLATION HAS NOT YET PEAKED

The rise in the Harmonised Index of Consumer Prices (HICP) has continued to gather pace, reaching 13.6% year-on-year in September after 13.4% in August and 12.8% in July. It is above the Eurozone average (+9.1% in August) but significantly lower than neighbouring countries. In Hungary and the Czech Republic, the Harmonised Index of Consumer Prices rose by 18.6% and 17.1% respectively in August. This regional difference is partly due to higher wage growth in these countries. It was 13.5% year-on-year on average in the second quarter in Poland and 15.2% in Hungary compared to 7.4% in Slovakia.

According to the latest available figures, inflation is being driven mainly by food and transport items. Food prices rose by 21% year-on-year in August and contributed 4.8 points to the HICP inflation figure. The surge in energy prices will continue to fuel food production costs. In addition, temporary halts of production at fertiliser plants in Poland could also have an impact on the price of agricultural goods. Transport contributed 1.3 points.

Core inflation, which is also rising sharply (+9% year-on-year in September), is the result of supply constraints, higher wages and production costs.

To contain inflation, the authorities decided in February to implement a partial freeze on household electricity tariffs until 2024. Inflation could peak at the end of the year or early in 2023.

With regards to monetary policy, the ECB has raised its key policy rate by 125 basis points since June. Meanwhile, the pace of monetary tightening has been greater in neighbouring countries, mainly in Hungary, with a cumulative rate hike of +1240 basis points since May 2021.

DETERIORATING CURRENT ACCOUNT BALANCE AND PUBLIC ACCOUNTS

The current account balance deteriorated significantly during the first seven months of the year, to -4.1 billion euros compared to -0.3 billion euros over the same period last year and -1.9 billion euros over 2021 as a whole (-2% of GDP in 2021). In 2022 and 2023, this deficit is expected to increase to 5.5% and 6.0% of GDP respectively. The trade balance, which has been in structural surplus for years, could show a deficit in 2022, mainly due to higher energy bill. Over the first 7 months of the year, the trade balance was -2.8 billion euros. Financing the deficit should not be a major problem. It should be partly financed by foreign direct investment flows (2.1 billion euros since January 2022) and European funds under the resilience plan.

SLOVAKIA: INFLATION RATE

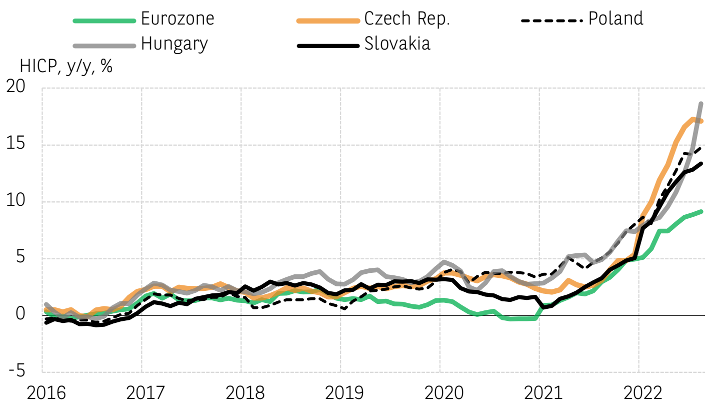

CHART 2 SOURCE: EUROSTAT, BNP PARIBAS

As for public accounts, the budget deficit is likely to remain high at 5.5% of GDP in 2022, according to our estimates. Supportive measures aimed at containing inflation risks are estimated at 1% of GDP this year. They have taken the shape of subsidies (100 euros per child) and tax rebates for families with children. With regard to pensions, the thirteenth month's payment will be brought forward to support pensioners. A nationwide freeze on electricity and gas prices is also being considered. Fiscal easing is likely to continue next year, as in most central European countries. The process of fiscal consolidation is expected to resume after 2023 and public debt should gradually return to the level observed before the Covid-19 crisis. Public debt-to-GDP slightly exceeded the 60% threshold in 2021, at 63.1%, and is likely to stay above 60% in 2022.

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BRAZIL

BUCKING THE TREND

Accelerating growth, slowing inflation, falling unemployment and the interruption of monetary tightening differentiate Brazil from most of the world's major economies. These developments, which are largely attributable to fiscal stimuli (higher social transfers, reduction in taxes and fuel prices), are complicating the task of monetary authorities by partially diluting the restrictive effects of their policy. In the second half of the year, the maintenance of fiscal stimulus should again help limit the slowdown in activity. Brazil's solid economic performance has allowed financial assets to hold up well despite the general elections and a deteriorating global environment.

GENERAL ELECTIONS: SOME SURPRISES

The general elections held on October 3rd 2022 delivered several surprises: i) no candidate was able to obtain an absolute majority in the presidential election (a second round will take place on October 30th), ii) the gap between the two main candidates – Luiz Inacio Lula da Silva and Jair Bolsonaro (48% vs. 43% of votes, respectively) – was much smaller than the polls predicted. Since the return of democracy, the leading candidate following the first round has always won the presidential election. Finally, iii) the right-leaning and centrist coalitions – allies of Bolsonaro – will have more power in the Senate and the Lower House than during the last term.

RESILIENT ECONOMIC ACTIVITY

Growth defied expectations considerably in the first half of the year. After an increase of 1% (q/q) in Q1, real GDP grew by 1.2% (q/q) in Q2 (3.3% y/y), marking a third consecutive quarter of strong growth. Activity was driven by an upturn in investment and a strong increase in consumer spending fuelled by the expansion of household disposable income, largely attributable to the Government's stimulus measures[1]. The drop in « Covid » savings, the increase in household debt and the good performance of the labour market also boosted demand. On the supply side, agricultural and iron ore production recovered (the drought in 2021 led to low soybean harvests at the beginning of the year, while heavy rainfall limited extraction activities in Q1). Construction grew by almost 9% in H1 (y/y) reaching a level of activity almost 11% higher than that in Q4 2019. However, services remained the main driver of growth.

Activity in H2 should also be better than previously predicted with the economy benefiting from measures introduced by the Government in June to help preserve households' purchasing power (temporary reductions in energy prices and other regulated prices, 50% increase in benefits to the poorest households under *Auxilio Brasil* as well as exceptional transfers to truck and taxi drivers). These measures and the drop in unemployment – which reached its lowest level in August since Q3 2015 – led to a rebound in consumer and business confidence in August/September. Production in the manufacturing sector should also benefit from the recent drop in input costs – which is encouraging companies to rebuild inventories despite the anticipated easing of demand. Meanwhile, concerns over the provision of fertilizers in the wake of the war in Ukraine have largely subsided – the country having managed to triple its purchases over the course of the year.

FORECASTS

	2019	2020	2021	2022e	2023e
Real GDP growth, %	1.2	-3.9	4.6	3.0	0.5
Inflation, CPI, year average, %	3.7	3.2	8.3	9.4	5.4
Fiscal balance / GDP, %	-5.8	-13.2	-4.4	-8.4	-9.5
Gross public debt / GDP, %	74	88	82	81	86
Current account balance / GDP, %	-3.5	-1.7	-1.8	0.4	-0.8
External debt / GDP, %	36	44	42	39	40
Forex reserves, USD bn	357	356	362	340	350
Forex reserves, in months of imports	16	19	15	12	13

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

BRAZIL: UNEMPLOYMENT VS. INFLATION

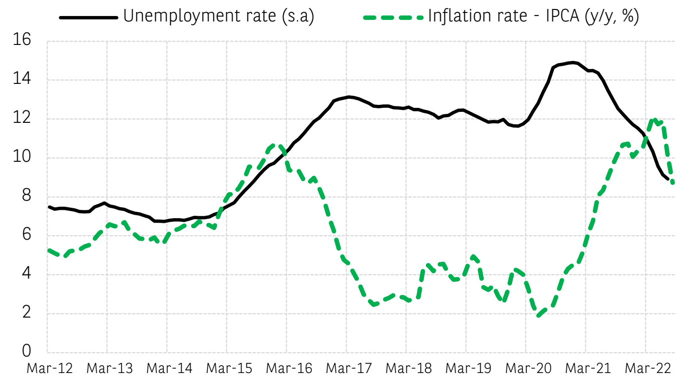

CHART 1

SOURCE: IBGE, GSP, BNP PARIBAS

That said, signs of deceleration are apparent in some sectors. Construction survey data are pointing to activity losing steam in the sector. The agricultural and bovine sectors are also more heavily impacted by the slowdown in global trade, the easing in the price of certain commodities (soybeans, iron ore) and the slowdown in China (the latter absorbed

1 Taking into account salary bonuses (all paid from January to March), authorisations to withdraw from FGTS accounts (a workers' insurance fund), early payments a) of the "13th salary" to INSS beneficiaries (National Institute of Social Security) and b) pension benefits to retirees, a total of almost BRL 110 bn was injected into the economy according to GSP.

close to 30% of exports since January). The difficult situations in Argentina and Chile are also weighing on the volumes of manufactured exports, which have been on the retreat since May. In H2, the slowdown in credit should help cool domestic demand, while the reduction in exports and the concurent increase in import volumes should meanwhile translate into a negative contribution of net exports to growth. In 2023, GDP growth is expected to be close to equal to the statistical carry-over from 2022 (around 0.5%).

