

ECO EMERGING

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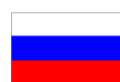
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ECONOMIC RESEARCH DEPARTMENT

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Editorial

Growing concerns on economic growth

Growth concerns for both advanced countries and emerging countries have picked up again on the back of a collection of new economic data but also — and perhaps more importantly — due to continued high uncertainty. The latter stems from escalating tensions between the US and China over trade. The effects of this confrontation already show up in the Chinese data while in the US, mounting anecdotal evidence also point to its detrimental impact on business and the agricultural sector. The Federal Reserve has turned a corner and indicated that rate cuts are coming, much to the joy of the equity market. The ECB has also changed its message: with risks tilted to the downside and inflation going nowhere, it considers more easing is necessary.

■ New records

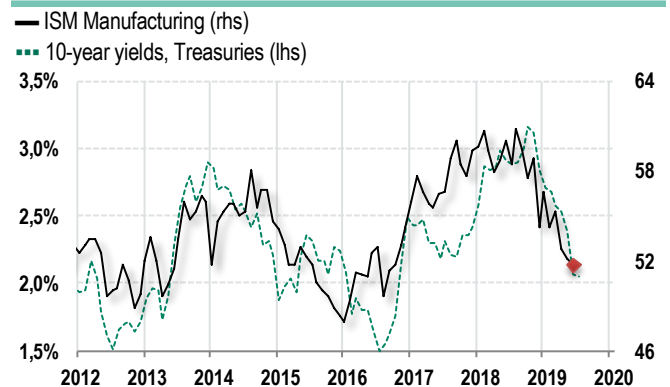
While the S&P500 reached new highs, US treasury yields dropped on the back of a revised outlook regarding the path of monetary policy and further declines in the term premium. Based on calculations by the Federal Reserve of New York, this risk premium, which investors are supposed to receive for taking on duration risk, has reached a record low of -90 basis points at the beginning of July. As shown in the charts, the decline of US bond yields has, quite understandably, mimicked the decline of the purchasing managers index (ISM) for the manufacturing sector. The coincidence of a record high stock market and a record low term premium raises a certain discomfort: declining bond yields reflect unease about the economic outlook, so one wonders how long the stock market can stay immune to these concerns. The drop in US yields has been accompanied by a considerable descent into negative territory of Bund yields as well as yields in other eurozone bond markets. Apart from the usual transatlantic correlation, the change in message coming from the ECB has played a key role in explaining such dynamics. Indeed, if we take at face value the ECB president's speech in Sintra towards the end of June, a new cycle of easing is coming.

■ Growth concerns on the rise

In the US, while a sigh of relief followed the publication of first quarter GDP data, concerns over growth have since picked up again. The picture is mixed. The pace of job creation remains, on the whole, strong but investment activity is weakening. Market based signals (the inversion of certain parts of the yield curve) have raised recession fears, while increasing anecdotal evidence point to the detrimental impact of tariff increases on businesses and the agricultural sector. Although the US entered its 121st month of economic expansion, it appears that euphoria has largely given way to caution. In the Eurozone, the manufacturing sector, in particular in Germany, remains under pressure, although services are holding up well.

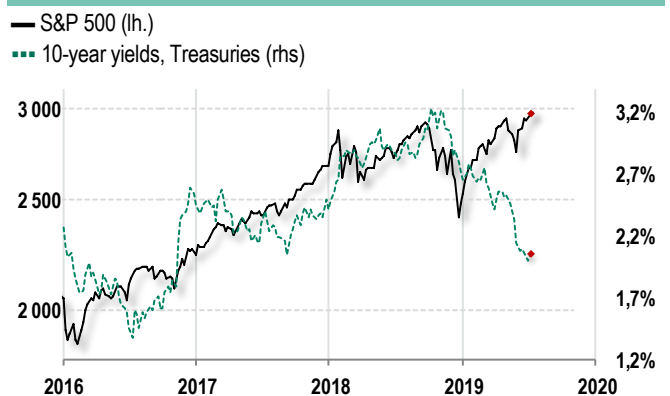
In Emerging Countries (ECs), growth slowdown is still on-going and may worsen in the course of the year. The trade war between China and the US has made the downturn in external trades within Asia worse. Despite official announcements regarding the negotiation process, external demand will remain a major impediment to growth for ECs, not only in Asia but also in Latam and MENA. Metal prices and oil prices are trending downward since respectively mi-2018 and Q4 2018 and agricultural prices have stagnated since mid-2015. The painful of a number of commodity exporters is not over.

