ECO EMERGING

4th Quarter 2021 — October 2021

EDITORIAL

ECONOMIC RESEARCH

BNP PARIBAS

The bank for a changing world

A LACKLUSTER SUMMER

The recovery in emerging countries remains fragile. Several economies in Asia and Latin America went through an air-pocket in Q2 2021. The emergence of Covid-19 variants has triggered new waves of the pandemic resulting in production stoppages, which have been temporary so far but which are eroding business confidence. Companies are also struggling with supply-side constraints, including supply-chain bottlenecks and energy shortages, which are contributing to fueling inflation and indirectly straining household confidence. Lastly, the Chinese economy is a source of concern with its sluggish household consumption and with the construction and real estate sectors in great distress. Still, to end on a positive note, according to IIF estimates, the rise in non-financial private debt has been moderate so far when compared with public debt.

A CHAOTIC RECOVERY

The recovery in emerging economies is proving to be bumpy. In Q2 2021, real GDP plummeted again for one third of the twenty- seven countries in our selection. The only countries that reported stronger growth were the member states of the European Union, thanks notably to the rebound in the Eurozone. It was primarily the Asian economies that went through air pockets, mainly due to the reintroduction of lockdown measures following new waves of the pandemic caused by Covid-19 variants (notably in India and Malaysia). And yet exports were still dynamic through June, even in Asia, and accelerated in other regions. Africa and the Middle East are the only regions where exports are still below the pre-pandemic level of 2019, which can be attributed to the oil production quotas that were maintained by OPEC+.

Summer trends do not provide much room for optimism. Granted, vaccination campaigns are being rolled out at an accelerated pace. But the business climate is deteriorating (except in Central Europe). Surging inflation is straining household confidence and driving more central banks to raise their policy rates. So far central banks have increased their policy rate cautiously (even the central banks of Brazil and Russia, which have been very reactive, remained behind the curve). This cautious approach is justified by 1) the usual inertia of core inflation relative to headline inflation (especially in Asia), and 2) the results of business surveys showing that the ratio between the output price diffusion index and the input prices one is generally less than 1.

The expected tapering of US monetary policy has triggered an outflow of portfolio investment, and exchange rates continue to depreciate against the dollar. Above all, the Chinese economy is a source of concern with its sluggish household consumption and with the construction and real estate sectors in great distress. These fears have already been reflected in the downturn in metal prices since mid-September.

The threat of a stronger-than-expected Chinese economic slowdown in Q4 2021 and 2022 presents a new downside risk for growth in emerging countries. If the slowdown is limited to the construction and real estate sectors, then the impact on Chinese demand could be circumscribed. Indeed, higher infrastructure spending could partially offset the shock that is already being felt in residential construction. Yet the indirect impact conveyed via the commodity channel is likely to be much faster. The first in line are the Latin American countries, which are already struggling.

THE COVID SHOCK DID NOT LEAD TO EXCESSIVE PRIVATE DEBT

The latest update of the IIF's Global Debt Monitor provides a preliminary picture of the health crisis's impact on debt in the emerging countries. The median increase in the public debt ratio was about 10 points of GDP between December 2019 and June 2021. In comparison, in the aftermath of the Lehman Brothers shock of 2008, the public debt ratio increased by only 5 points. For the non-financial private sector, in contrast, the median increase was equivalent to about 3.5 points during the two episodes. More surprisingly, corporate debt does not seem to have increased significantly more than household debt, even though companies benefited from emergency credit lines. With little or no unemployment insurance, households may have had to resort to borrowing to offset the loss of jobs or revenues (South Africa, Brazil, Colombia, Malaysia and Thailand). On the whole, although the IIF regularly warns about the increasingly high level of global debt (both public and private), the rise in the non-financial private debt has been moderate so far, when compared with public debt. Two exceptions are worth pointing out: Saudi Arabia and Russia, where non-financial corporate debt rose by 14 points of GDP. Yet Russia's non-financial private sector is not in an excessive debt situation (the credit gap is less than 5 pp). However, both economies are vulnerable given the structural constraints arising from their lack of diversification, which is holding back their growth potential.

Another lesson that can be drawn from the IIF estimates is that the Covid-19 shock did not increase the external vulnerability of emerging countries. At the aggregate level, the increase in the foreign-currency debt of non-financial agents (governments, companies and households combined) was more than offset by the increase in official foreign reserves, despite the volatility of portfolio investment.

The ratio of foreign-currency debt to foreign reserves has diminished in the vast majority of countries, with the notable exception of Turkey, and to a lesser extent, Saudi Arabia and Colombia. Another positive point is that emerging countries have maintained their capacity to issue debt either on the international markets or on their domestic market. With a few exceptions (Turkey, Brazil, Colombia), CDS spreads on sovereign debt have hardly widened since March 2020 despite the rise in public borrowing requirements. Sovereign issuers have relied on domestic savings and also non-resident portfolio investors.

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CHINA

PAINFUL ADJUSTMENTS

The Chinese economy is in the midst of a period of major adjustments. They arose after Beijing tightened regulations in a variety of sectors, from housing to certain new technologies and activities linked to the societal challenges facing the country. The adjustments can also be attributed to the debt excess problem of some state-owned and private enterprises, and reflect the authorities' determination to tighten their access to credit and to clean up practices in the financial sector. As a result, an increasing number of corporates is defaulting, and the troubles of the property developer Evergrande are symptomatic of the changes under way. For the authorities, the challenge is to maintain control over these events and to contain their negative impact on confidence in the financial system, on credit conditions for other economic agents and on economic growth.

NEW THREATS TO GROWTH

China's post-Covid economic rebound peaked earlier this year and growth rates have gradually returned to normal levels since March. However, the slowdown was particularly abrupt during the summer months and spread to all sectors. It can be attributed to both temporary factors as well as more lasting causes.

Lockdown measures and travel restrictions, which were reintroduced in August in response to the resurgence of the pandemic and the threat of the Delta variant, dealt another hard blow to private consumption. Growth in retail sales volumes slowed to 0.9% year-on-year in August, down from 6.4% in July and 11.9% in Q2 2021. Activity in the services sector was also hard hit by the lockdown measures (+4.8% y/y in August, down from 7.8% in July and 13.9% in Q2). The services sector has also been hit by regulatory changes in such industries as online services, tutoring and video gaming.

The tighter macro-prudential framework and credit conditions have also hit the property market while the tightening of fiscal policy in H1 2021 led to a major slowdown in investment in public infrastructure projects (see chart). As a matter of fact, after last year's post-Covid economic rebound, the authorities rapidly adjusted their economic policy to shift priority to debt reduction efforts by both local governments and corporates – notably property developers and state-owned enterprises.

Lastly, supply-side constraints have disrupted the industrial sector. Factories have been hit by an increasing number of power outages in recent weeks, as a result of strong demand, rising coal prices constraining energy production, rationing measures introduced in some provinces in order to comply with targets to reduce greenhouse gas emissions. Through August, however, industrial production growth slowed only moderately (+5.3% y/y, vs 6.4% in July and 9% in Q2) as it kept pace with persistently solid performance in exports (which still rose by 25% y/y in value in August). Moreover, investment growth in the manufacturing sector was also robust over the summer, bolstered by good corporate profit growth and historically high production capacity utilisation rates (78.4% in Q2 2021).

Although households are still extremely cautious, consumption and activity in the services sector should pick up as of September as most lockdown measures and travel restrictions are lifted. To a lesser extent, they should also get a boost from the advancement of the vaccination campaign (more than 70% of the population has received two doses). Consumer price inflation is still very low (+0.8% y/y in August), which may also encourage spending. In addition, the authorities are expected to support domestic demand again, mainly via carefully targeted measures to facilitate lending and a rebound in public investment.

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth (%)	6.0	2.3	7.8	5.6
Inflation (CPI, year average, %)	2.9	2.5	1.2	2.8
Official budget balance / GDP (%)	-2.8	-3.7	-3.2	-3.0
Central government debt / GDP (%)	17.0	20.6	21.0	21.7
Current account balance / GDP (%)	0.7	1.9	1.9	1.7
Total external debt / GDP (%)	14.5	16.3	15.1	15.8
Forex reserves (USD bn)	3 108	3 217	3 282	3 322
Forex reserves, in months of imports	14.9	16.3	14.0	12.9

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

DOMESTIC INVESTMENT

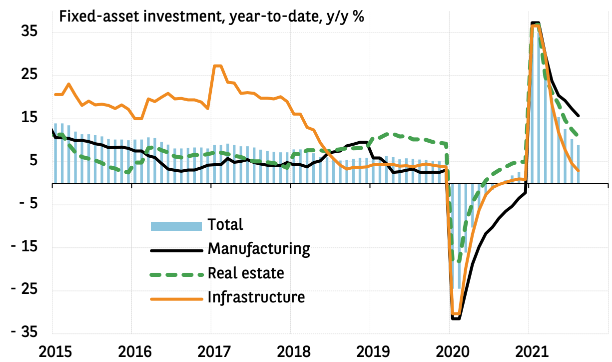

CHART 1 SOURCE: NBS

In the industrial sector, in contrast, supply-side constraints could persist for several more months. Above all, the adjustments being pushed by the authorities are placing new constraints on economic growth, at least in the short term.

First, the regulatory environment is becoming less predictable and less favourable for private investment in a number of sectors regarded as sensitive by Beijing. They include certain new technologies offering consumer services, data collection and activities pertaining to societal issues (such as education or wealth distribution).

Second, the number of payment difficulties and defaults, by both state-owned and private corporates, are on the rise due to: i) their heavy debt burden[1] and the deterioration in their financial performance after last year's crisis, combined with ii) government measures to reduce leverage levels in certain sectors by tightening their credit conditions, as well as to clean-up practices in the financial system (for example, by letting non-viable firms enter bankruptcy, and by weakening implicit state guarantees).

COMMON PROSPERITY, REAL ESTATE AND EVERGRANDE

Under this environment, the real estate sector is highly exposed. This is partly because the housing market plays a major role in the country's medium-term development strategy: moderate house price inflation and improvements in housing affordability are due to help stimulate household consumption and reduce inequalities, in compliance with Beijing's new priority to promote "common prosperity".

Second, the real estate sector is one of the most heavily indebted sectors, and it has largely benefited from the monetary easing measures introduced during the H1 2020 health crisis. Consequently, the authorities sharply tightened credit conditions and the prudential framework beginning in Q3 2020. They placed new limits on the banks' sector exposure[2] and imposed three "red lines" that property developers must comply with in terms of financial ratios[3]. Many provinces have also set up measures to discourage speculative transactions and moderate the rise in house prices.

In this increasingly restrictive environment, enterprises of the real estate sector have faced increasing financing and cash-flow problems in recent months. Growth in bank loans to property developers (which account for only part of the sector's financing sources) fell to 2.8% y/y in mid-2021, down from 8.4% in mid-2020. Growth in mortgage loans slowed to 8.6% from 14.8% during the same period. This downward correction should worsen in H2 2021. Meanwhile, housing construction and transactions have slowed, further reducing developers' liquidity levels (see chart).

The Evergrande case is symptomatic of the property sector's troubles. In the last days of September, Evergrande, which is the country's largest and most heavily-indebted developer, failed to pay part of the interests due to local creditors and on its US dollar bonds. The Chinese government did not grant any direct support.

WHAT IS THE FALLOUT?

Corporate deleveraging efforts and the clean-up of financial-sector practices are positive trends that should lead to a better allocation of capital in the medium term. Yet the adjustments are painful in the short term. Evergrande's first defaults had a severe impact on confidence and the financial markets, if for no other reason than the company's size (which accounted for nearly 5% of the total value of China's real estate transactions in 2020), its heavy debt and debt profile (which is mainly short-term)[4]. Evergrande's troubles have also impacted its payments to suppliers and shadow banking credits, thus accelerating the spread of liquidity pressures to other institutions.

In recent weeks, local bond markets have been increasingly differentiating between property developers based on their credit rating. As a result, a certain number of small firms in the sector have found themselves cut off from access to financing and are in danger of defaulting. Bond issuers in other sectors, in contrast, do not seem to have been affected much so far. Moreover, the banking sector is stable.

HOUSING MARKET CORRECTION

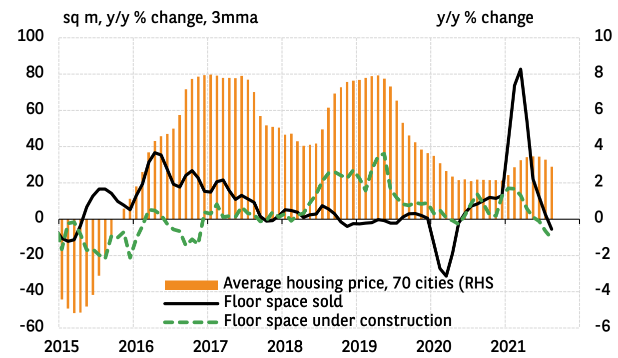

CHART 2

SOURCE: NBS

It is highly exposed to the real estate sector, which represented 28% of total bank loans outstanding in H1 2021 (of which 21% are mortgage loans and 7% are loans to developers), or 46% of GDP. Although some of the small banks may face severe difficulties due to property developers' troubles, China's largest banks have sufficient capital and provisions, and are robust enough to withstand the shock (and their direct exposure to Evergrande is manageable).

Above all, the authorities have the capacity to contain spill-over effects to financing conditions for the rest of the economy and to prevent instability risks in the financial system. The central bank has injected liquidity continuously in recent days, and the government is taking part in the negotiations between Evergrande and its creditors and in the debt restructuring process (asset sales, fund injections by other firms, etc.).

The Evergrande shock is unlikely to trigger a widespread liquidity crisis in the financial system. On the other hand, the forced deleveraging process for developers will have consequences on economic growth. Land sales, construction and housing transactions should continue to weaken in the short term. Yet the construction and real estate sectors are key growth engines for the Chinese economy. They account for 15% of GDP, and even 25% if we include indirectly linked activities. Real estate investment accounts for nearly a quarter of total investment. Moreover, land sales proceeds are a major source of revenue for local governments, and the majority of household wealth, especially in urban areas, is invested in real estate. Therefore, while allowing the weakest property developers to go bankrupt, the authorities are likely to take action to avoid a lasting contraction of the sector (by easing mortgage loan conditions, for example, or providing liquidity support for the most solid firms). Completing Evergrande's already existing construction projects is also likely to be one of the authorities' priorities, to address the discontent of families waiting for the delivery of their houses.

Completed on 30 September 2021

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1 China's corporate debt (most denominated in local currency) represented 159% of GDP in mid-2021, up from 152% at year-end 2019
2 The ceiling on real estate loans (property developers + household mortgages) as a share of total loans varies depending on the size of the bank.
3 The property developers must comply with three ratios: debt/assets <70%, liquidity/short-term debt >1 and net debt/equity <100%. Developers have 2 years to improve their ratios. The more a developer exceeds these limits, the tighter the restrictions on its access to credit. In H1 2021, 7 of China's 50 biggest property developers exceeded the three "red lines".
4 Evergrande's debt and liabilities total nearly USD 300 bn, or 2% of Chinese GDP.