INTERRUPTION IN THE MONETARY TIGHTENING CYCLE

Inflation has slowed sharply since the summer (8.7% y/y in August compared with 12.13% in April). However, this drop is not widespread (inflation in services remains high). Disinflation is mainly the result of tax cuts, particularly on electricity and gasoline. The easing of bottlenecks in supply chains is also contributing to the slowdown.

The Central Bank, which has had a restrictive monetary policy since Q4 2021 (cumulative rise of +1,175 basis points) kept its key rate unchanged in September at 13.75% for the first time since the beginning of the tightening cycle, in March 2021. In their decision, the authorities integrated the ongoing disinflationary process, the desire to smooth out fluctuations in the economic cycle and promote employment. Going forward, uncertainties surrounding the fiscal scenario will continue to limit the monetary authorities' degrees of freedom. The latter have to factor in: the likely redesign of the fiscal framework, the budgetary cost of disinflation, the rise in the real cost of debt, the likely roll-out of a tax reform as well as increased (social) pressures on public spending (the two candidates have already stated that they would maintain the BRL 600/month benefits as part of *Auxilio Brasil* while Lula is also favourable to raising the minimum wage[2]). Another concern for the authorities is that inflationary pressures in services could take more time than expected to ease, with the actual unemployment rate getting increasingly close to the structural unemployment rate as measured by NAIRU[3].

As a result of the rise in interest rates, there has been a rise in delinquincies by households (from a low base) in recent months as well as greater difficulties for corporates in raising financing in the local market. Corporates have cut back on their local currency debt issuances since the end of 2021 and are finding it more difficult to finance themselves using bank credit[4] – the rates of return on their projects having become much lower than the cost of financing, especially in real terms.

Companies are therefore turning to less expensive sources of financing: offshore arrangements (EUR-BRL swaps), intercompany loans or debt issuances in international markets (in particular an increasing recourse to sustainable bond issues, for which notional amounts have tripled in 2020-2021 compared to the period 2015-19, reaching more than USD 20 bn). In recent months, the authorities have introduced new measures to attract foreign investors and reduce the financing costs for local companies: tax exemptions on capital gains for corporate debt dealings[5], simplification of the procedures to issue debt, broadening of collateral eligibility requirements and facilitation of the process to convert debt into marketable securities).

BRAZIL: PRIVATE CREDIT GROWTH (CORPORATES AND HOUSEHOLDS)

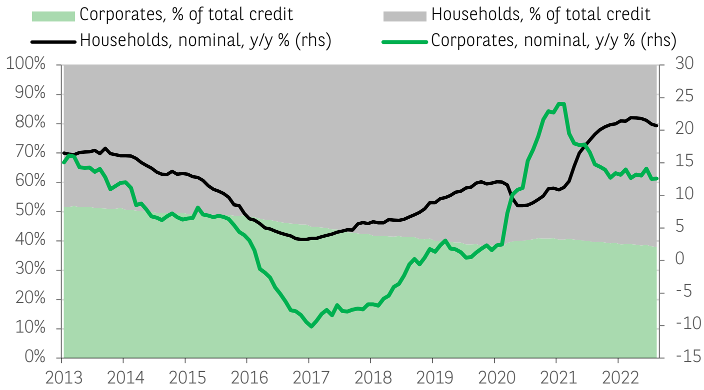

CHART 2 SOURCE: CEIC, BCB, BNP PARIBAS

ASSETS HOLDING UP WELL AMIDST MORE FORGIVING MARKETS

Brazilian assets have held up well since the beginning of the year given the electoral cycle, the global rise in investors' risk aversion and the strengthening of the US dollar. The reais posted one of the best performances against the dollar this year (+8% at the end of September), while it lost around 20% against the dollar before the elections in 2018. In dollar terms, the stock market has meanwhile outperformed its regional counterparts, with the exception of Argentina.

A number of elements help to explain this performance: upside surprises on growth, falling unemployment and inflation, rising and positive real yields ; meanwhile equities are attractive as stocks are trading at a sharp discount relative to their historical average. Brazil is also expected to post its first primary budget surplus since 2013 (helped by sizeable dividend transfers from Petrobras and a windfall resulting from the privatisation of Electrobras). Also, the country's external vulnerability remains low: FDI cover the current account deficit three times over, the external debt burden is moderate and external liquidity is abundant. Brazil's high energy independence is also a strength[6]. Finally, the formalization of the Central Bank's autonomy in 2021, coupled with the strengthening of the centrist and right-leaning coalitions in Congress as well as the extension of support for Lula by Henrique Meirelles – former governor of the Central Bank, architect of the country's main fiscal rule and a likely frontrunner to head the Ministry of Finance if Lula is elected – have collectively helped to reassure the markets – concerned with the implementation of unorthodox economic policies if the presidency changes.

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2 According to the National Treasury, a BRL 100 wage increase would increase federal spending by BRL 34 bn (0.3% of GDP).
3 Non-accelerating inflation rate of unemployment. A drop in the actual unemployment rate below the NAIRU leads to greater inflationary risk.
4 This is less true for small businesses that continue to benefit from the National Microenterprise Support Programme (PRONAMPE) and the Emergency Credit Access Programme (PEAC).
5 Foreigners were paying 15% tax on capital gains on corporate debt (exemptions applied on stock market and public debt gains).
6 85% of its energy mix comes from renewable sources – the highest proportion in the G20.

MEXICO

PRUDENCE

The economic dynamism seen in the first half of 2022 is waning. The rebound in private consumption is being held back by rising inflationary pressures, while exports are weakening due to slowing growth in the United States and global demand. Structural weaknesses in the economy (low investment, lack of infrastructure) are also limiting the growth recovery. Moreover, a deterioration in public finances is increasingly likely in the medium term. The very limited rise in fiscal income will not be enough to compensate for the necessary increase in government spending that is expected in the coming years. In addition, sovereign wealth funds have been used over the past two years and the government no longer has any reserves.

LOW ECONOMIC GROWTH DYNAMICS

The outlook for the Mexican economy remains mixed. After relatively robust performance in the first half of the year (real GDP grew by 1.8% and 2.0% year-on-year in Q1 and Q2, respectively), growth should slow in the coming quarters. First, a significant drop in exports is expected, reflecting the weak growth expected in the United States, in particular, and the slowdown in global demand in general. Net exports are expected to contribute negatively to real GDP growth over the next two quarters. The slowdown in exports should also result in a widening current account deficit.

Second, strong inflationary pressures and monetary tightening are weighing on the dynamism of domestic demand. Inflation has risen since the beginning of 2022, reaching 8.7% year-on-year in August. All inflation components are on the rise and inflation will remain high over the coming months. On 29 September, the Central Bank of Mexico raised its key interest rate by 75 basis points for the third time in a row (and for the eleventh time since the tightening cycle began in June 2021), bringing it to 9.25% (a total of 525 basis points). According to the Central Bank's projections, the rate of inflation might meet the target (between 2% and 4%) only in the last quarter of 2024. The press release also suggests that further rate hikes will be announced in the short term.