US Treasury yields vs ISM Manufacturing



Source: Institute for Supply Management, Refinitiv

S&P 500 vs US Treasury yields



Source: Refinitiv

The decision by the group of OPEC+ countries to renew the production quotas adopted at year-end 2018 will make the recovery very gradual.

Except for Central European countries, domestic demand will not compensate for the weakness of external demand notably for almost all the major ECs (China, India, Brazil, Russia, Mexico, Turkey, South Africa, GCC countries as a whole). Firstly, monetary policies will remain cautious. Secondly, there is a fiscal room of manoeuvre only in China, Russia, Turkey and GCC but at the expense of debt stability (Saudi Arabia) or financial stability (Turkey). In any case, the fiscal stimulus will be used with great moderation.



■ Tipping point

Against this background of increased growth concerns, the key question for the coming months remains whether a tipping point will be reached. Fundamentals (labour market, income growth, corporate profits growth, interest rates) are, on the whole, still satisfactory, but a protracted period of uncertainty could weaken the influence of these fundamentals on growth. This in turn could weigh on confidence and market behaviour and trigger a negative feedback loop. A reduction in uncertainty would obviously provide a boost of confidence and create an uptick in growth. Trade negotiators should keep this in mind when they meet.

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China

Hard blow

With the export sector hard hit by US tariff measures and private consumption growth weakening, investment growth has slowed. Although domestic demand could pick up in the short term, bolstered by monetary easing and fiscal stimulus measures, export prospects depend on the outcome of trade talks between Beijing and Washington, which remains highly uncertain. The authorities are bound to use foreign exchange policy sparingly to avoid creating a source of financial instability. Moreover, the current account surplus has improved again in recent months.

China's economic growth continues to slow. After decelerating for four quarters, real GDP growth remained stable at 6.4% year-on-year (y/y) in Q1 2019, but slowed again in Q2. The troubled export sector is the main reason for the slowdown, but domestic demand growth is also very sluggish.

■ The export sector is in shock

The increase in US tariffs on imports of Chinese goods has been a hard blow for exporters, especially since tariffs were raised at a time when world trade growth was already slowing. Trade tensions between the two countries and growing protectionism have had a direct impact on shipments of Chinese merchandise to the United States, but they have also begun to have an indirect impact on world demand, by eroding business confidence and investment. Tariff hikes have rapidly had a cascading effect on Asian supply chains as well.

Chinese export growth slowed from 14% y/y in H1 2018 to 8% in H2, before slipping slightly into negative territory in the first 5 months of 2019. Exports to the US, which amounted to USD 480 bn in 2018 (19% of Chinese exports), declined by 9% y/y in the first 5 months of 2019 according to China's General Administration of Customs (chart 2). US imports of Chinese goods that were hit by a 25% tariff hike as of July-August 2018 (about USD 50 bn) shrank rapidly following the US decision; their decline reached about 30% y/y in the first 4 months of 2019. Then the USD 200 bn of Chinese imports that were hit by a 10% tariff hike in September 2018, raised to 25% in May 2019, also contracted rapidly (following a rebound in Q3 2018 in anticipation of tariff increases): their decline reached more than 20% y/y in the first 4 months of the year, and the situation undoubtedly deteriorated in May-June.

Chinese exports to the rest of Asia (48% of exports) have also declined since December (-2% y/y), signalling the rapid transmission of US protectionist measures to other trading partners integrated in regional supply chains. Exports to Europe (19% of China's total exports) have continued to rise, but have nonetheless become less vigorous in the past six months, increasing by an average rate of only 7% y/y compared to 11% over the previous six-month period.

■ Private consumption growth slowing sharply

Private consumption growth has weakened. In April-May 2019, retail sales growth slowed to a new low of 7.9% y/y in value terms (vs an average of 9% in 2018) and 5.8% in volume (vs 7% in 2018). The