SLIGHT IMPROVEMENT

India's economic and financial situation has consolidated slightly since the summer. After contracting sharply in Q2 following the spread of the Covid-19 pandemic, economic activity rebounded strongly in Q3. Even so, at end-September, only 20% of the population was fully vaccinated, which means the country is not sheltered from a third wave of the pandemic. Growth prospects are still looking good for the rest of the year. Household consumption will benefit from falling inflation and higher government spending. Business leaders are still confident, even though they are taking a cautious approach to investment plans. Borrowing rates are low, and the banking sector, though still fragile, is doing better than it was three years ago. In the first five months of the fiscal year (April-August 2021), fiscal revenues increased sharply, and the government could lower its target for the fiscal deficit this year, from 6.8% of GDP to 6.2%. The debt-to-GDP ratio should decline, at least this year, reducing the risk of a sovereign downgrade by the rating agencies.

Q3 GROWTH IS POISED TO REBOUND

Adjusted for seasonal variations, Q2 2021 GDP contracted by more than 12.7% compared to the previous quarter according to our estimates. This contraction is due to lockdown measures introduced to halt the spread of the Covid-19 pandemic. Even so, the decline in GDP is a far cry from the one reported at the same time last year. By June, activity indicators had already rebounded, and this improvement was confirmed in the survey results for July-August. In August, however, activity was still far below the levels that prevailed in Q1 2021, and the recovery seems to be running out of steam. Households are much less optimistic than business leaders, and they are having a hard time regaining morale. Although inflation is falling, it is still high (5.3% in August 2021). The unemployment rate is higher than the level that prevailed before the second wave of the pandemic (7.5% at the end of September 2021) and employment continues to contract. It declined to only 34.6%, compared to a pre-crisis level of nearly 40%. Moreover, even though companies are consolidating their financial situation, private investment is still weak based on bank lending trends and the production of capital goods. In the first seven months of the calendar year, the value of investment projects was still lower than in 2020, even though interest rates fell to a low point in Q2 2021 (the average interest rate on new loan production in rupees was 7.8%, down from the pre-crisis level of 9.3%). Meanwhile, energy shortages and the steep rise in energy prices could threaten India's economic recovery.

The country is still vulnerable to a new wave of the pandemic since less than 20% of the population had been fully vaccinated at the end of September 2021. In the second half of the current fiscal year, growth should get a boost from higher government spending, ongoing export momentum and the upturn in services, in keeping with vaccine distribution and the slowdown in inflation. By year-end 2021, vaccination coverage could reach 40% of the population.

PUBLIC FINANCES CONSOLIDATE SLIGHTLY

Public finances are still fragile but they consolidated slightly in the first five months of fiscal year 2021/2022, reducing the risk of a sovereign downgrade by the rating agencies.

In FY 2020/2021, public finances deteriorated sharply due to increased spending at a time when revenues remained extremely limited. The government deficit swelled to 9.2% of GDP, from an average of only 3.8% of GDP during the previous five years. We estimate that the general government's fiscal deficit could have increased to 13.7% of GDP. Similarly, the public debt is likely to have accounted for more than 88% of GDP in FY2020/2021 (up from 72% of GDP the previous year).

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth(1) (%)	4.2	-7.2	7.0	11.2
Inflation (1) (CPI, year average, %)	4.8	6.1	5.4	4.5
General Gov. Balance(1) / GDP (%)	-7.3	-13.7	-10.8	-9.0
General Gov. Debt(1)/ GDP (%)	72.2	88.3	87.2	86.3
Current account balance(1) / GDP (%)	-0.9	0.9	-1.4	-1.7
External debt(1)/ GDP (%)	19.9	21.6	20.8	20.4
Forex reserves (USD bn)	457	542	585	615
Forex reserves, in months of imports	7.7	11.0	9.1	9.2

TABLE 1

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

ACTIVITY INDICATORS

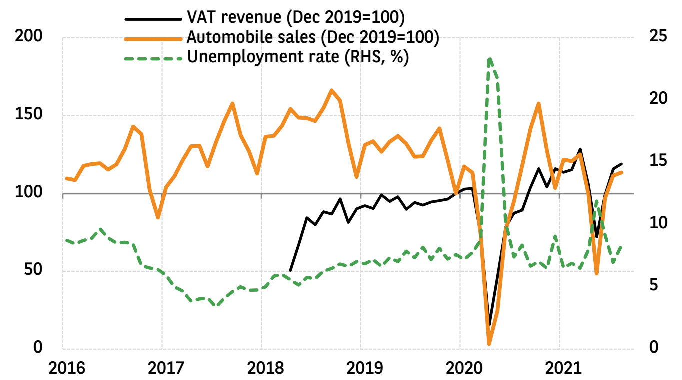

CHART 1

SOURCE: CEIC

Although government financing is not problematic given its low risk profile (financing in domestic currency, at a fixed rate, and with a long maturity), Fitch has placed a negative outlook on the sovereign rating based on its feeble tax base (government revenues have declined regularly since FY 2017/2018 and amounted to only 8.6% of GDP before the crisis) and the sharp increase in interest (40% of revenues last year) at the same time as its debt swelled.

In FY 2021/2022, the government plans to reduce the deficit to 6.8% of GDP. With nominal growth estimated at 14.4%, the debt-to-GDP ratio should improve, assuming the government manages to reach its target.

Public finances were solid in the first five months of FY 2021/2022, which is encouraging. For the first time since FY 2011/2012, only 31% of the planned full-year deficit was reached during this period. This strong performance can be attributed to a very big increase in revenues (+130% compared to the same period in 2019), which accounted for 42.4% of the full-year target (compared to an average of 29% over the previous five years), reflecting a sharp increase in taxes (notably VAT revenues). In contrast, the proceeds from divestments are once again expected to fall far short of the authorities' target. The biggest uncertainty is the pace of revenues over the rest of the year. The positive results in the first months of FY 2021/2022 seem to correspond to late payments that should have been collected during the previous year. If the improvement is due to a sustainable increase in the fiscal base, however, government revenues could reach 9.9% of GDP over the full year, which would be the highest level since FY 2013/2014.

Spending amounted to only 22.8% of the full-year target. The good news is that the share of capital investment increased. Moreover, even though the government announced economic support programmes to offset the second wave of the pandemic, direct budget costs will remain low (0.2% of GDP).

Lastly, the authorities' target of reducing the deficit to 6.8% of GDP seems to be within reach. It could even be revised downwards to 6.2% of GDP. Moreover, the government is not having any financing troubles. The Ministry of Finance estimates that 55% of net debt issues will be directly underwritten by the central bank, which held more than 17% of the debt in June 2021, compared to only 14% in the year-earlier period. The share of debt held by foreign investors is still extremely small (6%). Moreover, in the first half of the current fiscal year, the government did not encounter any difficulties in issuing bonds on the market. It borrowed at an average rate of only 6.2%, with an average maturity of 16.7 years.

A FRAGILE BUT RESILIENT BANKING SECTOR

In July 2021, the Reserve Bank of India (RBI) confirmed the banking sector's strong resilience to the Covid-19 crisis. Although still fragile, the sector is more solid than it was three years ago.

The quality of assets has improved over the course of FY 2020/2021. In March 2021, doubtful loans amounted to "only" 7.5% of all banking sector loans, down from a peak of 11.5% in March 2018. The government adopted four state-backed lending programmes for small and mid-sized companies as well as for the sectors in the greatest difficulty between May 2020 and June 2021. The Emergency Credit Line Guarantee Scheme helped increase the rise in credit risk. According to Fitch, these loans account for more than 10% of banking sector loans outstanding (nearly 5% of GDP). Yet whereas the quality of assets was consolidated in agriculture, industry and services, it deteriorated slightly for personal loans, even though some of the credit risk was still contained (2.1% for all personal loans). Jewellery and construction are still the sectors with the highest concentration of loans at risk.

Although the non-performing loan coverage ratio is still low, it was nonetheless 68.9% in March 2021, and the capital adequacy ratio (CAR) was satisfactory at 16%.

PUBLIC FINANCES

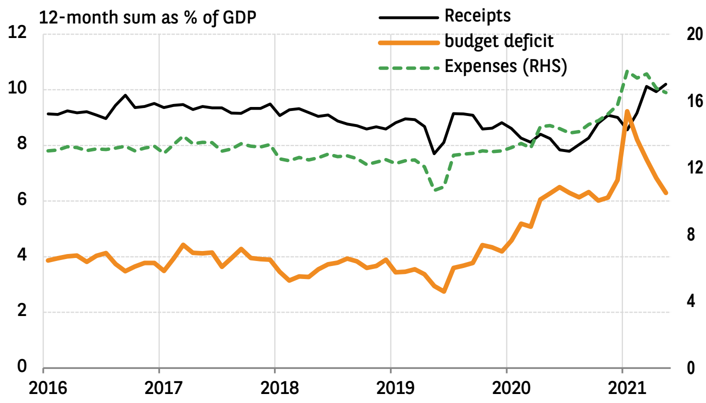

CHART 2

SOURCE: MOF, CEIC

Moreover, although the state-owned banks are in a much more fragile situation than the private banks, in July the central bank estimated that they were still in a position to face up to higher credit risks. In its central scenario (full-year growth of 9.5% in the current fiscal year), RBI expects the non-performing loan ratio to deteriorate from 7.5% in March 2021 to 9.8% in March 2022. However the CAR is expected to hold at a sufficient level (15.5%) to comply with regulatory requirements. Even in a worse-case scenario (growth of only 0.9%), all banks – including the state-owned banks – would comply with the regulatory ratio of 9%.

The biggest concern is the banks' capacity to increase credit supply. For the past two years, credit growth has slowed sharply (+6.1% y/y in July 2021), especially in industry (+1% y/y in July). Loans to individuals is the only category that continued to report strong growth (+11.2% y/y). To enable banks to support the recovery, in February 2021 the government announced the creation of the National Asset Reconstruction Company Ltd (NACL), a "bad" bank. Initially planned for June, its start-up was delayed. Moreover in September, the RBI estimated that the transfer of the first part of the non-performing assets of state-owned banks and public non-banking financial companies, for an amount of INR 900 bn (out of a planned total of INR 2 trillion: 1.8% of loans outstanding, or 0.9% of GDP) would not occur before year-end 2021.

Completed on 30 September 2021

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MALAYSIA

RISING FISCAL RISK

Although the political situation has stabilised somewhat following the appointment of a new prime minister, the economic environment has deteriorated. The spread of the Covid-19 pandemic in April forced the government to reintroduce lockdown measures that led to an economic contraction in Q2 2021. The situation is unlikely to improve before Q4, once health restrictions are lifted thanks to an accelerated vaccination campaign. In an attempt to boost growth, the government launched a series of economic support plans, even though fiscal revenue fell short of the full-year target in the first seven months of the year. Consequently, according to the Ministry of Finances, the fiscal deficit is expected to swell to between 6.5% and 7% of GDP, and it is likely to hold well above the pre-pandemic level over the next two years. The government announced that it would ask parliament to raise the debt ceiling in October. Even though the central government can easily access financing on the domestic market, it must face up to a structural decline in fiscal revenues and higher interest charges.

REAL GDP CONTRACTS IN Q2 2021

After reporting a contraction of 5.6% in 2020, Malaysian economic growth is likely to be much milder than initially expected this year. The recovery was cut short by a resurgence of the pandemic within a population with a low vaccination coverage ratio.

Malaysia was hard hit by the most recent wave of the Covid-19 pandemic, which began in April and peaked in June. The government reintroduced health restrictions in May, including the shutdown of non-essential businesses and restrictions on inter-regional travel. These measures were stepped up in June with the shutdown of companies in certain sectors and the reduction of workforce capacity to a maximum of 60% in the sectors still allowed to operate despite the pandemic. This triggered a sharp decline in domestic demand and an increase in the unemployment rate (+0.3pp to 4.8% in June). As a result, seasonally-adjusted economic activity contracted 2% in Q2 2021, compared to the previous quarter. Household consumption and corporate investment declined 10.7% and 7.5% q/q, respectively, while exports were still buoyant.

Economic growth in Q3 was impacted by the health restrictions that were still in place in the majority of States in July and August, including Kuala Lumpur and Johor, which together account for 26% of GDP. Industrial output contracted 6% in July compared to the previous month. Retail sales rebounded slightly compared to the month of June, but were still lower than the Q2 figure. The wholesale sector continued to decline. According to the PMI survey, industrial activity contracted again in August for the third consecutive month, even though PMI rebounded slightly to 43.4 (well below the 50 threshold that separates expansion from contraction).

Yet with the acceleration in the vaccination campaign (nearly 63% of the population had been vaccinated at the end of September 2021, compared to less than 1% in early April), health restrictions have been eased, raising hopes for a significant rebound in household consumption in Q4 2021. In full-year 2021, growth is expected to reach 4.1% according to the consensus forecast of economists.

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth (%)	4.4	-5.6	4.1	5.6
Inflation (CPI, year average, %)	0.9	-1.2	2.3	0.4
General Gov. balance / GDP (%)	-3.4	-6.2	-6.1	-3.8
General Gov. debt / GDP (%)	52.4	62.1	66.3	67.9
Current account balance / GDP (%)	3.5	4.2	3.1	3.0
External debt / GDP (%)	62.6	67.6	73.2	74.0
Forex reserves (USD bn)	100	100	104	106
Forex reserves, in months of imports	5.7	6.2	5.7	5.6

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

ACTIVITY INDICATORS

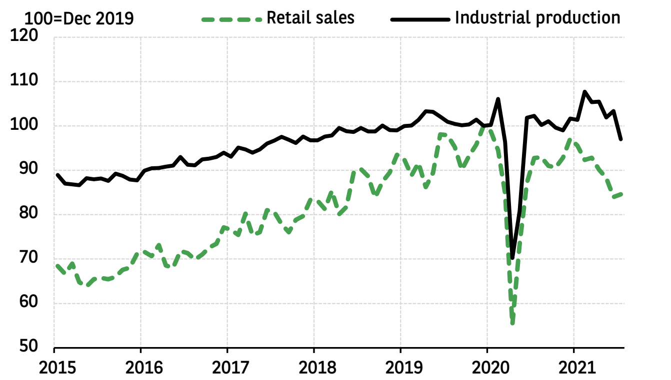

CHART 1

SOURCE: CEIC

THE DEBT CEILING IS RAISED FOR THE SECOND TIME SINCE THE OUTBREAK OF THE HEALTH CRISIS

Public finances have deteriorated sharply. In full-year 2020, the fiscal deficit swelled to 6.2% of GDP, compared to an average of only 3.3% over the period 2015-2019. Despite swinging back into growth in 2021, public finances could deteriorate further this year. In June, the Ministry of Finance raised its deficit target from an initial 5.4% of GDP to 6.5-7% to take into account the slowdown in growth due to the second wave of the pandemic and fiscal support measures.