Finally, the government's decision to maintain its austerity policy during the 2020-2021 health and economic crisis (support measures represented just over 1% of GDP, among the lowest in emerging economies) has exacerbated the structural weaknesses of the Mexican economy (e.g. low productivity, a lack of infrastructure, and a downward trend in the investment rate), which will continue to restrict growth in the short term. Furthermore, the quality of the labour market has deteriorated since the beginning of the crisis (a rise in informal jobs and a drop in the female participation rate).

The reduction in the investment rate the loss of confidence of foreign and Mexican investors have also been exacerbated by several government initiatives put forward over the past two years (in particular, the project to reform the energy sector and the cancellation of the project to build the new Mexico City airport).

In total, the level of activity at the end of Q2 remained almost 2% lower than in Q4 2019 and it now seems that this level will not be reached before the end of 2023. Besides the level of GDP, growth dynamics also seem to have been affected in the longer term. According to Moody's, the rating agency, low investment, the lack of infrastructure and the high level of poverty will keep real GDP growth to no more than 2% over the next five years (the potential growth estimated by the IMF in December 2019 was over 2.5%).

FORECASTS

	2019	2020	2021	2022e	2023e
Real GDP growth, %	0.1	-8.1	4.8	1.8	1.3
Inflation, CPI, year average, %	3.7	3.4	5.7	7.9	5.9
Budget balance / GDP, %	-1.7	-2.8	-2.9	-4.1	-3.9
Public debt / GDP, %	46.4	53.1	51.3	50.1	49.8
Current account balance / GDP, %	-0.2	2.4	-0.4	-0.8	-0.9
External debt / GDP, %	36.6	42.6	34.6	37.6	38.1
Forex reserves, USD bn	180.0	195.0	202.4	200.0	198.0
Forex reserves, in months of imports	3.5	5.3	5.1	4.8	4.4

e: ESTIMATE & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

MEXICO: INFLATION AND POLICY RATE

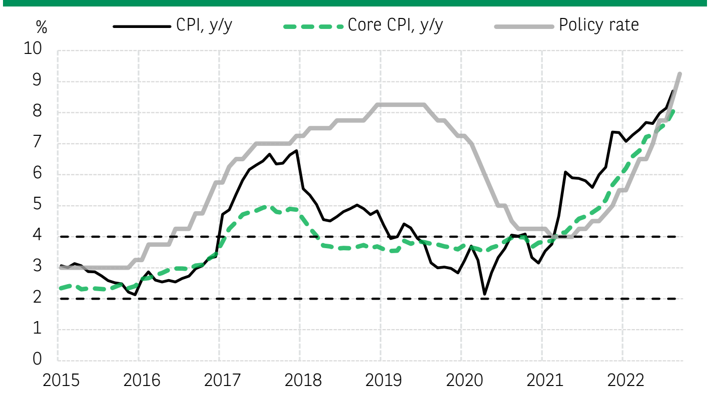

CHART 1 SOURCE: CENTRAL BANK, BNP PARIBAS

A SLIPPAGE RISK FOR PUBLIC FINANCES

On 8 September, the Mexican government presented its draft budget for 2023. As has been the case since the beginning of the administration, in 2018, the government intends to stick to the austerity policy to which it had committed in its election manifesto. The objective has been achieved for the time being: the deficit and public debt have remained generally stable since 2018, at around 3% and 50% of GDP, respectively, in both 2020 and 2021.

The assumptions used in the proposed 2023 budget are optimistic: the plan is based on GDP growth at 3%, an inflation rate of 3.2% on average over the year and oil production of over 1.8 billion barrels per day (an increase of almost 12% compared to the average daily production over the past 12 months). Public spending once again prioritises infrastructure projects chosen by the President (the Dos Bocas refinery and the Maya Train), to the detriment of spending on the most vulnerable households.

That said, the government should be able to maintain its budgetary targets until the end of its mandate in 2024, partly thanks to a rather conservative oil price assumption (USD 69 per barrel on average in 2023).

In the medium term, however, a slippage in public finances seems more and more likely. The prospects for improving revenues will be limited, in line with the expected sluggish economic growth. In addition, it has not been possible to implement the extensive tax reform that the government envisaged in 2021.

The robustness of public finances has, in fact, already been slowly deteriorating over the past five years. The government has had contradictory messages over its fiscal policy and its objectives have been difficult to achieve, such as the commitment to maintain a balanced budget, by significantly increasing expenditure and social benefits but without generating any real increase in income.

Moreover, since 2018, the government has gradually used up all the sovereign funds and fiscal reserves that it had in order to maintain a relatively low public deficit despite increasingly high spending. In particular, the Budget Revenue Stabilisation Fund (FEIP), the assets of which accounted for around 1% of GDP at the end of 2018, was cleaned out in 2020. The government no longer has any budgetary reserves that would protect it against future shocks.

Finally, the policies put in place since 2018 have led to more rigid public spending. In particular, as part of its energy policy, the government has repeatedly supported Pemex, the national oil company. Transfers, capital injections and investment support represented almost 1.5% of GDP in 2021. Over the next few years, support for Pemex should continue and represent almost 1.5% of GDP each year, according to estimates made by Moody's, the rating agency. At the same time, the government has reduced the Pemex profit-sharing tax to 40%, compared to 54% in 2022, and has included in its own accounts certain expenses related to Pemex (such as the construction costs for the Dos Bocas refinery).

Transfers also increased as a proportion of total public expenses (notably due to an increase in pensions) from 20% in 2018 to 22% in 2021, as well as as a share of GDP from 3.8% in 2018 to 4.4% in 2021. The subsidy for the most vulnerable elderly people, which has increased by 50% since the start of the mandate, is also expected to increase in the coming years, in line with the ageing population.

Finally, although the debt interest payment charge has remained relatively stable at around 12% of total budget spending since the start of the mandate, it is expected to increase in the coming months.

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MEXICO: INVESTMENT

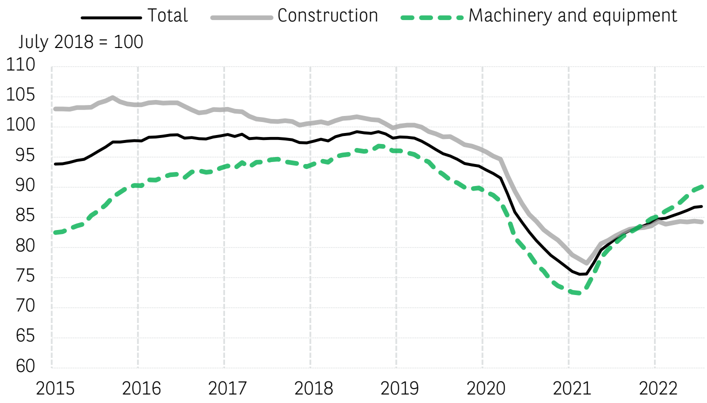

CHART 2

SOURCE: CENTRAL BANK, BNP PARIBAS

PERSISTENT PRESSURE ON THE BALANCE OF PAYMENTS

Egyptian external accounts have been under pressure since the beginning of the year and the outlook is uncertain. Although the current account was able to withstand external shocks thanks to the rise in gas revenues, only the massive support of the Gulf countries enabled Egypt to cope with portfolio investment outflows and to avoid a foreign exchange crisis. The dynamic remains negative in the short term, given the drop in net foreign currency assets in the banking system and persistent exchange rate pressures, despite depreciation of more than 20% since the beginning of the year. In the short term, support from the IMF and the Gulf countries, as well as a favourable gas outlook, are positive factors, but, in the medium term, external financing needs are high and are rising, and dependence on volatile capital flows remains significant.

Despite improving current account balance, the Egyptian economy faces the accelerated deterioration of its foreign currency liquidity due to structural weaknesses in its balance of payments and to external shocks. Foreign currency liquidity across the banking system has contracted since the beginning of the year and exchange rate pressures are significant.