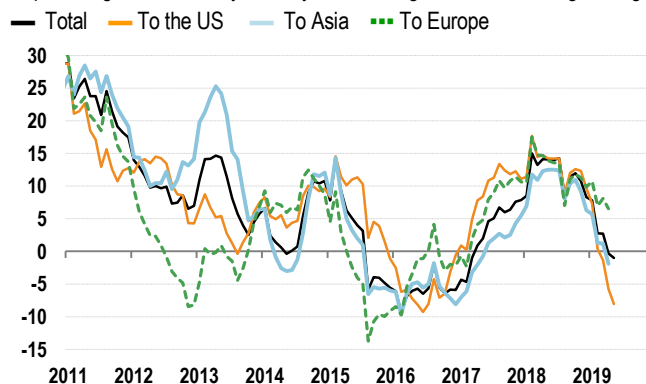
1- Forecasts

	2017	2018	2019e	2020e
Real GDP growth (%)	6.8	6.6	6.2	6.0
Inflation (CPI, year average, %)	1.6	2.1	2.2	2.6
Actual fiscal balance / GDP (%)	-3.7	-4.2	-4.4	-4.5
Central government debt / GDP (%)	16.4	16.6	19.6	22.1
Current account balance / GDP (%)	1.6	0.4	0.1	-0.5
Total external debt / GDP (%)	14.4	14.5	14.0	14.0
Forex reserves (USD bn)	3 140	3 073	3 087	3 100
Forex reserves, in months of imports	17.0	14.5	14.5	14.0
Exchange rate USDCNY (year end)	6.5	6.9	6.9	6.7

e: BNP Paribas Group Economic Research estimates and forecasts

2- Exports falling

Exports of goods in USD, year-on-year % change, 6-month moving average



Source: China's General Administration of Customs

decline in automobile sales (-3% in 2018 and -13% y/y in January-May 2019) has had a heavy impact on the overall performance (automobiles account for about 10% of the total value of retail sales), but other sectors have also reported sluggish sales, notably durable goods (in line with the decline in real estate transactions) and leisure goods. Online sales growth has eased since H2 2018, but is still robust (+22% y/y in the first 5 months of 2019). Consumption of services is also still dynamic (it is estimated to account for nearly half of total consumer spending) but seems to be slowing more significantly in recent months.



The poor performance of private consumption is worrying because it delays the process of rebalancing the economy at a time when China is facing very unfavourable external conditions. The sluggishness of Chinese consumers is partially due to the troubles in the export sector and its consequences on confidence and the labour market. As a matter of fact, the “jobs” sub-component of the manufacturing PMI published by the National Bureau of Statistics has deteriorated rapidly since September 2018. In June 2019, it hit a low of 46.9 compared to an average of 48.9 in 2017-2018.

Consumer price inflation accelerated to 2.6% y/y in May-June 2019 from an average of 2.3% in 2018 and 1.6% in 2017. Inflation is mainly driven by a rapid increase in food prices over the past 3 months (+6.9% y/y in April-May, compared to an average of 1.8% in 2018). Meanwhile, core inflation declined slightly from 1.8% y/y at the end of 2018 to 1.6% in May 2019, a sign of sluggish domestic demand. Inflationary pressures are unlikely to hamper the accommodating bias of monetary policy in the short term, but they will constrain households' real income. The increase in per capita disposable income already slowed last year, dropping from 7.3% in real terms in 2017 to 6.5% in 2018, and standing at 6.8% y/y in Q1 2019.

The slowdown in private consumption growth can also be blamed on the weaker expansion in real estate loans and consumer credit. This has resulted from a still relatively tight property policy, from the strengthening in financial-sector regulation implemented since late 2016, and from repressive measures introduced more recently to reduce the number of P2P platforms for loans between individuals. At the same time, the household debt burden has increased in recent years and may well have begun to strain consumption. Household debt accounted for 53% of GDP at the end of 2018, up from 49% at year-end 2017 and 33% at year-end 2013.

In response to the slowdown in exports and private consumption, investment growth also decelerated in the first 5 months of the year, notably in the manufacturing sector (3.2% y/y in value, compared to 6.2% in 2018).

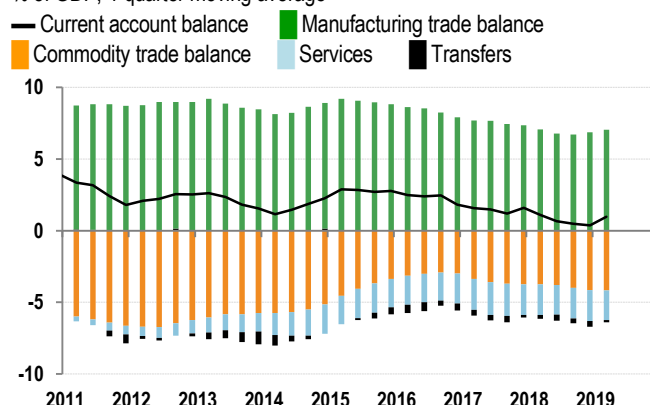
The economic growth slowdown is expected to continue in the very short term. Export prospects remain very uncertain given the major disagreements between Washington and Beijing, even though trade talks are due to resume. As to domestic demand, the main factors behind the slowdown in private consumption are still in place. Soon, however, spending of households and corporates should begin recovering, bolstered by fiscal stimulus measures launched since early 2019 and by the ongoing but prudent easing of the credit policy.