In the first eight months of 2021, fiscal revenue had reached only 58% of the full-year target, even though the government had set a particularly low target this year (15.1% of GDP, compared to an average of 17% in 2015-2019).

This decline can be attributed to the absence of an exceptional dividend pay-out by Petronas, which accounted for 4.4% of revenue in 2020 (0.7% of GDP). The government is seeking to reduce its dependence on oil revenue, which has risen sharply since the elimination of the goods and services tax in 2018.

Although the government initially planned to increase fiscal spending by 1.1 percentage points (pp) compared to 2020, the full-year target of 20.5% of GDP had already been surpassed in the first eight months of the year. The government's initial budget called for pandemic-related expenses of more than 1% of GDP. But with the pandemic's spread and the introduction of lockdown measures, this figure had to be adjusted upwards. Between March and June 2021, the government announced the adoption of four supplemental fiscal programmes for a total value of MYR 225 bn (16% of GDP), although the direct impact on the budget should be limited to only 2% of GDP.

In the first eight months of the year, the deficit was almost entirely financed via the domestic market. The government did not have the least difficulty in issuing bonds, even though interest rates have risen since the beginning of the year (10-year bond yields rose 50 basis points in the first eight months of the year).

Under this environment, the debt-to-GDP ratio continued to deteriorate in H1 2021. The federal government's debt (excluding state-backed guarantees and 1MDB's debt) swelled to 64.3% of GDP in Q2 2021 (62% of GDP according to the definition used by parliament to calculate the debt ceiling), which is 12 pp higher than at year-end 2019. After including all contingent liabilities, we estimate the total public debt at 91.3% of GDP.

Since the debt ratio is higher than the legal threshold of 60% of GDP (using parliament's definition), the government will ask parliament to raise the debt ceiling by 5 pp to 65% of GDP in October, for the second time since the outbreak of the Covid-19 crisis. On the same occasion, the government will present its 2022 budget. It plans to continue pursuing an expansionist fiscal policy to offset the impact of the Covid-19 pandemic. Once again, the consolidation of public finances will have to wait. So far, the government has had no trouble covering its financing needs. Given the abundance of funding on the local domestic market, the government does not need to issue bonds on the international markets. At the end of June 2021, residents held nearly 76% of government debt, which was denominated almost exclusively in the local currency. In contrast, the increase in the interest charge since 2018 is a source of concern, because it reduces the government's manoeuvring room to support the economy. In the first six months of the year, the interest charge accounted for 17% of revenues (compared to only 11% five years earlier).

TOWARDS A LESS STABLE POLITICAL SITUATION?

The political situation has been unstable since the 2018 elections: the ruling coalition is comprised of several small parties and can only claim a very slim majority in parliament. The resignation of Prime Minister Mahathir Mohamad in February 2020 only increased the instability. Appointed by the king to replace Mahathir Mohamad, Muhyiddin Yassin was eventually forced to resign in August 2021, after 18 months of political tension in the midst of a health crisis, because he had lost the support of part of the United Malay National Organisation (UMNO).

On 20 August, Ismail Sabri Yaakob was named Prime Minister, which should restore some stability, at least in the short term. Although this appointment marks the return of the UMNO (directed by Anwar Ibrahim), the ruling political party between 1957 and 2018, the new prime minister will still have only a very small parliamentary majority (114 seats out of 220). To continue to adopt economic support measures, the prime minister just signed a protocol agreement with the main opposition party, the Pakatan Harapan (HP), which has 88 seats. The agreement covers the fiscal support package but also judicial independence and parliamentary reform. Such an agreement should help ensure some stability, at least over the next several months. The next elections are scheduled for 2023, but we cannot rule out the possibility that early elections will be called in the meantime.

PUBLIC FINANCES

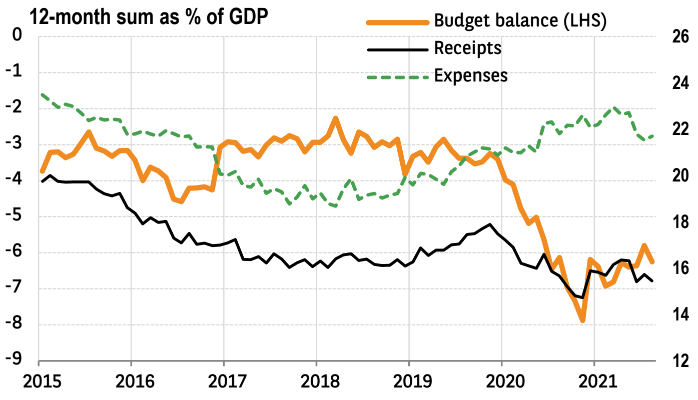

CHART 2 SOURCE: MOF, CEIC

Completed on 30 September 2021

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SOUTH KOREA

A COMPLEX ECONOMY

The third wave of the Covid-19 pandemic is unlikely to jeopardise the dynamic momentum of South Korea's economic recovery. Solid fundamentals, diversified exports and massive fiscal and monetary support should help limit the impact of the crisis on the country's medium and long term growth prospects. In contrast, an ageing population continues to erode the country's growth potential and public finances, even though the government has implemented a series of structural reforms. Household debt has picked up rapidly over the past 18 months. The associated credit risks are limited, however, thanks to the implementation of macroprudential measures and the comfortable level of household financial assets.

"LIVING WITH COVID-19"

Unlike the majority of countries in the region, the resurgence of the Covid-19 pandemic at the end of Q2 2021 did not undermine the economic rebound. The Google mobility index rose to an all-time high in mid-September (after easing briefly at the end of August), despite the relatively high number of new Covid-19 cases. The elderly and the most vulnerable populations have already been vaccinated, and the number of Covid-related deaths was relatively low during the third wave of the pandemic.

The government also announced that it would rapidly abandon its *"zero Covid"* strategy with its draconian health restrictions starting in late October, and would instead adopt a series of measures that aim to *"live with Covid-19"*. The goal is to return to *"normal life"* by gradually lifting the restrictions in place. The government has also set a target of fully vaccinating (two doses) 80% of the total population by the end of the year. At 4 October, nearly 80% of the population had received at least one dose, and 55% had received two doses.

The recovery continued in H2 2021. The rebound in domestic demand was only marginally affected by the recent spike in cases. At the same time, the labour market continued to strengthen. The unemployment rate has declined continuously since early 2021, from 6% in January to 2.4% in August. New consumer support measures announced in early September (for a total of nearly 0.5% of GDP) are also expected to boost household consumption.

External demand is also going strong. Exports have rebounded vigorously since Q3 2020 as South Korea benefited from strong demand for electronic goods arising from the development of working remotely. This strong export performance carried over to investment, notably in the telecom sector, such as infrastructure projects for the development of 5G networks. In real terms, investment increased at an average rate of nearly 4% y/y in H1 2021, compared to a long-term average of just over 3% (2015-2019).

Yet exports should slow in the last three months of the year as momentum erodes due not only to base effects, but also to supply-side constraints and the laborious start-up of supply chains. Supply constraints can be found in all sectors, especially the automobile sector, which was hard hit by the shutdown of a semi-conductor plant in Malaysia due to tighter health restrictions introduced following a new wave of the pandemic.

After a very mild recession in 2020 (GDP contracted 0.9%), thanks to effective pandemic management and massive fiscal and monetary support, GDP growth is expected to reach 3.9% and 3%, respectively, in 2021 and 2022.

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth (%)	1.8	-0.9	3.9	3.0
Inflation, CPI, year average (%)	0.4	0.4	2.1	1.7
Gen. gov. balance / GDP (%)	-0.6	-5.8	-4.0	-3.2
Gen. gov. debt / GDP (%)	39.5	44.0	48.2	52.1
Current account balance / GDP (%)	3.6	4.6	4.4	4.0
External debt / GDP (%)	28.4	30.1	30.4	29.2
Forex reserves (USD bn)	404	408	443	481
Forex reserves, in months of imports	7.5	7.5	7.3	7.8

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

EXPORT REBOUND

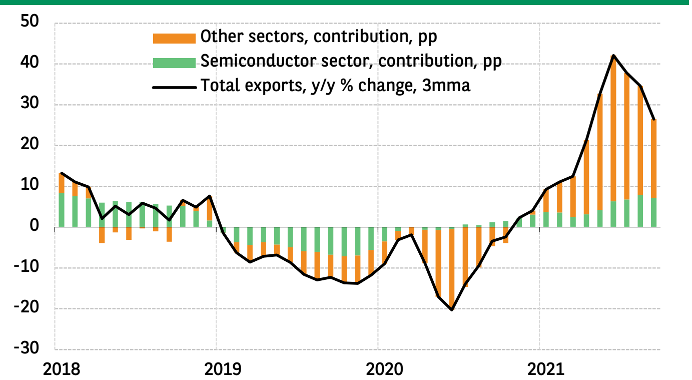

CHART 1

SOURCE: MINISTRY OF TRADE

The Covid-19 crisis should continue to have a very limited impact on South Korea, thanks not only to the authorities' massive support measures, but also to the economy's capacity to absorb shocks. This is facilitated by the economy's complexity, i.e., the diversity of export sectors and the intensity of knowledge and skills used to produce these goods. According to Harvard University's Atlas of Economic Complexity, South Korea's economy ranks fourth in terms of complexity (out of a selection of 133 countries), behind Japan, Switzerland and Germany.

In contrast, medium-term growth prospects continue to deteriorate due to an ageing population. A recent IMF study revised downwards its estimate of South Korea's growth potential to 2%, from 2.5% previously, due to the impact of the decline in the active population (15-64 age group) and the expected acceleration of this decline over the next decade. In the study, the authors even took into account the government's proposed reforms to improve productivity gains, notably the "Korean New Deal" with its three Green, Digital, and Human pillars, which aim to facilitate public and private investment.

FISCAL POLICY WILL REMAIN ACCOMMODATING IN 2022

The public deficit (excluding the social security fund) swelled rapidly in 2020, to 5.8% of GDP (compared to an average of 1.6% between 2015 and 2019). The government used its fiscal manoeuvring room to launch economic support measures, and four waves of stimulus measures were announced over the course of the year, for a total of nearly 3% of GDP.

The same policy was applied in 2021. In March, July and September, the government announced three series of measures that aim to boost domestic demand by targeting the most vulnerable households as well as SMEs. It is also counting on the smooth rollout of its vaccination campaign. Thanks to strong growth of fiscal revenues, South Korea should nonetheless manage to reduce the deficit to 4% of GDP in 2021.

In its 2022 budget proposal presented in September, the government announced that it would maintain an expansionist fiscal policy in 2022, with spending set to increase again by more than 8%, before gradually consolidating public finances as of 2023. Even so, revenue growth is expected to be strong enough to significantly reduce the deficit, to 3.2% of GDP as of 2022.

The government also plans to gradually slow the pace of spending increases (to an average of 5.5% a year by 2025) and to stabilise the deficit at between 2.5% and 3% of GDP over the same horizon.

Under this environment, the public debt would swell continuously, from 48.2% of GDP in 2021 to nearly 58% in 2025. Yet the increase in debt does not present a risk in the short to medium term.

The results of the presidential elections scheduled for March 2022 are unlikely to call into question these assumptions, since all of the candidates have pledged to consolidate the country's public finances.

HOUSEHOLD DEBT HITS A RECORD HIGH

Inversely, monetary policy has already begun to return to normal. The central bank raised its key rate to 0.75% in August, after leaving it at an all-time low of 0.5% since May 2020. Inflation is expected to level off at an average of about 1.7% in 2022, after peaking at 2.1% in 2021. In addition to the strong cyclical recovery, the central bank's press release points out the growing risks to financial stability.

A small supply of houses and exceptionally low interest rates drove up real-estate prices. At the national level, the house price index has increased by more than 15% since the beginning of 2021, and by more than 25% since mid-2020. Naturally, household debt rose sharply over the same period: it amounted to nearly 110% of GDP at the end of Q1 2021, up from 94.1% in Q4 2019. Debt outstanding rose 12% over the period.

HOUSEHOLD DEBT

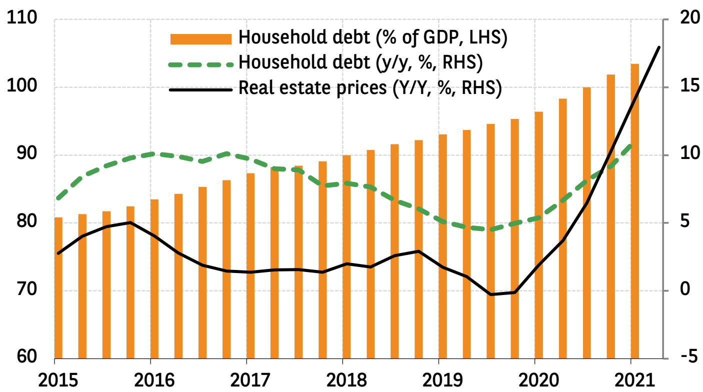

CHART 2 SOURCE: CENTRAL BANK

In the short term, the credit risk associated with household debt seems to be mild. On the one hand, the banking sector as a whole is relatively solid, and on the other, according to the central bank's most recent financial stability report, the amount of household assets is still twice as high as the amount of household debt. Moreover, macroprudential measures that were regularly implemented since 2017 have steadily reduced the number of loans to the most vulnerable households, i.e., those with limited capacity to repay their debt. At the end of Q1 2021, the amount of loans outstanding with vulnerable households accounted for only 5% of total loans outstanding (down from nearly 7% in 2017). Lastly, the government and the central bank recently announced new macroprudential measures.

Completed on 6 October 2021

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BRAZIL

FRAGILE CONSOLIDATION OF THE RECOVERY

The recovery has failed to consolidate in Q2 2021, with production stalling over the quarter despite the dynamism of external demand and the normalization of activity in the service sector. The slowdown of the epidemic since the summer and the acceleration of the vaccination campaign, however, point to a rebound in the second half of the year. But upside risk to growth will be challenged by the persistence of supply constraints in industry, the risk of electricity rationing, the slowdown in China and aggressive monetary tightening to counter soaring inflation. Against this backdrop, the real is still struggling to appreciate despite the rise in rates and the good performance of external accounts. The currency's weakness make the process of controlling inflation more difficult. The threat of fiscal slippage ahead of the 2022 Presidential election is yet another downside risk to the inflation outlook.

STAGNATION OF ECONOMIC ACTIVITY IN Q2

In the second quarter, the Brazilian economy was unable to capitalize on its good performance from the beginning of the year. Real GDP recorded a slight decline (-0.1% q/q, in seasonally adjusted terms) due to a downturn in agricultural production (due to drought and frost) as well as a decline in industrial activity (supply chain disruptions and higher production costs, especially in the manufacturing sector). These losses were only partially offset by the normalization of activity in the service sector, induced by increased mobility in the wake of the 2nd wave of Covid-19. On the demand side, supply constraints weighed on investment decisions and greatly accelerated the drawdown of inventories (especially in the automotive sector, still challenged by the global shortage of semiconductors). The reversal of gross investment alone helped cancel out the positive contribution of net exports to sequential GDP (+1.4 pp).