LOWER CURRENT ACCOUNT DEFICIT DESPITE EXTERNAL SHOCKS

During the fiscal year (FY) 2022 (June year-end), the current account deficit fell by 10% to 3.7% of GDP, despite the consequences of the war in Ukraine (rising prices of food and tourist flows from Russia and Ukraine drying up over the last quarter). The trade deficit deteriorated only slightly (+USD 1.3 billion to USD 43.5 billion). This performance was mainly due to the large surplus of the hydrocarbon balance (USD 4.4 bn, the highest since 2010) which benefited from the rise in European demand for natural gas and the sharp rise in gas prices on the international markets. Non-hydrocarbon imports grew relatively moderately (+16%), considering the rise in prices and the 15% depreciation of the Egyptian pound in March 2022. The introduction of regulatory constraints on imports has probably hampered their increase.

The doubling of the balance of services surplus (up 120% in tourism revenues and 7.5% in revenues from the Suez Canal) and sustained remittances resulted in a reduction in the current account deficit.

A CURRENCY CRISIS AVOIDED THANKS TO GULF SUPPORT

The Egyptian external financing requirement is declining but remains significant. The sum of the current account deficit and amortisation of external debt amounted to USD 28 bn (6.3% of GDP) in FY2022. Its financing, which relies largely on volatile capital flows, remains the Egyptian economy's Achilles' heel. The war in Ukraine and its consequences for the financial markets triggered a massive capital flight from the Egyptian market (USD 21 bn) and a sharp rise in the sovereign currency risk premium, which has been above 800 bps since April 2022. It temporarily closed the international bond market for the Egyptian Government and it was thanks to the financial support of the Gulf countries that a balance-of-payments crisis was avoided. Government deposits at the Central Bank (around USD 15 bn from Saudi Arabia, the UAE and Kuwait) and purchases of Egyptian assets by Gulf sovereign funds (at least USD 3 bn) have helped limit the deterioration of the balance of payments and the extent of the depreciation of the pound (-22% against the dollar since January 2022).

FORECASTS

	2019	2020	2021	2022e	2023e
Real GDP growth, %	5.6	3.5	3.3	5.4	4.5
Inflation, CPI, year average, %	11.0	10.2	7.2	8.5	14.5
Central. Gov. balance / GDP, %	-8.0	-8.0	-7.4	-7.0	-7.0
Central. Gov. debt / GDP, %	84	90	91	89	90
Current account balance / GDP, %	-3.6	-3.1	-4.7	-3.7	-3.4
External debt / GDP, %	36	34	35	34	38
Forex reserves (excl. gold), USD bn	42	34	36	33	35
Forex reserves, in months of imports	6.4	5.4	5.4	3.9	3.9

TABLE 1

FISCAL YEARS FROM JULY 1ST OF YEAR N-1 TO JUNE 30TH OF YEAR N
e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

EGYPT: CENTRAL BANK'S FOREIGN EXCHANGE RESERVES

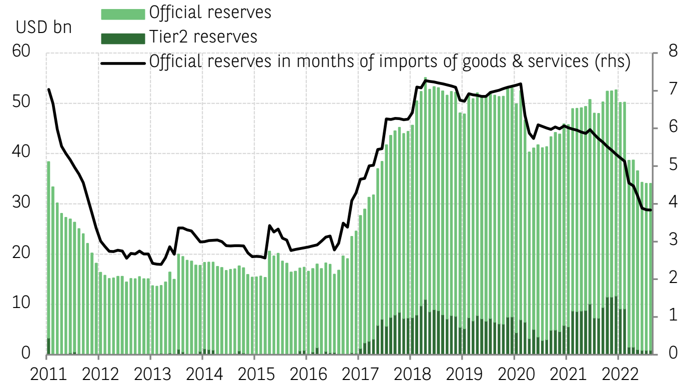

CHART 1

SOURCE: CENTRAL BANK, BNP PARIBAS

Foreign currency liquidity, however, deteriorated sharply between December 2021 and June 2022, despite the massive external support and the currency depreciation. The Central Bank's foreign exchange reserves fell by USD 7.6 bn to USD 33.4 bn (i.e. 3.9 months of imports of goods and services) and the net external liabilities of commercial banks rose by USD 1.5 bn to USD 11.6 bn. At the same time, the Central Bank's Tier 2 foreign exchange reserves (for managing volatile portfolio flows) fell by USD 11.8 bn to USD 0.9 bn. The crisis was avoided at the expense of a sharp increase in the vulnerability of external accounts:

the foreign currency position of the whole banking system deteriorated sharply, the future financing requirement is substantial and investors' aversion to Egyptian risk remains strong.

PERSISTENT TENSIONS IN THE SHORT TERM

Since the beginning of FY2023, the Central Bank's foreign exchange reserves have remained stable, but the recent deterioration in the net external position of commercial banks (net external liabilities increased by USD 2 bn in August) indicates an outflow of portfolio investment. According to the Central Bank, foreign investors held USD 7.5 bn in Government T-bills in July 2022. On the future market, the 12-month EGP/USD exchange rate is currently 24.4, i.e. a difference of around 20% from the current rate. The risk of another significant depreciation of the pound is a constraint on portfolio investment inflows as well as for remittances. Against this backdrop, the outlook is very uncertain and the financial support from the IMF, which is being negotiated, does not guarantee the end of tensions on foreign currency liquidity.

DECREASE IN THE CURRENT ACCOUNT DEFICIT EXPECTED IN 2023

The current account should continue to improve in FY2023. Food commodity prices have been falling since June (wheat prices have dropped by around 8%) while tensions on the energy market should persist and favour Egyptian hydrocarbon exports. Non-hydrocarbon imports should remain limited at least in volume due to constraints on non-priority imports. On the other hand, the continued depreciation of the pound will continue to weigh on the prices of imported goods. Assuming that remittances remain high and tourism revenues do not suffer a geopolitical shock, the current account deficit should shrink slightly but remain above 3% of GDP. In FY2023, the total external financing requirement is expected to amount to around USD 26 bn.

POSITIVE GAS OUTLOOK, AT LEAST IN THE SHORT TERM

This scenario is relatively conservative, and the trade balance could be better than expected thanks to the energy sector. According to the Egyptian oil minister, LNG sales income should go up from USD 6.5 billion in 2022 to USD 8.5-10 billion in 2023. Given the pressure on foreign currency liquidity and the sharp rise in European demand, the authorities are maximising LNG exports. Nevertheless, it should be highlighted that the increase in exports comes at the expense of restrictions on domestic gas consumption (summer temperature ceilings in public buildings and reduced public lighting) and thanks to the switch from gas to oil as the energy source for some power stations. In H1 2022, oil consumption increased fivefold, year on year, and returned to a level close to that seen in 2018 before the massive increase in gas' contribution to the energy mix. According to MEES, oil's share of the energy mix went from 1.1% in May 2021 to 11.5% in May 2022. In the short term, the coming on stream of an offshore gas pipeline in Q2 2023 should make it possible to increase Israeli exports to Egypt. Indeed, it is partly thanks to imports from Israel (on average 650 million cubic feet per day compared to a total Egyptian production of 6.6 billion cubic feet per day) that Egypt has an export surplus. In the medium term, maintaining Israeli export capacities depends in part on the Karish gas field entering into operation, which is currently subject to geopolitical uncertainties. In addition, both Egypt and Israel experience peaks in energy consumption in the summer which significantly limit Egyptian

EGYPT: USD/EGP EXCHANGE RATE

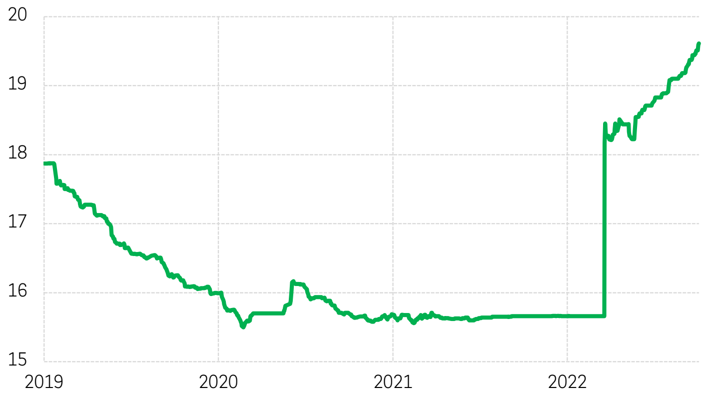

CHART 2 SOURCE: CENTRAL BANK, BNP PARIBAS

export capacities. Finally, in the longer term, export capacities will depend on discovering new gas fields in Egypt.

THE EXTERNAL FINANCING REQUIREMENT IS EXPECTED TO INCREASE

Whatever the amount of the IMF's financing (a total of USD 3-5 billion is likely with the release of USD 1 billion in the first year), the external financing gap will require significant net portfolio investment and direct investment inflows (at least USD 15-20 bn). Some of these flows will continue to come from Gulf countries which should continue to take stakes in local companies and participate in the opening-up of the capital of public-sector companies (although the timing is uncertain for the time being). More generally, the international environment is different from that of 2016, when the IMF's first financing plan triggered a significant flow of capital. The rise in interest rates in developed countries, global inflationary pressures and the persistence of geopolitical tensions will continue to have a negative impact on the attractiveness of emerging debt in local currency.

In Egypt, the external financing requirement will increase in the medium term, given the amount of debt amortisation expected in FY2024 and FY2025 (USD 13.3 bn and USD 19 bn, respectively) and a current account deficit which should amount to around USD 15 bn per year.

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GAS REVENUES PROVIDE ROBUST ECONOMIC PROSPECTS

The Qatari economy, which is poorly diversified and based on long-term gas export contracts, has not experienced the same volatility as elsewhere in the Gulf during the last five years. In the short term, high oil prices and the forthcoming World Cup will support growth and enable a return to substantial external and budgetary surpluses. Likewise, the reduction in banks' external liabilities should continue. Inflation will remain relatively moderate thanks to government intervention and the impact of the stronger dollar on import prices. In the medium term, the macroeconomic outlook is very positive as a result of the significant increase in gas revenues. However, it is less certain in the longer term, in the context of the energy transition. The status of natural gas as a transition fuel is a significant advantage for Qatar, but its reliance on hydrocarbons will remain very high.

ECONOMIC ACTIVITY

The Qatar economy is the least volatile of the Gulf Cooperation Council (GCC). Indeed, gas production (around 85% of hydrocarbon GDP) does not vary much, since it is linked to long-term export contracts. Furthermore, since Qatar is not a member of OPEC, its oil production is not subject to the cartel's quotas policy.

The non-hydrocarbon GDP (approximately 62% of total GDP compared to a GCC average of 66%) is mainly focused on construction, financial services and manufacturing (essentially petrochemicals). Activity in all these sectors remains linked to the oil market, either directly or indirectly via public spending. In this context of low diversification, and given the central role of gas production, the country's economic downturn was moderate in 2020 (down 3.6% compared to a GCC average of 4.9%), but its rebound was also more limited in 2021 (1.6% compared to 2.6%).

Growth is expected to accelerate in 2022 (3.3%), but will remain well below the rest of the region (6%). Oil production should be marginally lower due to the natural decline in the production of mature fields. On the other hand, total natural gas production is expected to rise slightly. Liquefied natural gas (LNG) exports were up 2% (in year-on-year terms) in Q1 2022, reaching 46.5 million tonnes (Mt). The increase in exports to Europe (up 1.1 Mt) and Asia (up 0.7 Mt) was partially offset by a drop in demand from the US (down 1.1 Mt). The current sharp rise in European demand for gas can only be partially met as more than 90% of exports are directed towards Asia under long-term supply contracts. Overall, hydrocarbon GDP is expected to grow by 2% this year.

Activity in non-hydrocarbon sectors should also be sustained (up 4.5%), especially in connection with the World Cup, which takes place from November 2022. Nevertheless, the short-term consequences of this event on activity must not be overestimated. Most of the infrastructure work was completed before 2022 and a large proportion of World Cup visitors will be accommodated in neighbouring states, and in particular Dubai. Approximately 1.2-1.5 million visitors are expected and the services sector (transport, restaurants, etc.) stands to benefit the most. Since the start of the second half of 2022, leading indicators of activity have remained in positive territory, although they are down. The PMI index for September stood at 50.7 compared to 67.5 in June.

In the medium term, economic momentum will undoubtedly come from the hydrocarbon sector, which will see an increase of over 60% in natural gas production and export capacity from 2025. According to the IMF, the construction and production startup phase should lead to a 5.7% increase in GDP until 2027, with the rise in exports leading to a 3.5% increase in GDP. Beyond 2027, the country will receive significant additional export income and budget receipts.

FORECASTS

	2019	2020	2021	2022e	2023e
Real GDP growth (%)	-0.4	-3.6	1.6	3.3	2.5
Inflation (CPI, year average, %)	-0.6	-2.8	2.3	4.3	3.0
Gen. Gov. balance / GDP (%)	1.0	-2.1	0.2	13.5	9.9
Gen. Gov. debt / GDP (%)	50	48	47	46	47
Current account balance / GDP (%)	2.4	-2.0	14.6	20.5	14.4
External debt / GDP (%)	123	139	114	97	93
Forex reserves (USD bn)	38	38	39	47	48
Forex reserves, in months of imports	6.8	7.6	7.6	7.8	7.6

e: ESTIMATE & FORECASTS

TABLE 1

SOURCE: BNP PARIBAS ECONOMIC RESEARCH

QATAR: INFLATION

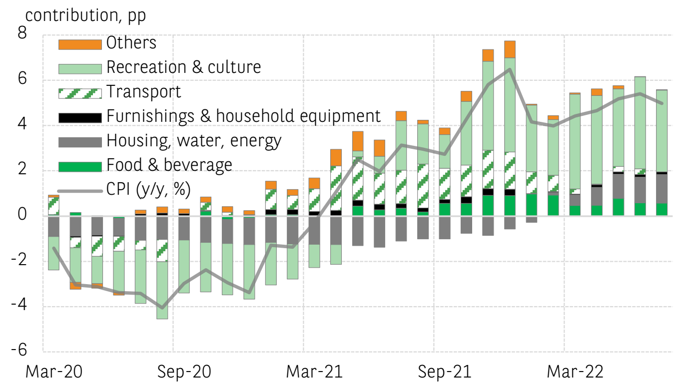

CHART 1

SOURCE: CEIC, BNP PARIBAS

GOVERNMENT INTERVENTION KEEPS INFLATION MODERATE

As in the other GCC countries, consumer price inflation is accelerating in 2022 but is expected to remain moderate. It should reach 4.3% on average, compared to 2.3% in 2021. Price increases are mainly driven by a recovery in the recreation and culture sectors following the lifting of restrictions imposed during the pandemic. Food products are making a positive contribution to price inflation, though this remains moderate as a result of government measures designed to control food prices.

At the same time, energy prices are constrained by the persistence of high subsidies (equivalent to 3.7% of GDP according to the IMF). Finally, the stronger performance of the US dollar against the main global currencies since the start of the year (the DXY index has risen by 15% since January 2022) is having a beneficial effect on imported inflation, given the Qatari riyal is pegged to the US dollar. Inflation is expected to reach 3% on average in 2023.

A RETURN TO BUDGET SURPLUSES

Despite a strong reliance on hydrocarbon income (more than 80% of total income), Qatar's public finances held up well against the fall in oil prices in 2020, thanks to a decrease in certain categories of investment spending. The budget surplus, which was limited in 2021, should be very high in 2022 (14% of GDP) owing to the rise in oil prices. Revenues from LNG (which were 30% higher than oil revenues in 2021, according to the IMF) are highly dependent on oil prices. In 2023, sustained oil prices should enable a surplus equivalent to approximately 10% of GDP. While Qatar's budget performance has been very favourable, progress towards diversifying fiscal resources has been limited compared to what can be seen around the Gulf. Qatar is one of only two countries in the region (with Kuwait) that has not introduced a value added tax (VAT). In this context, and given the significant increase expected in LNG production capacities, the public finances will remain highly reliant on hydrocarbon revenues in the medium term.