The rebound in activity in the second half of the year could be more moderate than expected. On the one hand, the progression of the epidemic has slowed down sharply since the end of June (despite a higher prevalence of the Delta variant), allowing a wider reopening of the economy and an increase in economic activity (the IBC-BR, a leading indicator of real GDP, rose +0.6% in July). The strengthening of services (+4% in July above its level of February 2020) helped bring about a fall in the unemployment rate (drop by one point to 13.7% in July compared to April). The improvement in the labour market was primarily driven by micro and small businesses responsible for nearly three quarters of the 1.8 mn formal jobs created between January and July. The acceleration of the vaccination campaign (at the end of September 70% of the population had received one dose, and 40% were fully vaccinated, vs. 38% and 14%, respectively, in early July) has helped Covid-19 related deaths and hospitalizations drop to levels last seen in November 2020. In the short term, the economy should continue to benefit from high commodity prices, the gradual rebuilding of inventories in the manufacturing sector and a broader recovery in the service sector.

On the other hand, the indicators available in Q3 show that supply constraints in industry, in particular weighing on costs, have not eased (BRL depreciation, delivery delays, increase in the price of electricity and freight costs). These persistent difficulties have begun to erode confidence in the sector (the FGV-industry index fell 1.4 points between July and August and has continued to deteriorate in September). In surveys, companies worry about the risk of electricity rationing that could cause production stoppages this year and next (the thermoelectric plants, which form part of Brazil's emergency system, are operating at full capacity and the country has had to increasingly rely on electricity and gas imports from Argentina and Bolivia).

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth (%)	1.4	-4.3	5.0	1.5
Inflation (CPI, year average, %)	3.7	3.2	8.0	7.0
Fiscal balance / GDP (%)	-5.8	-13.2	-6.4	-7.2
Gross public debt / GDP (%)	74	89	82	84
Current account balance / GDP (%)	-2.7	-0.9	0.5	-1.5
External debt / GDP (%)	37	45	42	44
Forex reserves (USD bn)	357	356	368	361
Forex reserves, in months of imports	16	19	16	15

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

COVID-19 : SLOWDOWN OF THE EPIDEMIC AMIDST RISING VACCINATIONS

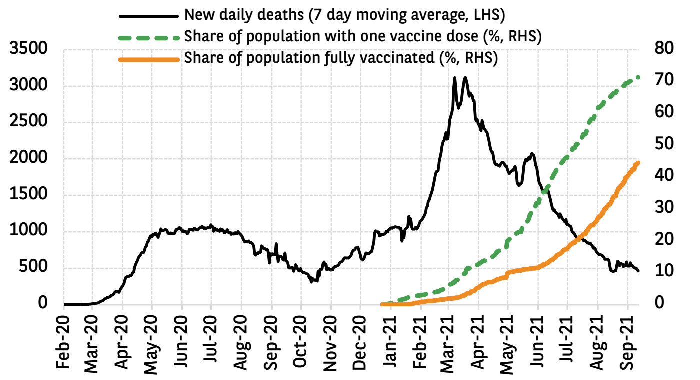

CHART 1

SOURCE: OUR WORLD IN DATA, BNP PARIBAS

In 2022, the recovery should continue, but at a slower pace (1.5%). Household consumption will be constrained by slow wage growth, accelerating inflation, high unemployment and tightening credit conditions. At the same time, the start of the electoral cycle ahead of the October 2022 Presidential election should be less favourable to private investment. The normalization of supply conditions in industry as well as recent regulatory changes destined to provide SMEs with better access to credit, are not expected to weigh significantly in the balance of risks (dominated by the threat of the emergence of new variants affecting the vaccine effectiveness and the risk of an energy crisis). Finally, it is important to note that the economy will benefit from a significantly smaller statistical carryover effect next year compared to this year (some 0.3 pp estimated vs. 3.7 pp). Medium-term growth will depend above all on improving the business environment — a keystone for stimulating private investment, increasing productivity and offsetting the effects on the economy resulting from the country's demographic transition (*cf. Eco conjoncture, August 2020*).

INFLATION IS SPREADING

Inflation has continued to accelerate through August. The IPCA index rose at an annual rate of 9.68%, the highest rate since February 2016 and 1.1 pp higher than the BCB's central scenario last June. The IPCA mainly came under pressure from food products, but also from industrial goods due to supply chain bottlenecks and higher input prices. Price increases are also spreading to the service sector. By 2022, the pressure on drinks and food prices are expected to dissipate. In contrast, the rise in price for electricity and fuel are likely to be more persistent. Core inflation is estimated at the moment to be some 4 percentage points lower than headline inflation. According to the BCB's survey of market participants, inflation expectations for 2022 remain above the BCB's target (4.1% vs. 3.5%). Market expectations for 2021 are meanwhile running at 8.45%.

Against this backdrop, the BCB has continued to raise its key rate (5th increase in September of the SELIC, up 425 basis points since March). The monetary authorities' task of controlling inflation is being made all the more difficult by the persistent weakness of the real: the currency has struggled to appreciate despite the rise in the SELIC, the fall in the current account deficit and the resumption of portfolio investment flows. The currency has in particular fallen prey to a more tense political environment (accusations of corruption in the purchase of vaccines, President's repeated attacks on institutions, increased tensions with the Supreme Court, threats of cancelling next year's Presidential election, multiplication of requests for impeachment etc.).

THE RISK OF FISCAL DOMINANCE

The anchoring of inflation expectations is also being obstructed by fiscal uncertainties (as of late, loss of visibility over the government's reform priorities, fears that in the last year of its mandate, the authorities could free themselves from budget constraints to stimulate domestic demand). These fears are not totally unfounded. Already in 2021, fiscal manoeuvring had helped circumvent the spending cap. Also, according to a note by the IIF, Brazil is not typically accustomed to reducing primary spending during election years. Lastly, the President intends to launch a new social programme (*Auxilio Brazil*) to replace *Bolsa familia* (although this programme will be partly financed by a temporary tax increase on financial transactions in Q4 2021).

Fiscal uncertainties tend to raise risk premiums and weaken the real, forcing the Central Bank to tighten monetary policy (imported inflation). The resulting increase in the cost of debt induces a rise in spending (as it is very difficult to change the composition of fiscal expenditure as nearly 95% of it is protected by the Constitution). In this scenario, monetary policy is almost entirely dominated by fiscal policy (fiscal dominance). This vicious circle would maintain the gap between the effective interest rate on government debt and the rate of growth of the economy (which has been slow in recent years) – resulting in a mechanical deterioration of public debt dynamics.

RESORPTION OF THE CURRENT ACCOUNT DEFICIT AND REVERSAL OF PORTFOLIO FLOWS

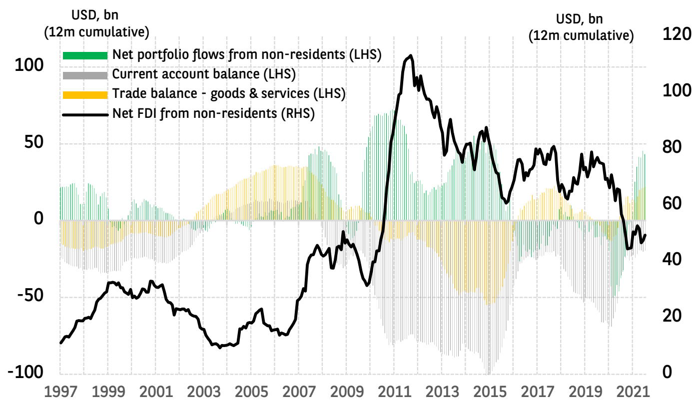

CHART 2 SOURCE: BCB, BNP PARIBAS

So far, fiscal ratios have not deteriorated, if only because of strong nominal GDP growth. The deficit is also contained thanks to the payment of deferred taxes (25% increase in tax revenue in the first half of the year). The tightening of financing conditions and the turmoil associated with approving the 2021 budget (*cf. EcoEmerging Q3*) have also, for the moment, not hampered the government's ability to refinance itself (debt rollover, which has amounted to more than 10% of GDP since the start of the year, has occurred relatively smoothly). Yet the recent improvement in fiscal balances does not reflect a fundamental consolidation of public finances, which are still subject to major rigidities.

Completed on 6 October 2021

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PUBLIC FINANCES INEVITABLY DETERIORATE

Mexico's medium-term economic prospects continue to deteriorate. The robust recovery already seems to be running out of steam, while the economy's structural weaknesses (low investment and competitiveness) have been exacerbated by the Covid-19 crisis and by the government's lack of fiscal support. Yet economic policy is unlikely to change much over the next two years. Following mid-term elections, the governing coalition managed to maintain a simple majority in the Chamber of Deputies. And the government's 2022 budget proposal confirms its determination to maintain austerity through the end of its mandate in 2024. Considering the relatively optimistic assumptions retained by the government, including financial support for the state-owned oil company Pemex, it seems inevitable that the public finance situation will deteriorate before the end of President AMLO's term.

POLITICAL CONTINUITY

Mexico's attractiveness and competitiveness continue to deteriorate. According to the Mexican institute for competitiveness (IMCO), the competitiveness of the Mexican economy has declined continuously since 2018, and the country has dropped from 31st place to 37th out of a ranking of 43 countries.

According to the IMCO, the country has regressed in 5 out of the 10 categories evaluated (environment, social cohesion, political climate, international relations and innovation). The report also underscores how the numerous gaps between Mexico and the other countries in the selection are getting wider, and can only be absorbed if the country "continually" seeks to attract new investment.

Yet the country's attractiveness is unlikely to improve significantly before the end of the term of President Andres Manuel Lopes Obrador ("AMLO") in 2024. Economic policy will probably remain fairly muddled. Last June's mid-term elections gave the presidential coalition (comprised of Morena, the party of President AMLO, and the two centrist parties PT and PVEM) a simple majority in the House of Deputies, with 275 seats out of a total of 500. Consequently, it should be rather easy to pass the new budget bill without forming a new coalition. Following the elections, the Minister of Finance and the Central Bank Governor were replaced by persons close to the president.

Last July, AMLO announced that he would present the House of Deputies with a constitutional reform project that would guarantee that the Federal Electricity Commission (CFE) has a minimum stake of 54% in the country's electricity production.

This proposal follows numerous initiatives by the president since the beginning of his mandate that aim to control and reduce the private sector's stake in the electricity sector in particular, and in the energy sector as a whole, rolling back efforts to open up the market since 2013. Yet the governing coalition no longer has a qualified majority (two thirds of the seats), so a new coalition would be necessary to pass this reform. Large-scale reforms in other sectors now seem less probable before the end of his term, especially since Mexico's Supreme Court has rejected the vast majority of reform proposals made so far.

All in all, the lack of visibility over economic policy is placing a heavy strain on both domestic and foreign investment (in the energy sector and in other sectors), as well as on the country's attractiveness since the beginning of AMLO's mandate.

ECONOMIC GROWTH SLOWS

After a vigorous recovery between Q4 2020 and Q2 2021, fuelled by a strong base effect but also by the robust rebound in the US economy, Mexico's GDP growth is expected to slow as of Q3 2021. The third wave of the Covid-19 pandemic was extremely severe, with more new cases than during the first two waves, which eroded domestic demand.

Yet health restrictions are gradually being lifted, thanks to the acceleration of the vaccine campaign (35% of the population has received two doses of the vaccine at the end of September, compared to only 15% in early July), and the continuous decline in new cases since mid-August, which should support the services sectors in the last months of the year.

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth (%)	0.1	-8.3	6.0	2.5
Inflation (CPI, year average, %)	3.7	3.4	5.4	4.6
Budget balance / GDP (%)	-1.7	-2.3	-4.4	-3.5
Public debt / GDP (%)	46.4	53.7	52.3	54.5
Current account balance / GDP (%)	-0.2	2.5	0.8	-0.3
External debt / GDP (%)	37.7	41.2	41.8	42.5
Forex reserves (USD bn)	180.0	195.0	201.0	209.0
Forex reserves, in months of imports	3.5	4.3	4.5	4.1

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

INVESTMENT

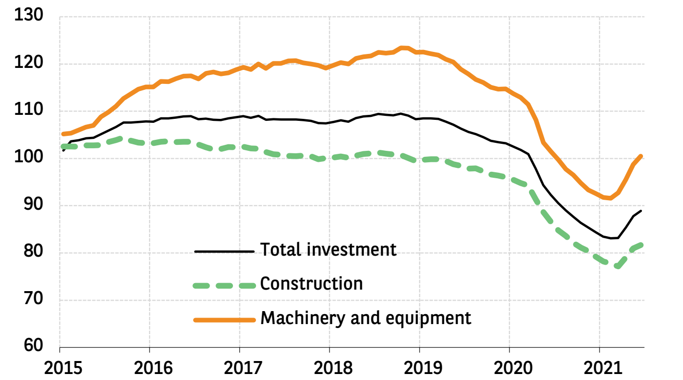

CHART 1 SOURCE: INEGI

Mexico will continue to report "two-speed" growth throughout 2022: domestic demand will remain in a lasting slump, notably due to structurally weak investment and a fragile labour market, while exports are expected to be dynamic throughout the year. All in all, after 6% growth in 2021, GDP is expected to rise only 2.5% in 2022. At this pace, GDP will not return to the pre-Covid level of year-end 2019 before mid-2023, and private investment will not return to the 2019 level before 2024.

At the same time, rising commodity prices and the shocks due to supply chain disruptions are placing upward pressure on inflation. Inflation peaked at 6.1% y/y in April, the highest rate since 2018, before easing to 5.6% y/y in August. In the months ahead, inflation is expected to remain above the central bank's target range of 3%, give or take 1%. At its September meeting, the central bank raised its key rate by 25 basis points to 4.75% (after key rate increases in June and August). The central bank's press release placed emphasis on inflation expectations (currently at 6% for the end of the year), so several more key rate increases are expected in the months ahead.

2022 BUDGET PROPOSAL: PUBLIC FINANCES DETERIORATE IN THE MEDIUM TERM

Like it has since the beginning of President AMLO's mandate, the government continues to give priority to the stability of the public debt ratio. Through the end of his term in 2024, the public debt ratio is expected to hold at about 51% of GDP (the same as in 2021), after peaking at 53.7% of GDP in 2020. The government is targeting a deficit of 3.1% of GDP in 2022 (after 3.2% in 2021). We think it will have a hard time meeting this target, and we are rather expecting a deficit of 4.4% in 2021 and 3.5% in 2022.

Spending will continue to rise as it has over the past three years, which underscores the government's priorities, notably for big infrastructure projects such as the Maya train across the Yucatan and the Tehuantepec Isthmus rail corridor. For the moment, it does not seem to be taking any measures to support private domestic demand, which has been hard hit by the Covid-19 crisis.

As to revenues, the fiscal reform project has been postponed (which rules out any new taxes or increases in existing tax rates), and the government is instead giving priority to improving tax collection and reducing tax evasion (which targets small and very small enterprises in particular).