Paradoxically, despite good fiscal performance, government debt is relatively high (58% of GDP in 2021). The government took advantage of favourable market conditions to finance major investment projects through borrowing, and has continued to allocate part of its budget surpluses to the sovereign wealth fund. With the end of the cycle of infrastructure projects such as transport and stadium, and the favourable budgetary outlook, the fall in government debt that began in 2021 looks set to continue. Based on the IMF's assumption that two thirds of the budget surplus will be transferred to the sovereign wealth fund, government debt is expected to amount to 33% of GDP in 2024.

The increase in hydrocarbon revenues and the slowdown in the project cycle also have a positive impact on the net external position of the banking system. This position had actually been deteriorating significantly since 2009 (USD -114 billion in June 2022, *i.e.* approx. 50% of GDP), because of the need to find external resources to finance investment policy. This trend has reversed since the end of 2021 as a result of the slowdown in domestic borrowing and the rise in residents' deposits. In August 2022, growth in domestic credit reached 0.5% yoy, while domestic deposits accelerated by 12.7%. Net external liabilities should continue to shrink, but it remains a potential risk to public finances as the government would support the banking system in case of necessity.

THE CHALLENGE OF THE ENERGY TRANSITION

As a major hydrocarbon producer (the fourth largest gas producer in the world and the largest exporter), Qatar is exposed to the consequences of decarbonisation policies implemented in order to fight against climate change. Qatar itself only contributes 0.3% of total annual CO_2 emissions, but its greenhouse gas (GHG) emissions per capita are among the highest in the world (41 tonnes in 2019, which is more than six times the global average). Furthermore, the forthcoming 60% increase in gas production capacity and the growing needs of the population (*e.g.* for water from desalination plants, which are particularly energy-intensive) will contribute to an increase in GHG emissions, and the IMF estimates these could reach 30% by 2030.

QATAR: COMMERCIAL BANKS' BALANCE SHEET, MAIN ITEMS

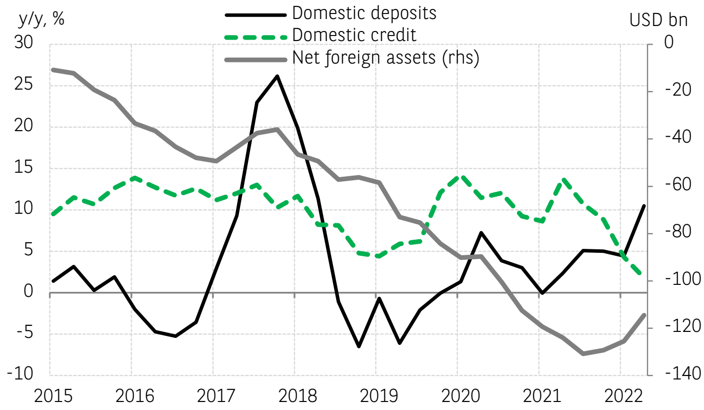

CHART 2 SOURCE: IMF, BNP PARIBAS

Qatar is faced with the challenge of a fall in the demand for hydrocarbons (even if the pace of this remains uncertain), and in the long run, of a drop in the value of hydrocarbon-related assets. Yet it has several advantages, and is largely basing its policy of decarbonisation on technological solutions. Natural gas emits relatively lower GHG than other fossil fuels. It is regarded as a transition fuel, facilitating the switch from fossil fuels to renewables. As is the case for all the other hydrocarbon producers in the Gulf, the development of carbon capture and storage technologies should reduce the carbon footprint of gas production. The target is to reduce CO_2 emissions by 11 Mt a year by 2035 (total emissions from the consumption of fossil fuels and industry were 107 Mt in 2020). This would reduce the carbon intensity of LNG plants by approximately 35%. Finally, reducing the volume of flared gas should also help meet this objective. With regard to the primary energy mix, the development of solar capacity could enable 20% of the country's electricity to be produced from renewable energies, whose contribution to the energy mix is currently marginal.

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TUNISIA

GROWING CONCERNS

Two years after the shock of the pandemic, Tunisia is now being hit hard by the consequences of the conflict in Ukraine. The rise in commodity prices is leading to a dangerous deterioration in external accounts and public finances. Inflation is at historically high levels, weighing further on economic activity, which has already been struggling to recover since the 2020 crisis. In the absence of any financial room for manoeuvre, Tunisia is hoping to obtain support from the IMF to ease macroeconomic tensions. There are pressing needs.

Despite some positive steps forward recently, Tunisia's situation remains a cause for concern. Following the adoption of a new constitution in July and the publication of an electoral law in September, prior to the holding of legislative elections set for 17 December, the government has just reached agreement with the powerful trade union, the UGTT, on an annual increase of 3.5% for salaries of civil servants until 2025. This agreement does not address all the problems, but it should help to calm the social climate, at least in the short term. Above all, it could open the way for an IMF aid programme for which a broad consensus is needed on the reforms to be implemented. Unblocking this could be a catalyst for support from the country's other traditional bilateral and multilateral creditors, and may help to restore investor confidence. The authorities are convinced of this and expect it to be signed shortly. They have developed a programme of reforms which has found favour with the IMF. However, caution is called for, and the ability of the authorities to adhere to the roadmap negotiated with the IMF is open to question given the fragility of the Tunisian socio-political context. Nonetheless, given the deep economic crisis, there is no alternative.

FORECASTS

	2019	2020	2021	2022e	2023e
Real GDP growth (%)	1.3	-8.7	3.3	2.5	2.7
Inflation (CPI, year average, %)	6.7	5.7	5.7	8.2	6.5
Central Gov. balance / GDP (%)	-3.1	-9.6	-7.7	-8.8	-6.6
Central Gov. debt / GDP (%)	67.3	77.8	79.7	82.3	85.7
Current account balance / GDP (%)	-8.1	-6.0	-6.2	-9.8	-8.5
External debt / GDP (%)	90.2	97.3	87.0	90.5	94.4
Forex reserves (USD bn)	7.6	9.4	8.4	7.9	8.9
Forex reserves, in months of imports	3.8	5.8	4.2	3.2	3.6

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

DANGEROUS WIDENING OF EXTERNAL IMBALANCES…

The surge in oil and cereal prices as a result of the conflict in Ukraine is putting significant pressure on external accounts. Over the first eight months of the year, the trade deficit widened by 46% compared to the same period in 2021, reaching the almost unprecedented level of USD 5.5 billion (chart 1). More than 70% of the widening in the trade deficit comes from the energy and agricultural deficits. The increase in oil and gas imports has been huge (+72%), the result of a powerful price shock as well as of an upward trend in needs due to the 38% decline in national hydrocarbon production over the last ten years. In 2021, the energy deficit was 4,614 tonnes of oil equivalent compared to just 605 in 2010. Regarding cereals, Tunisia was also already exposed to sources of vulnerability when the crisis broke out, as it has both one of the highest levels of per capita consumption in the world (255 kg of wheat per year, or five times more than the African average) and a high dependence on imports (around ¾ of national consumption), almost half of which comes from Ukraine and Russia.

Despite the recent easing in commodity prices, the current account deficit is expected to be around 10% of GDP this year, compared to 6.2% in 2020. The continued increase in financial transfers of the Tunisian diaspora and the recovery in the tourism sector will not be enough to cushion the full impact of the shock on external trade. After quite a satisfactory Q1, the current account deficit stood at a record level of USD 1.7 bn in Q2. It was USD 800 million in Q2 2021. Revenues from tourism rose by 43% year-on-year in Q2, but were still 31% below their 2019 level.