Another priority is to improve the financial situation of Pemex, the state-owned oil and gas company. It will be difficult to implement the proposed solutions, however, without them having a lasting impact on public finances. The first proposal is to lower the corporate tax rate paid by Pemex from 54% to 40% (compared to 65% in 2019), which would reduce oil revenue as a share of total revenue to 9% in 2021 and 8% in 2022. Several capital injections are also planned: they would have a neutral impact from a financial perspective if they were used to reimburse Pemex's debt, but not if they were used to finance new capital investments. Moreover, since the government has already pledged not to raise taxes, fewer and fewer funds will be available for these capital injections (sovereign funds, for example). Lastly, the government recently announced that it had purchased USD 7 bn in foreign reserves to cover part of Pemex's maturing debt (for a cumulative total of USD 7 bn by year-end 2022), via new capital injections. Once again, this operation will be hard to repeat, since government deposits with the central bank have diminished continually since the beginning of AMLO's mandate.

GOVERNMENT DEPOSITS AT THE CENTRAL BANK

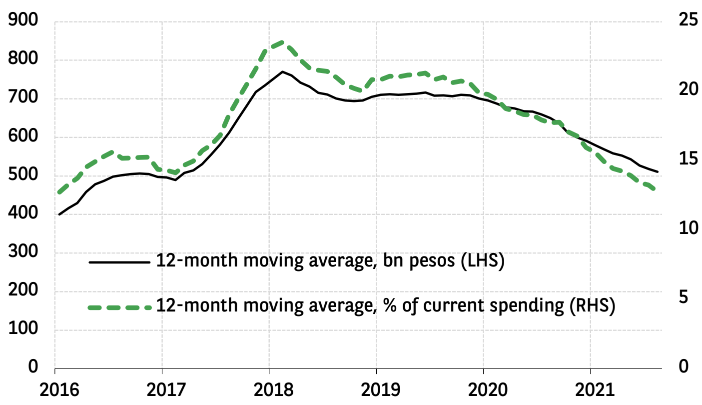

CHART 2

SOURCE: CENTRAL BANK

Lastly, the macroeconomic assumptions retained in the 2022 budget seem to be overly optimistic once again. The government is forecasting GDP growth of 6.3% in 2021 and 4.1% in 2022. It has probably overestimated Pemex's oil production capacity as well. It is forecasting 1.83 m barrel/day in 2022, compared to a forecast of 1.75 m b/d in 2021, and average oil production of only 1.68 m b/d in the first eight months of the year.

To summarise, the government's 2022 budget proposal calls for a structural increase in spending (on infrastructure projects and recurrent support for Pemex, which is probably underestimated), without seeking a veritable increase in revenue. It is also highly likely that spending has been underestimated while revenue increases have been overestimated. Under these conditions, it seems highly unlikely that the country will maintain a balanced budget through the end of AMLO's term. Moreover, Pemex's fragile financial situation is a structural problem that will continue to erode public finances in the future.

Completed on 6 October 2021

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HUNGARY

FULL-FLEDGED GROWTH

Hungary is benefiting fully from a high international trade exposure, which is now driving its growth. Supply-side pressures are increasing, with high capacity utilisation rates and rising scarcity of labour. These local issues come on top of global industrial shortages. This has resulted in a significant acceleration in inflation, to which the Central Bank has responded with its first policy rate increase in 10 years. Nevertheless, monetary policy remains relatively accommodative, as the Central Bank has acquired the equivalent of nearly 5 points of GDP of government debt in 2021. This support is important in a context where access to European funding (including the resilience and recovery plan) remains subject to sticking points (notably the rule of law clause). None of this undermines the two other driving factors behind Hungary's growth: a credit cycle financing a recovery in investment in construction (relatively sustainable, given the limited indebtedness of the private sector) and the attractiveness of the industrial base to foreign investment.

A FAVOURABLE ENVIRONMENT

Hungary is experiencing strong growth and significant inflationary pressure. On both indicators Hungary is near the head of the list of Central European countries.

The recovery in growth comes from a sharp rise in exports, driven by strong foreign demand, particularly in the automotive sector. The rebound in domestic demand has been limited by repeated severe waves of Covid, particularly in the spring of 2021. Household consumption is the only demand driver that has not yet returned to its pre-Covid level; this has been reflected in a higher savings rate (15% in 2020, from 12% in 2019).

This said, the economic situation has some similarities with pre-pandemic patterns, with high capacity utilisation rates and labour scarcities (unemployment rate of 4.8% in August 2021). These supply-side issues are exacerbated by the size of the manufacturing sector against a background of global shortages (particularly for semiconductors). Business confidence surveys show that these shortages are getting worse. Indeed, since the 3rd quarter they have become the main factor inhibiting production of intermediate and capital goods. The construction sector has experienced the same bottlenecks as a result of shortages of labour and materials.

Meanwhile, domestic demand should accelerate. The normalisation of the pandemic situation (with high vaccine participation) will lead households to raise their spending intentions, notably in the area of home improvements.

TIMELY MONETARY CONSOLIDATION

Thus, everything seems to suggest an acceleration in inflation, which reached 4.9% y/y in August. This is already higher than its pre-Covid level. This issue is even more acute for companies, with producer prices up 14.4%.

This led the Central Bank to begin tightening monetary policy in June 2021, for the first time since 2011. Such rarity of monetary tightening actions results from the room to manoeuvre available to the Central Bank, which can tolerate inflation above its target of 3% if inflation can still converge at this level over the medium term. For example, in 2018-19 inflation exceeded 3% in 14 of the 24 months without any intervention by the Central Bank.

The Central Bank made three increases of 30bp, before scaling back the size of the steps with an increase of just 15bp in September (taking the policy rate to 1.65%). This suggests that the Central Bank considered that the bulk of the rate increase had been achieved and that it was now more likely that inflation would return towards 3% over the medium term (end-2022).

However, core inflation has risen over recent months, reaching 4% in September. Against this background, the slowing of the pace of rate rises in September had a direct impact on the forint, which had been relatively stable until this decision, but which lost nearly 3% over the days that followed.

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth (%)	5.1	4.9	-5.8	5.5
Inflation (CPI, year average, %)	2.8	3.0	3.5	3.3
Gen. Gov. balance / GDP (%)	-2.1	-2.0	-6.0	-4.0
Gen. Gov. debt / GDP (%)	70.2	66.3	74.0	73.4
Current account balance / GDP (%)	0.0	-0.8	-2.0	-1.3
External debt / GDP (%)	77.0	78.0	82.0	76.8
Forex reserves (EUR bn)	27.4	28.4	30.0	31.0
Forex reserves, in months of imports	3.1	3.0	3.7	3.4

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

EXPORTS OF GOODS (12-MONTHS SUM, HUF BN)

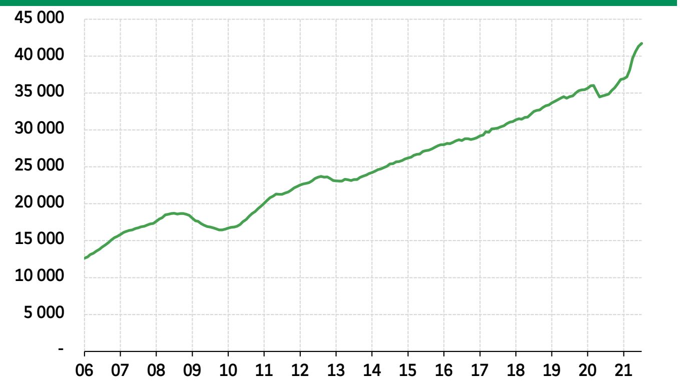

CHART 1 SOURCE: CEIC

UNCERTAINTIES ON FISCAL CONSOLIDATION PATH

Hungary should also be able to consolidate its public finances after the substantial fiscal support provided in 2020 (9.2 points of GDP in direct measures and 4.3 points of GDP in loan guarantees). As a result, the increase in government debt was amongst the biggest in Central Europe (up 15 points of GDP). The Central Bank made a growing contribution to financing this effort, by purchasing government debt in significant quantities: 2.4% of GDP in 2020 and an estimated 5% of GDP for the whole year of 2021.

However, many of the fiscal measures related to the pandemic are likely to be lifted as the situation returns to normal. Alongside this, the Central Bank has started to reduce its weekly purchases (HUF 40 billion from end-September 2021) and is likely to continue in this direction.

The strength of growth is likely to favour fiscal consolidation, even if the government plans to continue to provide considerable support to the economy in 2022 (expected deficit of 5% GDP). Meanwhile, long-term rates have tended to increase more than in other Central European countries, with a 10-year rate of 3.5% on 5 October, an increase of 150 basis points since the end of 2019.

The risk of delays to European funding disbursement under the resilience and recovery plan has increased, including the grants involved. If these are not paid in full, the debt issuance needed to make up the difference could increase Hungary's government debt by nearly 3 points of GDP. This would imply a stabilisation of government debt in 2022 at close to 80% of GDP.

CREDIT RISK UNDER CONTROL

Hungary is still enjoying the benefits of its banking sector consolidation that took place throughout the previous decade. Debt in the non-financial private sector is thus relatively low, and the share of foreign currency debt is contained. However, Hungary entered a credit cycle in 2018, with most notably an increase in residential real estate investment.

The debt repayment moratorium introduced in March 2020 saw much higher participation than elsewhere in Central Europe: 30% of loans to households by value were covered, compared to 20% of the value of loans to companies. This moratorium helped limit credit risk during the pandemic and the banks' non-performing loan rate fell to just 0.9% in the first quarter of 2021. This rate is now likely to rise, as the moratorium has come to an end for the bulk of the loans covered. Central Bank stress tests suggest that it could reach 4% in a negative scenario. The banks have a satisfactory level of capital (CET1 ratio of 17%) and were able to maintain their margins despite the moratorium (ROA of 1.4%). They should thus be able to cope with the potential increase in non-performing loans.

As the economy has reopened, credit growth has resumed, supporting household investment in construction. This growth does not so far appear to have been affected by the beginning of monetary tightening, with households' borrowing capacity remaining high (low indebtedness, strong income growth). Strong demand for real estate could result in an acceleration in price rises (14% y/y in the first quarter of 2021), against a background of shortages in construction materials.

FDI STOCK (HUF BN)

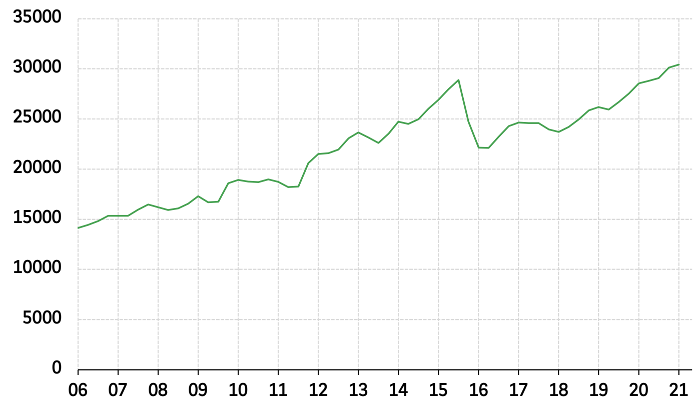

CHART 2
SOURCE: CEIC

ATTRACTIVENESS FOR FOREIGN INVESTORS REMAINS

Hungary is heavily involved in global supply chains. This is true in upstream areas, with the highest rate of Chinese inputs in the European Union. It can also be seen downstream, with the weight of exports in GDP.

The increase in transport costs (notably prices for container transport) and the transformation of supply (increasing use of electronics in the automotive sector) could change the landscape. The prospect of tax harmonisation on an international level could also limit incentives to invest in Hungary (preferential corporate tax rate).

Repeated labour shortages are also a factor limiting potential growth, despite strong and lasting productivity gains (3% per year on average over the last 4 years). In parallel, foreign direct investment continued to remain strong during the pandemic. A more negative factor could arise in case delays or incomplete disbursement of European financing, which has made a significant contribution to the country's development so far.

Completed on 6 October 2021

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TURKEY

GROWTH AND INFLATION ON THE MENU

Turkey is enjoying strong economic growth in 2021, following the credit-driven stimulus implemented in 2020. The cumulative performance over 2020 and 2021 has allowed the country to close the growth gap that resulted from the series of shocks between 2018 and 2020. Investment and the industrial sector have thus regained their previous size. Foreign currency reserves have recovered from the low levels they reached in 2020. Nevertheless, this has come at a price: inflation is running well ahead of levels seen in other emerging economies. As well as common factors (rising prices for oil and other commodities), there are specific country drivers (depreciation of the lira, untimely monetary policy decisions). There may also be an impact on bank balance sheets as measures relaxing the classification of non-performing loans come to an end - this will need to be monitored. In addition to an expansionist credit policy, reforms that benefit corporates and a substantial infrastructure investment programme are also growth drivers.

A RELATIVE NORMALISATION

Turkey has seen a recovery in activity, particularly in industry, that has exceeded all expectations. Economic growth is likely to hit 9.7% in 2021, following a year of positive growth, at 1.8%, in 2020.

The cumulative performance in 2020 and 2021 will have made up for the losses of preceding years when growth followed a boom-bust pattern. Investment, particularly in machinery and equipment, has been the main driver of growth. It contracted following the currency and interest rate shocks of 2018, which hit companies' ability to invest. Growth in investment since the 2nd quarter of 2020 has pushed it above its previous record level reached at the end of 2017.

As a result, industry has returned to the GDP share (24%) that it enjoyed before the mid-2018 crisis, thanks in particular to strong growth in manufactured goods exports since the 3rd quarter of 2020.

Foreign currency reserves have been partially rebuilt. They have returned to their pre-Covid levels, although remaining below these in relative terms (at 3.4 months of imports, from 4.2 months before Covid). Tourist flows have recovered, and are the main driver for improvements in the current account balance. The IMF's allocation of SDRs (USD 6 billion) and new bilateral currency swap agreements with other central banks have done the rest.

INFLATION HAS EMERGED AS THE N°1 PROBLEM

The rebound in Turkey's growth has been driven by a rapid expansion in credit, notably in response to several monetary easing decisions. Although this expansion came mainly in the 2nd and 3rd quarters of 2020, its consequences are still being felt. The investment recovery that it has financed is continuing to drive growth. However, this accommodative monetary policy contributed to a depreciation of the lira in 2020 (combined with the high current account deficit), which is now feeding through to inflation.

A TRY depreciation of 10% adds 1.9 points to inflation after two months, and has a cumulative impact of nearly 3 points after 12 months *(Eco-Conjoncture*, January 2021).

Turkish inflation has also been exacerbated by higher prices for oil, food and most industrial commodities (particularly metals and plastics). In September 2021 the year-on-year increases in producer prices and consumer prices were 44% and 19.6% respectively.

The transmission of higher imported prices to domestic prices is even greater than in other economies, including emerging economies. This shows that corporates have a tendency to price their goods in foreign currency or with reference to a foreign currency equivalent, a characteristic of high-inflation countries where monetary policy is not considered credible enough by markets and companies.

The 100 bp cut in the policy rate announced on 23 September 2021 by the Central Bank is an illustration of this. It followed a reduction in the current account deficit and an increase in foreign currency reserves, which gave the central bank more room to manoeuvre. However, this

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth (%)	0.9	1.8	9.7	3.5
Inflation (CPI, year average, %)	15.2	12.1	17.2	14.0
Gen. Gov. balance / GDP (%)	-3.5	-4.8	-1.3	-2.7
Gen. Gov. debt / GDP (%)	32.7	39.8	38.9	39.6
Current account balance / GDP (%)	0.9	-5.2	-2.8	-3.7
External debt / GDP (%)	57.1	61.0	55.6	48.2
Forex reserves (EUR bn)	79.0	50.0	77.0	69.0
Forex reserves, in months of imports	4.2	2.6	3.4	2.6

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

INFLATION RATE (%)

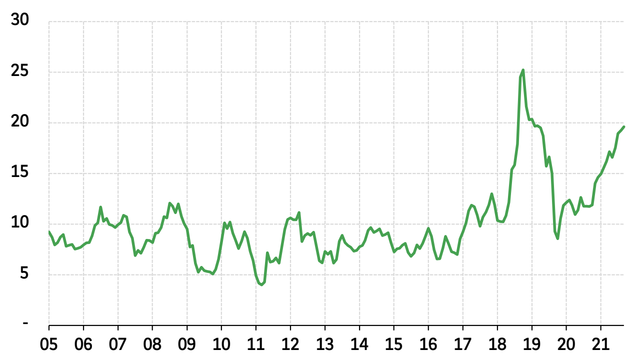

CHART 1 SOURCE: CEIC

move seems to lean against the wind as inflation pressures did not abate and other central banks are embarking on a tightening mood. This gap should become more critical as we move towards a tightening of monetary policy in the US. With high inflation and a structural external deficit, Turkey is one of the countries vulnerable to such a move, as seen in 2013 and 2018. In addition, there is an issue for all economic actors whose incomes are not indexed to prices.

HIGHER DEBT IN ABSOLUTE TERMS, BUT UNDER CONTROL IN RELATIVE TERMS

Strong nominal GDP growth should help stabilise the government debt-to-GDP ratio earlier than expected at below 40%, whilst the fiscal deficit should come down to 1.3% of GDP.

Similarly, corporates' turnover growth has also been very strong (72% in the first half of 2021, relative to the first half of 2019 in both industry and trade sectors). As a result, aggregate corporate debt ratios have stabilised despite credit growth in 2020 (35%).

This increase in credit has not so far resulted in an increase in lending risk for banks, due to flexibility in the classification of non-performing loans (extension of the late payment from 90 days to above 180 days to be considered non-performing). However, this measure came to an end in September. The non-performing loan ratio is likely to deteriorate (it was 3.7% of total loans in July 2021), with a potential increase of 1.8 points (corresponding to loans in arrears of between 90 and 180 days).

Credit expansion has helped keep afloat companies despite bumpy economic conditions. It has come along with government guarantees on the borrowings of these companies and a law that allows for the restructuring of debt. Nearly TRY 56 billion in loans had been restructured by end-May 2021, and the scheme has been extended until mid-2023. Meanwhile, the increase in the number of companies in liquidation has remained under control: 15,300 over the 12 months to end-August 2021, compared to 13,800 before the restructuring law came into force.

Moreover, having slowed since the beginning of the year, credit is now growing again, albeit less rapidly than in 2020: TRY 7 billion of new loans per week were issued in Turkisk lira over the last three months (figures to mid-September), compared to an average of TRY 20 billion per week in the 2nd quarter of 2020. Before the policy rate cut on 23 September, the central bank reduced all reserve requirement ratios on TRY deposits by 200 bp at the beginning of July.

INCREASED POTENTIAL GROWTH?

Turkey has generated growth with a lower current account deficit than prior to 2017 (excepting 2020, which was highly unusual). This rebalancing between domestic savings and investment flows suggests less reliance on capital flows.

However, the rebalancing came during a period of weak growth in 2018 and 2019. The reduction in investment weighed on potential growth. The rebound of investment since mid-2020 grounds to hope for an improvement in this potential.

Reforms have also helped. The number of procedures required to set up a company has been reduced since 2018. New business creations have hence increased rapidly, growing by as much as 20% in 2020 relative to 2019. This trend has come alongside the growing digitalisation of the economy, most visible in the 21% average annual increase in on-line bank accounts over the past three years, taking the total to 71 million in June 2021.

NEW LOANS IN LOCAL CURRENCY (TRY BN, 3-MONTHS MOVING AVERAGE)

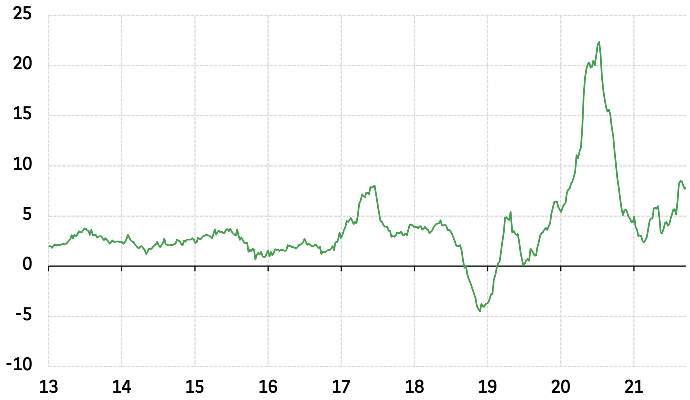

CHART 2

SOURCE: CENTRAL BANK OF TURKEY, BNP PARIBAS

At the same time, new loans have financed a number of companies involved in public-private partnerships, which have been worth a cumulative total of USD 134 billion over the last 20 years. These partnerships are used to develop the government's priority infrastructure (Istanbul Airport, the new canal providing an alternative route to the Black Sea Straits, the TurkStream gas pipeline). Infrastructure is a necessary condition for a lasting increase in potential growth, but is not in itself sufficient. Other types of investment, particularly in human capital, must follow to enable an increase in productivity, something that has not been largely observed over the past decade.

Completed on 6 October 2021

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EGYPT

POSITIVE SHORT-TERM PROSPECTS

Economic growth remained rather strong in FY 2020/21 thanks mainly to the dynamic momentum of household consumption and the moderate support of public spending. This bolstered the retail and construction sectors. Through cautious management of public finances, the government reported a slightly smaller fiscal deficit in FY 2020/21, and it should continue to report an improvement this year despite possible upward pressures on current expenditures. The main obstacle to a more ambitious fiscal policy lies in the government's debt service, which despite better financing conditions, will only narrow very gradually. As to the external accounts, there is not only the question of the attractiveness of Egyptian debt at a time when the US is expected to begin tightening monetary policy, but also the vulnerability of the current account deficit, which is subjected to the rigidity of imports, higher commodity prices and an uncertain recovery in tourism.

BUOYANT HOUSEHOLD CONSUMPTION

Real GDP growth maintained a rather rapid pace in fiscal year 2020/21 (+3.3%), thanks to the support of household consumption. This is a notable performance compared to other emerging countries, especially considering the troubles the tourism sector is having in the midst of the pandemic.

Private consumption has not contracted for a single quarter since early 2020. Lockdown restrictions due to the Covid-19 pandemic were very short-lived and had only a limited impact on activity. Household lending (excluding real estate loans) remains very strong. It has increased at an average rate of more than 30% year-on-year since the end of 2019, to about 8.5% of GDP in June 2021 (vs. 6.7% at year-end 2019). In real terms, lending has grown significantly since mid-2019 (over 20% y/y) as inflation has eased. At the same time, remittances from Egyptian expatriates (mainly in the Gulf countries) were very high in FY 2020/21, despite the tough economic situation in the Gulf in 2020 and the acceleration in labour market nationalisation policies. Remittances increased 13% in FY 2020/21 to a total of USD 31.4 bn, or about 40% of current account revenue. This growth seems to be linked to asset sales by expats leaving the Gulf region, and financial transfers that had to pass through official channels due to travel restrictions between countries. Moreover, although fiscal policy support is still moderate, targeted government subsidies helped boost the revenue of low-income categories of the population.

In contrast, investment trends continue to weigh on economic activity (down 50% y/y in the first three quarters of 2020/21), after a 20% decline in FY 2019/20. This is mainly due to an 80% decline in investment in the hydrocarbon sector (about 18% of total investment).

From a sector perspective, buoyant household consumption benefited the retail sector. Unsurprisingly, construction (+6.8% in 2020/21) and the real estate sector (17% of GDP altogether) also fuelled growth, bolstered by major urban and infrastructure projects. In contrast, the manufacturing sector (16% of GDP) contracted 5.8% over the course of FY 2020/21.

In the short term, we expect growth to accelerate to 5.6% in FY 2021/22. Leading economic indicators have rebounded since June 2021. The industrial output index has accelerated rapidly since the end of Q1 2021, while mobility indicators have shifted into recovery territory since June. Moreover, the FY 2021/22 budget calls for an increase in public-sector wages and pensions. As to tourism, tourist frequentation should increase very gradually as some existing travel bans are lifted and as the global pandemic possibly begins to ebb.

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth (%)	5.6	3.5	3.3	5.6
Inflation (CPI, year average, %)	13.4	5.6	4.5	5.9
Central. Gov. balance / GDP (%)	-8.0	-8.0	-7.4	-6.9
Central. Gov. debt / GDP (%)	84	90	94	94
Current account balance / GDP (%)	-3.6	-3.1	-4.2	-2.8
External debt / GDP (%)	36	34	36	37
Forex reserves (USD bn)	45	38	41	42
Forex reserves, in months of imports	8.0	6.1	6.2	6.9

(1): FISCAL YEARS FROM JULY 1ST OF YEAR N TO JUNE 30TH OF YEAR N+1
e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

REAL GDP GROWTH (CONTRIBUTIONS, %)

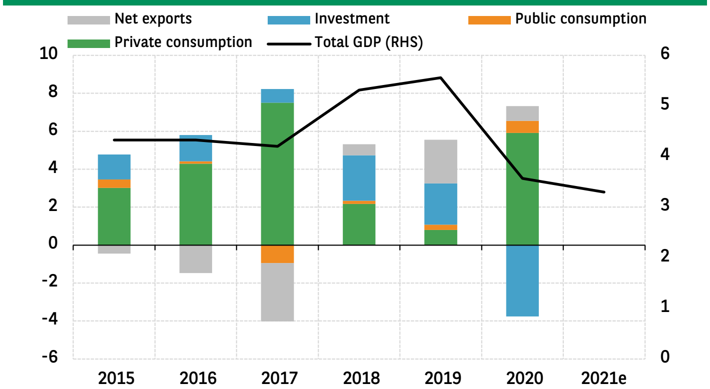

CHART 1 SOURCE: MINISTRY OF PLANNING, BNPPARIBAS

FISCAL CONSOLIDATION CONTINUES

In a relatively dynamic economic environment, limited fiscal support measures (about 2% of GDP, only part of which was actually spent) have mainly targeted low-income families and the sectors with the highest exposure to the consequences of the pandemic. At the same time, some exceptional taxes have helped buffer the economic slowdown's impact on government revenues. From a more structural perspective, fiscal revenues have also benefited from measures to improve tax collection since 2019, including the automation and digitalisation of some tax payments, and the expansion of the tax base. According to government sources, these measures contributed about 15-20% of the increase in fiscal revenues observed in the first three quarters of 2020/21. Altogether, revenues increased by 15% over the same period.

Total expenditures rose only 11%. As a result, the primary fiscal balance will remain positive in FY 2020/21 (equivalent to about 1.4% of GDP), which will help reduce the fiscal deficit given the quasi stability of the interest charge (+1% in the first three quarters of 2020/21). The full-year deficit is estimated at 7.5% of GDP, compared to 8% in FY 2019/20. Debt service continues to place the biggest strain on public finances. Although it declined slightly, to about 54% of total fiscal revenues (from 58% in FY 2019/20), it is still very high and sharply curtails the manoeuvring room of public policies.

Given higher economic growth, the fiscal deficit should continue to narrow in FY 2021/22 (to an estimated 6.8% of GDP), despite an increase in the public sector wage bill. This scenario has some downside risks, notably pricing trends for agricultural commodities and energy. Food subsidies, which account for 5% of total fiscal spending, increased by more than 10% in the first nine months of FY 2020/21. Egypt is the world's leading importer of wheat, and prices on the global market have risen 11% since end-June 2021. The impact of higher oil prices is less obvious since subsidies on petroleum-based products were officially eliminated in 2019. Yet the official quarterly fuel indexation mechanism for retail sales prices (within a limit of 10%) may be not fully in line with the trend in international market prices. Given the expected 40% increase in oil prices in 2021/22, an insufficient adjustment of sales prices could generate extra costs for public finances.

Debt service should continue to decline, albeit at a slower pace. The central bank is expected to end its monetary easing cycle, which should maintain bond yields in local currency at high levels. Longer maturities in the local market (there have been more net issues of T-bonds than T-bills since 2018/19) and the issue of medium to long-term international debt in foreign currency is positive for debt dynamics. According to the IMF, the average maturity of the debt stock was 3.38 years in February 2021 compared to 2.1 years in June 2016. Yet given the slope of the yield curve for debt issues in the local currency (230 bp yield spread between 1-year T-bills and 5-year T-bonds at end-September 2021), debt servicing will only be reduced very gradually.

EXTERNAL VULNERABILITY IS MANAGEABLE IN THE SHORT TERM

Thanks to IMF support in 2020, regular Eurobond issues, and portfolio investment inflows in 2021, foreign-currency liquidity has reached a satisfactory level. Central bank reserves amounted to USD 40.7 bn at the end of August 2021 (USD 53 bn including Tier II reserves), the equivalent of 6.1 months of imports of goods and services. Even so, this figure is about USD 5 bn less than at year-end 2019. The downside risks to external liquidity seem limited in the short-term given the attractiveness of Egyptian debt (in real terms, the yield on 10-year bonds is currently 9.2%). Yet the country still has significant external financing needs (more than USD 30 bn if we take into account public sector short-term debt held by non-residents, and assuming that the Gulf countries will renew their deposits with the central bank), and vulnerabilities persist. The current account deficit is high (estimated at 4.2% of GDP in FY 2020/2021, or more than USD 16 bn) due to the rigidity of imports and the slump in tourism frequentation.