TUNISIA: TRADE DEFICIT, FIRST 8 MONTHS OF THE YEAR

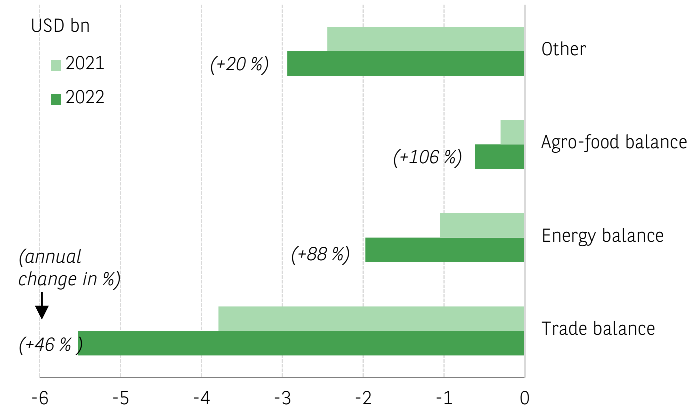

CHART 1

SOURCE: INS, BNP PARIBAS

In this context, the good performance of the dinar might come as a surprise. The TND remained stable against the euro and depreciated by only 8% against the US dollar. Despite foreign direct investment flows continuing to be low (only 13% of the current account deficit in H1) and the impossibility of tapping international financial markets, Tunisia has managed to mobilise sufficient support from its partners to cover its external financing needs. The central bank's foreign exchange reserves have fluctuated around USD 8 bn since the beginning of the year, equivalent to 3.6 months of imports of goods & services at the end of June (compared to 4.6 months in June 2021). Therefore, external liquidity appears to remain adequate. However, the coverage ratio is deteriorating and visibility remains very limited given the multitude of risks which continue to weigh on the dynamics of external accounts (crisis in Europe, volatility in commodity prices). In the absence of a rapid agreement with the IMF, foreign exchange reserves could fall rapidly.

...AND FISCAL DEFICITS

The situation of public finances is even more fragile. After peaking at 9.6% of GDP during the Covid crisis in 2020, the budget deficit had reduced to 7.7% in 2021 thanks to the good performance of fiscal revenues. It will widen again in 2022 because of the effect of a sharp hike in oil and food subsidy costs. Initially budgeted at 5.2% of GDP, they are likely to ultimately reach 8% of GDP this year. In fact, social policy relies to a large extent on a system of keeping prices low and stable for a wide range of products, mainly energy and cereals, and is therefore highly vulnerable to the current shock. The government has limited room for manoeuvre, even though tax revenues have continued to grow robustly since the start of the year. Over 70% of governement revenues are absorbed by the wage bill of public service employees (one of the highest in the world at 15.6% of GDP) and the payment of debt interest. Despite expected cuts in public investment, slippage in spending on subsidies is therefore likely to push the budget deficit to almost 9% of GDP this year. In addition to this there are significant debt repayments. The government's financing needs are now expected to be 17.6% of GDP in 2022 compared to 13.7% anticipated in the initial budget.

However, financing constraints are strong. The local debt market is narrow and has already been called upon to a significant degree in the past two years to compensate for the depletion in financial assistance from traditional donors and the inability to issue Eurobonds. Prior to the outbreak of the conflict in Ukraine, the government was hoping to cover more than 60% of its needs through external resources. Although some donors are continuing to provide funds, a wider mobilisation of external creditors remains conditional on getting an agreement with the IMF.

The increased reliance on domestic financing does not only pose a liquidity problem. It also aggravates an increasingly worrying debt dynamics. Government debt will exceed 80% of GDP in 2022 compared to 67.3% of GDP in 2019. Although 46% was still held by bilateral and multilateral creditors at the end of 2021, local currency debt is rapidly increasing (+11 points of GDP between 2019 and 2021), resulting in a shortening of the average maturity of the debt (from 6.8 years in 2018 to 5.9 years in 2021) and an increase in its cost. 12% of government revenues are therefore expected to be allocated to debt interest payments in 2022 compared to 10% in 2019. With financing requirements exceeding 15% of GDP over the next two years, it will be difficult for the government to continue on this path as it risks undermining the sustainability of its debt. In addition, the debt trajectory is also sensitive to currency shocks and to the deterioration in growth prospects.

ECONOMIC GROWTH: A VERY UNCERTAIN OUTLOOK

The dangerous deterioration in macroeconomic imbalances poses an additional threat to the recovery of an economy already weakened by a decade of sluggish growth and a recession in 2020 that was amongst the most severe in the region. Despite the upturn in tourism activity, growth only reached an average of 2.8% in the first half of 2022.

TUNISIA: MONETARY ENVIRONMENT

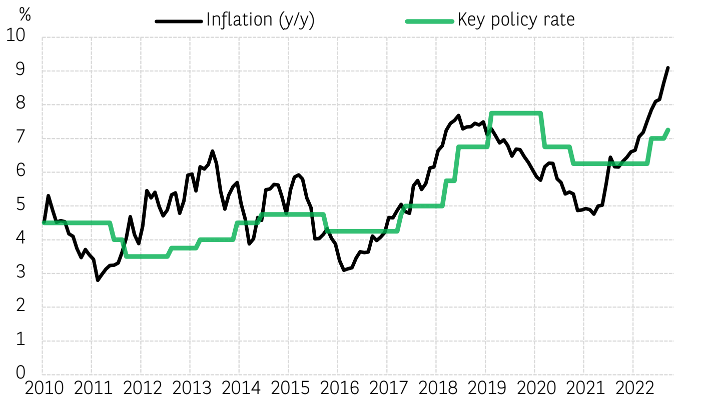

CHART 2 SOURCE: INS, CENTRAL BANK, BNP PARIBAS

At this pace Tunisian economic activity may not return to its pre-pandemic level until the end of 2023/start of 2024. But downside risks are accumulating, starting with a deteriorating economic situation in Europe, which is by far the country's most important economic partner (75% of exports and 85% of FDI in 2020). Moreover, inflationary pressures are high. Inflation has just reached an all-time high of 9.1% in September (chart 2), driven to a large extent by the rise in food prices (+13%) despite the system of subsidies. In addition to the disruptions caused by the international context, there were delays in payments by the State, which destabilised the distribution channel and generated shortages and price increases even for certain subdizided products. Inflationary pressures are likely to remain strong in the short term, which could force the central bank to raise rates following the hike of 75 basis points decided upon in May and the 25 bps hike in October. At 7.25%, however, the key policy rate is still well below inflation, highlighting the central bank's cautious attitude towards an economy which would find it difficult to cope with too sharp a monetary tightening. In the absence of an agreement with the IMF, domestic financing conditions could deteriorate further. The government could therefore be forced to make further cuts in its public investment programme, the level of which has steadily decreased in recent years (3% of GDP in 2022 compared to 5.3% in 2017) and is already insufficient given the country's development needs.

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KENYA

UNCERTAINTIES

In 2020-2021, thanks to its diversified economy, Kenya was relatively more resilient to the shock of the pandemic than other sub-Saharan African economies. But in 2022-2023, the recovery will be constrained by the indirect effects of the war in Ukraine and subject to significant downside risks. The country faces a deterioration in its terms of trade. Accelerating inflation will weigh on domestic demand, with the risk of fuelling social instability. This could complicate fiscal consolidation efforts, which are necessary to maintain the support of multilateral creditors, particularly the IMF. The new president has ruled out the option of preventive debt restructuring. But the government's external liquidity and solvency remain fragile.

RECOVERY DENTED BY THE IMPACT OF THE WAR IN UKRAINE

Thanks to the diversification of its economy, Kenya recorded a limited contraction in activity estimated at -0.3% in 2020, compared with the average of -1.6% in sub-Saharan Africa. Although weakened, the economy saw a strong upturn in 2021 (+7.6%), driven by investments in infrastructure, the recovery in private consumption and the services sector. In 2022, real GDP growth is expected to slow to an average of +5.5%, despite a still very dynamic first quarter (+6.9% y/y). The effects of the drought on the agricultural sector and continued fiscal consolidation are expected to dampen the recovery. Kenya is also particularly affected by the consequences of the war in Ukraine. The combined effect of the negative impact of terms of trade and the rising costs of imports on real GDP is estimated at -0.8% .

Manufacturing activity is weakening; the Purchasing Managers' Index (PMI) remained below the expansion zone threshold between April and August with sharp declines in the "production" and "new orders" subcomponents in the first half of 2022. While the index rebounded in September, the outlook remains constrained. Companies are facing a sharp rise in input costs (supply constraint), which they are increasingly passing on to their sales prices, which in turn is weighing on demand.