CURRENT ACCOUNT (% OF GDP)

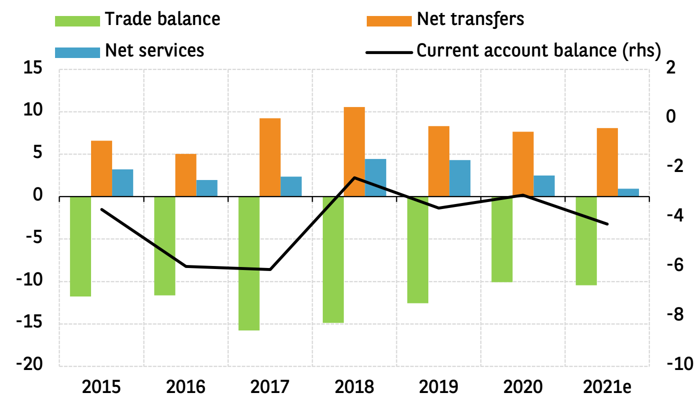

CHART 2 SOURCE: CENTRAL BANK OF EGYPT, BNPPARIBAS

In the short term, accelerated growth should favour a rise in imports, while tourism frequentation will gradually pick up. Higher oil prices should widen the deficit on the energy accounts. The sustainability of LNG export growth observed since mid-2020 must still be confirmed. In FY 2021/22, the current account deficit should reach 4.4% of GDP. Foreign direct investment declined 19% in Q3 2020/21, and we are maintaining a conservative estimate of FDI inflows in 2021/22 (equivalent to 2% of GDP). Given the mixed prospects for FDI, a key factor for external liquidity will be to maintain a high volume of government debt held by non-residents (which is volatile by nature). Lastly, the central bank's determination to limit exchange rate volatility potentially could be costly in terms of foreign currency, as was the case in early 2020. This makes it difficult to estimate the acceptable level of the central bank's foreign reserves.

Completed on 6 October 2021

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U.A.E.

AN UNEVEN ECONOMIC RECOVERY

The United Arab Emirates (UAE) was hit by a twin shock with the fall in oil prices in 2020 and the pandemic's impact on the services sector. The 2020 recession was severe, and the recovery this year is expected to be mild. Despite the positive prospects of the World Expo, Dubai's economic activity will continue to be restrained by structural difficulties in the real estate market and uncertainty in the tourism and logistics sectors, which are unlikely to return to normal before 2023. Against this backdrop, public finances and the external accounts remain very favourable thanks to the accumulation of years of surpluses, but credit risk is on the rise. Some government-related entities active in the real estate sector are experiencing difficulties, and government support will remain selective.

A GRADUAL ECONOMIC RECOVERY

Of the Gulf countries, the United Arab Emirates (UAE) was the economy hit hardest by the double shock of the fall in oil production and prices, and the impact of the Covid-19 pandemic on the services sector. Real GDP contracted 6.1% in 2020 due to a decline of roughly 6% in hydrocarbon GDP (about 30% of total GDP) and non-hydrocarbon GDP. As OPEC's third largest oil producer, the UAE accounts for 10% of the cartel's total oil production. Under the restrictive policy of OPEC+ producers, oil production was cut back by 7.5%. The Covid-19 pandemic had a massive impact on logistics (down 16%) and retailing (down 13%), which account for 6% and 13% of GDP, respectively. In construction and real estate, which together account for 14% of GDP, activity contracted 9%. Most of the country's non-hydrocarbon activity is concentrated in Dubai, which accounts for about 30% of UAE GDP. With the downturn in retailing (-12%), restaurant services (-33%) and logistics (-36%), Dubai's GDP contracted 11%.

In 2021, GDP growth in the UAE is expected to reach 2.0%. This sluggish recovery is due in part to the decline in hydrocarbon GDP (-2.8%) for the second consecutive year. Oil production has picked up since June, but only gradually, and current production levels (2.8m b/d in September 2021) are still far from that of April 2020 (3.7m b/d). As to non-hydrocarbon activity, leading indicators are still mixed for H1 2021, and the situation will not change fundamentally with the opening of the Dubai World Expo in October. Despite one of the world's most extensive vaccination campaigns, mobility indicators are still barely higher than pre-pandemic levels. In Q1 2021, Dubai's GDP contracted 3.7% due to an ongoing decline in logistics (-32% y/y), and despite a mild rebound in retailing (+2.8% y/y). At 30 June 2021, passenger arrivals at the Dubai airport were down 70% year-on-year. Over the same period, the number of building completions was down 41%. Tourism picked up over the summer months and the opening of the Dubai World Expo over the next six months should add to this momentum.

The economic recovery is not expected to consolidate before 2022. Hydrocarbon GDP growth is estimated at about 7% thanks to the ongoing increase in oil production, but also the upward revision of the UAE's production quota within OPEC. Although the UAE has major oil production capacity (4.2m b/d), it is worth being cautious about oil market trends since demand is uncertain, and non-Opec+ oil producers could increase their production. The expected increase in oil prices should benefit the non-hydrocarbon economy, notably the real estate sector. With the gradual decline in the pandemic's restrictive grip on travel, non-hydrocarbon GDP should increase by 3.2%. All in all, GDP growth in the UAE is likely to reach 4.4%. Yet there are still major downside risks. If the pandemic persists, it could have a negative impact on global oil demand and tourist traffic. The logistics sector activity is expected to be constrained for several more quarters due to the disruptions in world trade. As a result, business is not expected to return to normal before 2023.

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth (%)	3.4	-6.1	2.0	4.4
Inflation (CPI, year average, %)	-1.9	-2.0	-0.1	0.9
Gen. Gov. balance / GDP (%)	0.6	-5.5	1.8	2.5
Gen. Gov. debt / GDP (%)	17	16	17	18
Current account balance / GDP (%)	8.9	5.8	6.8	7.6
External debt / GDP (%)	66	66	67	68
Forex reserves (USD bn)	107	103	109	123
Forex reserves, in months of imports	40	46	46	50

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

REAL GDP GROWTH (%)

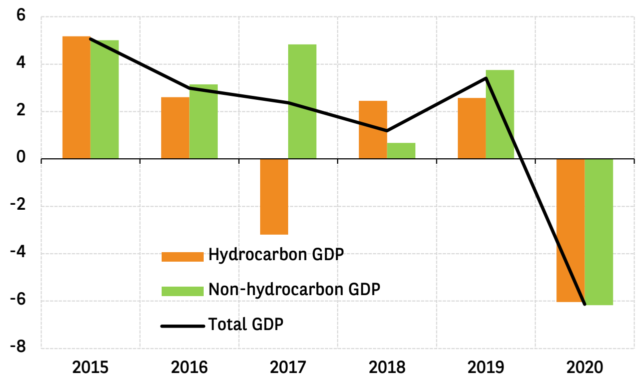

CHART 1

SOURCE: FEDERAL COMPETITIVENESS AND STATISTICS CENTRE, BNP PARIBAS

In the medium term, the hydrocarbon sector should benefit from the investment plan announced by the national oil company ADNOC, which plans to invest massively over the next five years (a total of USD 122 bn, the equivalent of 40% of hydrocarbon GDP each year) to increase its oil and gas production capacities and to boost petrochemical production.

In the non-hydrocarbon sector, prospects are not as clear. For several years, Dubai has been caught in a lasting crisis in the real estate sector. Due to a structural oversupply, transaction prices and rent have fallen constantly since 2015. Passenger traffic growth at the Dubai airport has also been constantly losing momentum since 2015 (+4.3% on average in 2015-19, vs. +11.2% in 2009-14), and it has slipped into negative territory since June 2019. Looking beyond the cyclical influence of the hydrocarbon sector, this downturn could signal Dubai's relative loss of attractiveness as a destination. Airport traffic trends at Dubai have fallen short of global passenger traffic growth since 2019. Generally speaking, since 2020, the authorities have engaged in a programme to improve the UAE's attractiveness for companies and residents alike at a time of growing regional competition.

SOLID MACROECONOMIC FUNDAMENTALS

Despite the sharp contraction in GDP growth, the fiscal and external accounts have not deteriorated much. In 2020, according to our estimates, the fiscal deficit amounted to about 5.5% of GDP. Accounting for about 45% of total revenue, hydrocarbon revenue fell by a third as oil production and prices plummeted. Total spending contracted by about 15% despite specific economic support measures, equivalent to about 2% of GDP. The UAE is expected to report a slight surplus in 2021 (1.8% of GDP) thanks to a significant increase in hydrocarbon revenue and a mild increase in spending. Yet this still falls far short of the pre-pandemic level of 2019.

Public solvency is bolstered by the moderate level of consolidated government debt (36% of GDP in 2020) and by very large sovereign wealth funds (more than twice GDP), the majority of which are held by the Emirate of Abu Dhabi. Each emirate is fiscally autonomous (excluding defence and security budgets, which are federal) and can issue debt in the international markets. Since 2020, a total of about USD 25 bn has been issued by the Emirates of Abu Dhabi (USD 20 bn, or about 10% of Abu Dhabi's GDP), Sharjah (USD 2.3 bn, or 7.4% of GDP) and Dubai (USD 2.9 bn, or about 2.8% of Dubai's GDP). Abu Dhabi's bond issues go beyond the financing of any fiscal deficits or the rollover of maturing debt. Thanks to regular bond issues, they serve as a benchmark for other issuers. As to Dubai, part of its financing is used to support certain ailing state-owned enterprises (notably in the transport sector). Moreover, for the first time, the federation issued an international bond in October 2021 for a total amount of USD 4 bn. The federation has been authorised to call on market funds only since 2019. It should finance infrastructure projects.

The external situation is very comfortable, with high and recurrent current account surpluses, even during downturns in the oil cycle. These surpluses have averaged 7% of GDP since 2016, and we are forecasting a surplus of 6.8% of GDP again this year. Foreign reserves are currently equivalent to about 4.5 months of imports of goods and services.

PERSISTENT CREDIT RISK

The exposure of banks to the sectors hit hardest by the economic slowdown has had a negative impact on the quality of loan portfolios. At the federation level, the non-performing loan ratio rose to 8.2% in June 2021 (according to the IMF), the highest among the Gulf countries, up from 6.5% at year-end 2019. In Dubai, a number of real estate developers are experiencing financial troubles and have begun to renegotiate their debt, which could lead to partial defaults. The construction and real estate sectors accounted for 20% of domestic loans outstanding in June 2021.

COMMERCIAL BANKS' BALANCE SHEET: MAIN ITEMS (YOY, %)

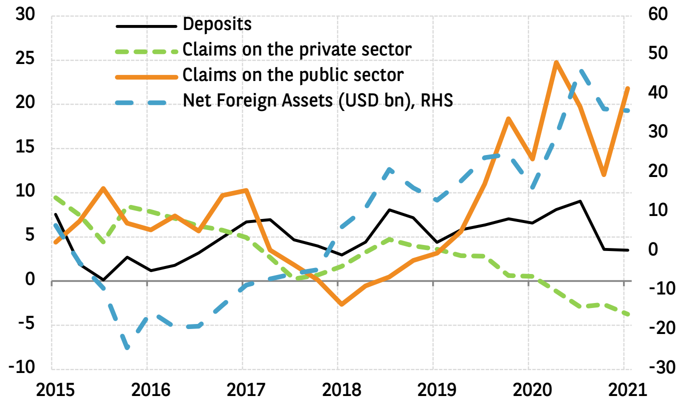

CHART 2

SOURCE: IMF, BNP PARIBAS

The increase in credit risk is not a systemic risk. Bank liquidity is still comfortable given the slow growth of domestic lending and the increase in deposits (+1.1% in June 2021). Lending to the private sector (70% of domestic lending) was down 2.1% y/y in June 2021 (-1.6% for domestic lending). With the slowdown in lending and the upturn in government deposits thanks to the improvement in the oil cycle, the net external position of the banking sector shows a significant surplus: USD 36 bn in March 2021, up from USD 16 bn in March 2020. The central bank has set up measures to support the banking sector: liquidity injections, the easing of certain prudential standards, and key rate cuts (by 125 bp in 2020). In general, although systemic banks can be assured of receiving federal support if needed, support is more selective for the government-related entities (notably in the real estate sector), which fall under the responsibility of the federated governments, which have more limited resources.

Completed on 6 October 2021

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ALGERIA

SOME RESPITE BUT NO RALLY

Algeria has not pulled out of the crisis yet, but it is no longer in the danger zone. Real GDP growth swung back into positive territory in Q1 2021, and external pressures have eased considerably. The factors behind these improvements are essentially cyclical, however, starting with the upturn in oil prices and strong European demand for natural gas. But this will not be enough to balance public finances. The vaccination campaign has not advanced enough to rule out the emergence of a new wave of contaminations. Against this backdrop, parliament just adopted the new government's action plan. Although diversification efforts are highlighted once again, the lack of quantified targets and a precise timetable throws doubts on their implementation. Moreover, some economic policy decisions suggest that the authorities are still caught up in emergency management at the risk of putting off much-needed adjustments and even aggravating imbalances (notably monetary).

EXTERNAL ACCOUNTS: PRESSURES EASE

For the first time since April 2015, forex reserves increased by USD 2.4 bn in August (chart 1). Granted, this is largely due to the IMF's allocation of USD 2.7 bn in special drawing rights (SDR). Yet this stabilization also comes from the current improvement in external trade dynamics. The trade deficit was slashed to less than USD 1 bn in the first eight months of 2021, compared to USD 7.6 bn in the year-earlier period. In addition to soaring oil prices, Europe's strong demand for natural gas is also driving hydrocarbon exports at a time when several development projects are reaching completion. According to JODI statistics, natural gas production and exports rose 28% and 76% YoY, respectively, at the end of July. Although it is difficult to extrapolate these trends, notably due to seasonal factors, natural gas export volumes could reach a record high for the decade. This would help offset some of the shortfall imposed by the OPEC+ oil production quotas, assuming the latter are regularly raised. All in all, hydrocarbon exports are expected to rise to more than USD 33 bn in 2021, up from USD 20 bn in 2020. Excluding hydrocarbons, exports more than doubled during the first eight months of the year, a performance that is worth pointing out, even though it must be kept in perspective given their low weighting as a share of foreign trade (12% of total exports).

At the same time, imports are holding at a low level. Although they rose 8% at the end of August compared to the same period in 2020, they were still 20% lower than in 2019. Reducing imports is a top priority of the government's policy, whether by tightening non-tariff measures or through the depreciation of the exchange rate. Since the beginning of 2020, the dinar has lost 13% in value against the dollar and 17% against the euro. Yet the spread with the exchange rate on parallel market is still higher than 30%, which suggests that the overvaluation of the dinar is far from being corrected. The reduction in imports is due above all to sluggish economic activity. The fall in imports of machinery and equipment accounted for more than half of the decline in 2020.

All in all, the current account deficit should narrow to less than 5% of GDP this year, after swelling to nearly 13% of GDP in 2020. External liquidity will continue to erode, albeit at a much slower pace. Forex reserves fell to USD 49 bn at year-end 2020, compared to USD 180 bn at year-end 2014, and they should shrink by another USD 6 bn in 2021. That is three times less than during the past four years. Moreover, FX reserves are still comfortable at 14 months of imports of goods and services, and should remain so in the short term, assuming that oil prices hold above USD 70 a barrel. In other words, the risk of a balance of payments crisis in the short term has reduced.