The indirect effects of the conflict are also expected to have an adverse impact on consumer spending. Since the beginning of the year, consumer price inflation has accelerated and reached +9.2% in September (its highest level in 5 years). The acceleration in inflation is particularly strong in the food component, which represents 1/3 of the consumer basket: the food price index increased by more than +15% in September. Indeed, Kenya is particularly exposed to rising cereal prices, with almost 20% of its consumption coming from Russia and Ukraine. The volatility in prices and the risk of food shortages have also been exacerbated by the unprecedented drought. Price rises are also beginning to permeate across all goods, due to the increase in energy prices which is gradually being passed on to retail prices. These changes have forced the government to introduce temporary subsidies on fuel and maize to ease the pressure on consumer purchasing power. However, these subsidies are gradually being phased out, as required by the IMF.

Against this backdrop, the tightening of monetary policy continues to be limited and the policy mix remains accommodative. In response to the acceleration in inflation, the central bank (CBK) raised its key policy rate by 50 bps to 7.5% in May. The rate remained unchanged at the July committee meeting, with the authorities arguing that the first rate hike had not fully spread through the economy. Nonetheless the persistence of inflationary pressures justified an increase of 75 bps, to 8.25%, at the last meeting at the end of September. Meanwhile, the government has maintained an expansionist fiscal policy in the context of the general elections.

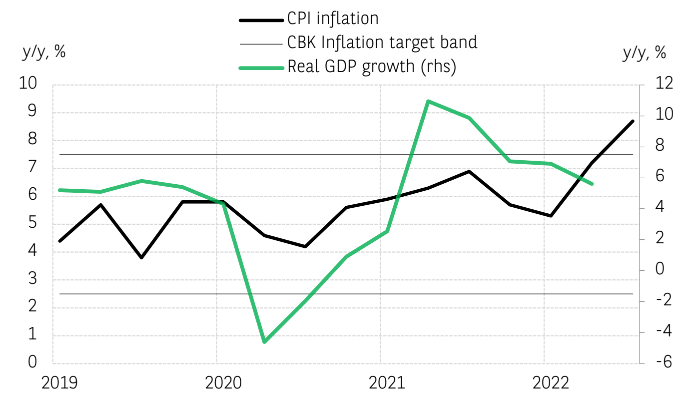
FORECASTS

	2019	2020	2021	2022e	2023e
Real GDP growth (%)	5.0	-0.3	7.6	5.5	5.5
Inflation (CPI, year average, %)	5.2	5.3	6.1	7.3	6.3
Cent. Gov. balance / GDP (%) (1)	-7.6	-8.5	-6.2	-8.5	-7.1
Cent. Gov. debt / GDP (%) (1)	58.6	63.7	67.9	69.4	68.7
Current account balance / GDP (%)	-5.3	-4.7	-5.4	-5.8	-5.1
External debt / GDP (%)	51.5	57.4	57.6	59.7	59.5
Forex reserves (USD bn)	8.8	7.8	8.8	8.1	9.5
Forex reserves, in months of imports	5.4	4.8	4.4	3.9	4.2

TABLE 1

(1) FISCAL YEARS FROM JULY 1ST OF YEAR N TO JUNE 30TH OF YEAR N+1
e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

KENYA: SLOWING GROWTH AND ACCELERATION OF INFLATION



GRAPHIQUE 1

SOURCE: BLOOMBERG, KENYA NATIONAL BUREAU OF STATISTICS, BNP PARIBAS

A SENSITIVE SOCIO-POLITICAL CONTEXT

The election took place on 9 August, in a relatively calm environment. The results were very tight in a country characterised by strong divisions. The opposition's dispute as to the results did not lead to any protests or disruption to economic activity. The results were also confirmed by the Supreme Court, with William Ruto appointed as successor to the incumbent president Uhuru Kenyatta, who had been in power since 2013.

Nevertheless, there is still significant uncertainty regarding the transition of power. Ruto's main challenge is to preserve national unity in a context where the growing hardship of the population is fuelling frustration and where the low turnout (around 65%, the lowest in 15 years) reflects the reduced confidence of voters in the political system. For the first time since 2002, the new president is not from the majority ethnic group, the Kikuyu. He will therefore have to create a new political and ethnic balance in this country where community membership is an essential cornerstone of the political landscape. The new president will also face economic challenges: a delicate task because the ruling party has only a small majority. It will also be twofold, because the government will have to both implement measures to support the economy against the backdrop of the inflation shock and undertake measures to consolidate the budget and reduce public debt. The president has ruled out the option of preventive debt restructuring.

PUBLIC DEBT FINANCING AND SUSTAINABILITY RISK

The health crisis has accelerated the deterioration in public finances that has been ongoing for several years. The budget deficit fell from -6.6% on average before the pandemic to -8.5% of GDP in 2020, and public debt amounted to some 70% of GDP (vs. 49% in 2015). In addition, the debt profile has deteriorated due to the increasing share of commercial loans and the decrease in concessionary borrowing. The cost of debt has therefore increased. Interest payment charges now represent more than 20% of budgetary revenue and total debt servicing absorbs 50% of revenue (vs. 38% in 2015). These ratios point to a worrying deterioration in the sustainability of public debt. In addition, almost 40% of public debt is denominated in foreign currency. The debt burden is therefore likely to increase further given the depreciation of the shilling (-6% against the US dollar since the start of the year).

In view of this, the government has taken steps and the successful implementation of the 2021/22 budget has been encouraging. The risk of default is moderate in the short term thanks to the support of multilateral creditors. However, Kenya's external liquidity and solvency are weak.

The country's financing capacity is now severely limited. On the domestic market, the issuance of Treasury bonds has not met the expected objectives since the start of the 2022/23 fiscal year. The CBK had to forgo some offers, as the requested rates were higher than anticipated. Furthermore, Kenya had to forgo financing on the international bond market in H1 2022 given the market conditions: spreads exceeded the threshold of 1000 bps in the first half of the year. Even though they have fallen back since then, they remain well above their recorded levels over the past 5 years. Currently the country is financed almost exclusively through multilateral creditors. Support from the IMF, through the facility running until 2023, has allowed Kenya to cover its financing needs and meet the interest payments on its debt. The country recently benefited from a disbursement of USD 235.6 billion bringing the IMF's credit to USD 1.21 billion out of a total of USD 2.34 billion provided for by the agreement. However, Kenya's level of external liquidity remains worrying, equivalent to 4.2 months of imports.

KENYA: INCREASING PUBLIC DEBT RATIO AND BURDEN

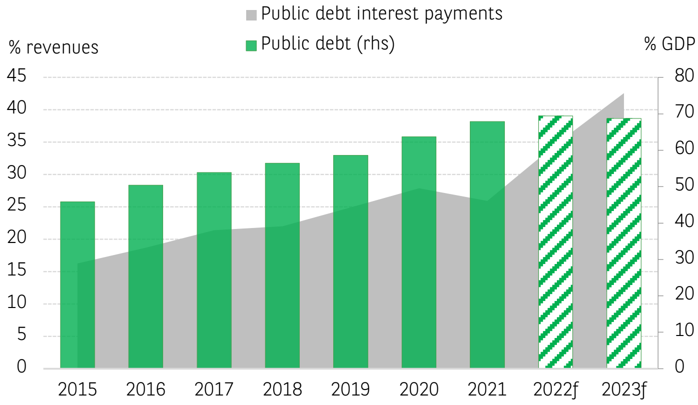


CHART 2 SOURCE: IMF, KENYA'S TREASURY, BNP PARIBAS

The rigorous continuation of fiscal consolidation measures will be crucial to retain the support of multilateral creditors and in particular the IMF. However, the measures targeted by the IMF programme, which are a prerequisite for the disbursement of the next tranches of financing, are extremely restrictive. The objectives envisage halving the deficit by 2024 (USD 4.4 bn compared to USD 6.8 bn in 2021). However, the envisaged reduction in expenditure (-37% in nominal value over the 2021/24 period) may be difficult to implement in the current inflationary environment. The consequences of an incomplete fiscal adjustment could jeopardise the financing of official creditors and the sustainability of public debt.

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