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth (%)	0.8	-4.9	3.5	2.4
Inflation (CPI, year average, %)	2.0	2.4	5.2	4.8
Gen. Gov. balance / GDP (%)	-9.8	-14.4	-9.6	-9.7
Central. Gov. debt / GDP (%)	45.8	53.4	58.7	64.8
Current account balance / GDP (%)	-9.9	-12.8	-4.9	-5.7
External debt / GDP (%)	2.7	3.5	3.5	3.8
Forex reserves (USD bn)	62	49	43	36
Forex reserves, in months of imports	13.8	13.8	11.0	8.8

e: ESTIMATES & FORECASTS

TABLE 1

SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

FOREX RESERVES

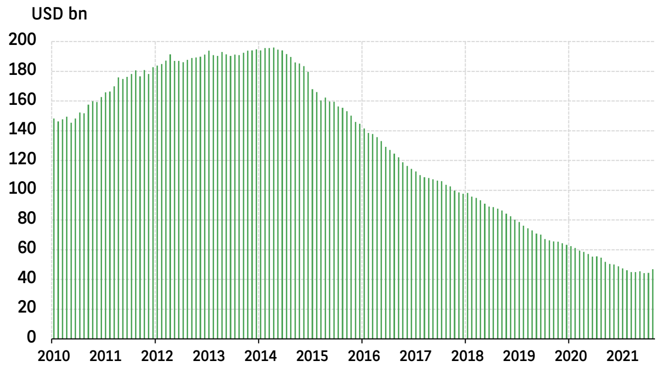

CHART 1

SOURCE: IMF

PUBLIC FINANCES: STILL A LONG WAY TO GO

The public finances situation, in contrast, continues to be worrisome. Despite adjustment efforts to face up to the drop in oil revenue (40% of total revenue before the crisis), the budget deficit widened considerably in 2020 to more than 14% of GDP (according to our estimates). Yet given the orientations of the 2021 finance bill, we do not foresee a major rebalancing. Based on the hypothesis of oil prices of USD 45 a barrel, the government can obviously count on extra revenues (about 4% of GDP). But with spending up 10%, three quarters of which is due to higher current expenditures, the budget deficit is estimated at more than 5% of GDP. We must also add 4 points of GDP for net transfers and loans to support ailing state-owned companies and to cover the financing needs of the National Pension Fund. All in all, public finances are expected to report a deficit of about 10% of GDP in 2021, whereas most of the region's other oil-exporting countries are expected to virtually balance their accounts.

Consequently, debt will swell rapidly again. The increase in debt ratios in 2020 was mainly due to the contraction of GDP. About two thirds of financing needs were covered by transfers from the Treasury's current account with the central bank, a large part of which came from the 2017-2019 direct monetary financing programme. Since this account dried up, the authorities decided to proceed with a new, more indirect monetary financing mechanism starting on 1 July 2021, via open market operations amounting to DZD 2,100 bn (about 10% of GDP) spread over 12 months. At first sight, that should suffice to finance the deficit, but that does not solve the problem of the shallowness of the capital market, nor the structural imbalance of public finances. Government debt is expected to approach 60% of GDP at the end of this year, compared to only 7% of GDP in 2014. However, the debt is still fundamentally captive in so far as the central bank finances the State at real negative rates with long maturities. Moreover, there is virtually no foreign currency debt.

OUTLOOK: TOWARDS A SLUGGISH RECOVERY

Despite the expected increase in public spending and a more favourable external environment, the economic recovery will be slow. After four quarters of contraction, the Q1 rebound is certainly good news, but it must be kept in perspective. First, it was very moderate at only 2.4% year-on-year (chart 2). Second, it is largely due to the increase in natural gas production. Excluding hydrocarbons, GDP rose only 1.4%.

There are still major headwinds. Although the vaccination campaign has accelerated in recent weeks, it has not advanced enough to rule out another wave of Covid-19 cases like the one that swept the country last summer. At the end of September, only 20% of the population had received a first dose of the vaccine. Moreover, inflationary pressures have intensified since year-end 2020 and peaked at 7.2% in March 2021 due to surging food prices (+9.7%; 43% of the consumer basket). Although they have eased somewhat since, inflation still averaged 5.7% in the first six months of the year (compared to 2.4% in 2020), and sources of risk are numerous. In addition to the impact of the dinar's depreciation, monetary factors could come into play (acceleration of money supply growth since the beginning of the year to 12% at the end of July due notably to the upturn in oil and gas revenues, liquidity injections by the central bank since mid-2021).

Above all, the Covid-19 shock triggered a 4.9% recession in 2020, hitting an economy that was already weakened. Since 2017, the growth of real GDP per capita is negative and investment rate of the private sector has continued to fall. The efficiency of public spending to stimulate growth is now weak. The same can be said about the central bank's support measures, which the authorities just announced will be extended until year-end 2021. The easing of monetary policy and prudential constraints will undoubtedly help preserve the stability of the financing system, although it will not boost lending activity. At the end of July, bank lending to the private sector and to state-owned companies was still growing at a slower pace than inflation.

SECTORAL CONTRIBUTION TO GROWTH

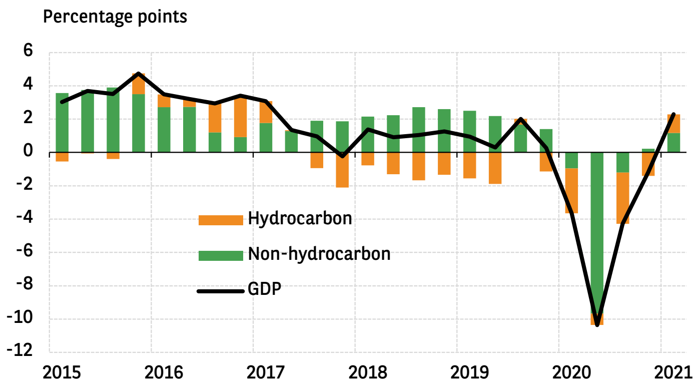

CHART 2

SOURCE: ONS, BNP PARIBAS

Under this environment, we expect economic growth to reach only 3.5% in 2021 before slowing to 2.4% in 2022. Thereafter, the dynamics of growth will be closely correlated with the authorities' ability to reform a system with severe imbalances. Parliament has just adopted the action plan presented by the new government. Once again, it highlights diversification efforts, but the lack of quantified targets and a precise timetable throws doubts on their implementation. At a time when oil prices are rising again, there is also a big risk that the authorities will postpone much-needed fiscal adjustments.

Completed on 6 October 2021

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ETHIOPIA

A NO LONGER ROARING TIGER

In Ethiopia, the coronavirus pandemic triggered an economic crisis that has jeopardised the country's development model of the past decade. Belated reforms, major logistics costs and a shortage of foreign currency have sharply slowed economic modernisation. Civil war in the Tigray region also threatens the country's political stability and worsens the humanitarian crisis. With no resources, Ethiopia lacks the means to face up to the pandemic's economic fallout, and is still highly dependent on international aid. The ratio of foreign currency debt to export receipts has become excessively high. The country has requested foreign debt treatment as part of the G20s' common framework for debt restructuring. Yet the diplomatic crisis with international partners is currently delaying its implementation.

A VERY FRAGILE DEVELOPMENT MODEL

Despite a decade of economic modernisation based on an industrialisation strategy, Ethiopia has failed to withstand the shock of the pandemic. The government's development model promoted the creation of industrial parks managed by the State that offered low taxation and very low labour costs. In reality, the tax-exempt zones presented major logistical problems (such as hooking up to water and power networks), a very high employee turn rate, and poor productivity.

According to central bank data, real GDP growth slowed to 6.1% in 2020, from 9% the previous year, despite the support of public spending (see chart 1). On the supply side, agriculture was the only sector that increased its contribution to growth (1.4%, vs. 0.9% in 2019) thanks to bumper harvests. Already hampered by the irregular supply of electrical power, industrial production and construction activity had to be suspended. No lockdown was officially imposed due to the pandemic, but travel restrictions enforced as part of the state of emergency clobbered the commercial sector. Transport and tourism were hit hardest after flights were suspended.

The recessionary impact of the pandemic will continue to be felt in 2021, with growth estimated at only 2%. Although the state of emergency was lifted in September 2020 after lasting five months, household consumption will remain depressed due to persistently high inflation pressures. Despite the decline in exports, the current account deficit will continue to narrow due to sluggish imports. At the same time, however, direct investments will continue to contract. The fiscal deficit is bound to widen with another increase in healthcare spending. The Minister of Health just confirmed the presence of the Delta variant in Ethiopia, which is spreading rapidly due to the low vaccination coverage. Uncertainty caused by the pandemic is straining growth prospects. Efforts to fight poverty are likely to be brought to a halt. In particular, food risks have been exacerbated by disruptions in the agricultural sector due to a massive invasion of crickets.

RISK OF DEBT DISTRESS

Exports of textiles and horticultural products were hard hit by the pandemic. Delays in privatisation projects reduced foreign direct investment (to 2.6% of GDP in 2020, compared to about 5% before the pandemic). As a result, foreign reserves have tended to dwindle since 2019. Pressures have increased on the local currency (the birr), and low foreign reserves have left the country highly dependent on international aid. The ratio of foreign public debt to GDP was 35% in 2021, but nearly 200% relative to export receipts. External debt servicing rose to 26% of export receipts (compared to 17% in 2015) after concessional loans expired. Today the country is mired in an excessive debt situation.

Ethiopia has officially requested debt restructuring from the G20 countries as part of the common framework for debt treatment[1]. The World Bank and IMF concluded that Ethiopia's debt was sustainable but that rescheduling its foreign debt payments would reduce the risk of

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth (%)	9.0	6.1	2.0	8.7
Inflation (CPI, year average, %)	15.8	20.4	21.7	19.0
Government balance / GDP (%)	-2.5	-2.8	-3.3	-3.0
Government debt / GDP (%)	57.7	59.7	61.7	60.4
Current account balance / GDP (%)	-5.3	-4.6	-3.6	-3.9
External debt / GDP (%)	30.5	31.6	35.6	37.9
Forex reserves (USD bn)	3.0	3.0	3.2	3.4
Forex reserves, in months of imports	1.7	1.9	1.7	1.8

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

CONTRIBUTIONS TO GROWTH

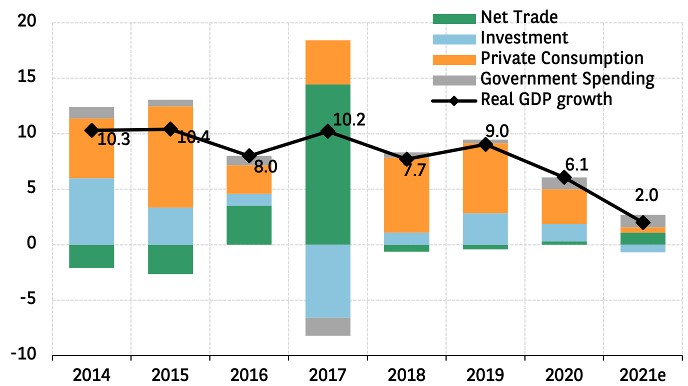

CHART 1 SOURCE: NATIONAL BANK OF ETHIOPIA

1 In November 2020, the G20 countries adopted a common framework to manage any debt restructuring needed by the world's 73 poorest countries. After a debt sustainability analysis conducted by the International Monetary Fund (IMF) and the World Bank (WB), negotiations will initially be held with the G20 member countries and any other creditor countries that want to join the initiative. During a second phase, under IMF supervision, the country must negotiate with all other creditors using terms at least as favourable as those obtained with the G20 countries.

an excessive debt situation at the end of the current IMF programmes. Ethiopia is currently benefiting from two IMF facilities, an expanded concessional credit facility that expired in September 2021, and an expanded non-concessional credit mechanism that is still operational. The committee of creditors met on 16 September to examine the debt restructuring request, but negotiations have bogged down over the question of the comparable treatment of private creditors. The country has a Eurobond issue outstanding with a nominal value of USD 1 bn, but its value has plummeted since the announcement that Ethiopia would participate in the common framework[2].

VERY HIGH POLITICAL RISKS

General elections on 21 June 2021 confirmed the victory of the Prosperity Party, the new political arm of the incumbent Prime Minister, Abiy Ahmed. He took power in April 2018 as part of a four-party coalition that brought together regional ethnic groups but was dominated by a minority party, the Tigray People's Liberation Front (TPLF). At the end of 2019, Abiy Ahmed ended the coalition and replaced it with a single party dominated by the Amharas. Actually, three out of ten regions were unable to participate in the elections due to the civil war in the northern part of the country.

The ethnic conflict started in the Tigray in November 2020 and spread rapidly to the neighbouring states of Afar and Amhara. The conflict now threatens the stability of the entire region.

The extent of the violence can be attributed to the frustrations of the Oromo, the ethnic group of Prime Minister Abiy Ahmed, who were expecting improved living conditions and greater inclusion in political life. Recent military cooperation between Ethiopia's two main insurrection movements[3] are putting pressure on the federal government.

On 23 May 2021, the United States placed economic sanctions on the country (visa restrictions, partial suspension of aid and pressure on the IMF and the World Bank to freeze future pay-outs). The US is alarmed by chronic insecurity in the region, which is hampering humanitarian operations. It is waiting for the results of a UN Security Council investigation concerning accusations of human rights violations that may constitute war crimes. Meanwhile Abiy Ahmed has lashed out against American interference, which makes no distinction between its treatment of the government and the insurgents, who are now listed as terrorist organisations.

Bolstered by his solid electoral victory, the Ethiopian prime minister is now seeking to strengthen his diplomatic relations elsewhere, notably with the African Union and Turkey, which whom it recently signed military and economic cooperation agreements.

Completed on 30 September 2021

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FOREIGN RESERVES AND EXCHANGE RATE ARE UNDER PRESSURE

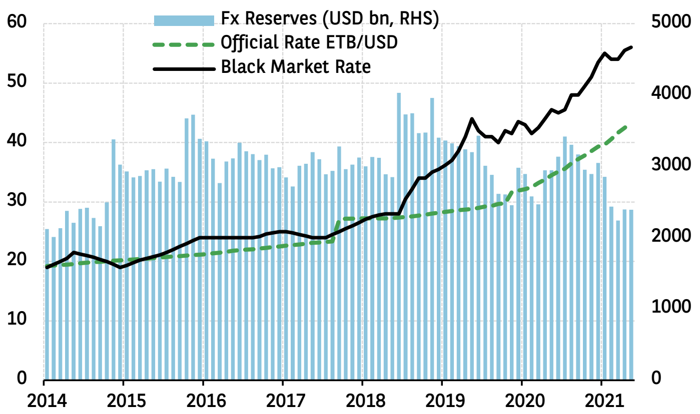

CHART 2
SOURCE: NATIONAL BANK OF ETHIOPIA, IMF

2 The spread with the JPMorgan Emerging Market Bond Index Global (EMBIG) widened to 1000 basis points in early September.
3 Tigray People's Liberation Front (TPLF) and the Oromo Liberation Front (OLF)

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