■ Moderate deterioration in external accounts

China is bound to maintain a prudent foreign exchange policy. Over the past year, the authorities have responded to the increase in US tariffs by letting the yuan weaken against the dollar (by 9.1% between end-March and end-December 2018, and then by 2.5% in May 2019). These bouts of depreciation have helped partially offset the impact of tariff hikes on exports. Although more could follow, they are bound to be moderate in scope, temporary and followed by slight re-appreciation movements. An overly rapid depreciation of

3- Current account surplus persisting

% of GDP, 4-quarter moving average



Source: SAFE

the yuan risks triggering periods of financial instability and capital outflows, which Beijing would rather avoid.

Moreover, recent dynamics in China's external accounts have tended to reduce the downward pressure on the yuan. After shrinking rapidly in 2018, the trade surplus has begun to swell again since early 2019 (USD 131 bn in the first 5 months of the year, compared to USD 102 bn in the same period of 2018) despite the poor export performance. Imports contracted more sharply given the reduced need for industrial inputs, sluggish domestic demand and the decline in commodity prices.

The services balance continues to show a major deficit due to the solid momentum of Chinese tourism abroad, but it has levelled off at close to 2% of GDP since last year. All in all, the current account surplus picked up slightly in Q1 2019 after contracting from 1.6% in 2017 to 0.4% in 2018 (chart 3). As to the financial account, net capital flows have been relatively stable since early 2019. Foreign exchange reserves have increased slightly, reaching USD 3100 bn at the end of May 2019.

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India

A big victory for Modi in the midst of a tougher economic environment

Narendra Modi won a major victory in the general elections, further bolstering his legitimacy. His party won a strong majority in the lower house of parliament and could go on to clinch a majority in the upper house by late 2020 as well, if it manages to maintain power in the upcoming State legislative elections. The country's economic situation was not very favourable for the Prime Minister as his first mandate came to an end. Economic growth slowed sharply in the last quarter of fiscal year 2018-19 and prospects have been revised downwards. The government must accelerate the reform process in order to increase the pace of job creations and encourage foreign investment.

■ Economic growth slows sharply

In the fourth quarter of fiscal year 2018/19 (ended 31 March 2019), India's economy reported the sharpest slowdown in the past five years. Growth slowed to only 5.8% year-on-year (y/y) compared to 7.2% in the year-earlier period. This slowdown can be blamed only partially on unfavourable base effects. It is essentially due to the sharp slowdown in investment in a less favourable economic and financial environment. After five consecutive quarters of growth of more than 10%, investment increased only 3.6% y/y, even though production capacity utilisation rates are still high.

Household consumption also slowed, albeit by only 1 percentage point (pp) compared to the previous quarter, to 7.2% y/y. Although exports of goods and services also slowed mildly, to 10.6% y/y, net exports continued to make a negative contribution to GDP growth. Business is still buoyant in the services sector, but slowed sharply in manufacturing and construction, while agriculture contracted.

The first economic indicators available so far do not suggest a strong rebound in the first quarter of 2019/2020 (April-June 2019). On the whole, although industrial output accelerated slightly in April and business confidence indicators picked up in May, other indicators tend to dampen this good news. Investment is unlikely to accelerate given the ongoing decline in capital goods production and imports. Output of consumer durables also remained extremely weak, and automobile sales contracted in April for the sixth consecutive month. Lastly, based on the slowdown in cement and steel output in April, activity in the construction sector did not rebound either.

Economic growth faces major risks. The central bank has lowered its 2019 outlook by 0.2 percentage points to 7%. To stimulate activity, the central bank has made three 25bp key rate cuts since the beginning of the year, trimming the repo rate to 5.75%. Moreover, although inflationary pressures have increased slightly since the beginning of 2019 (+3% y/y in May), inflation is still below the central bank's target of 4%. So far, monetary easing has lowered the average interest rate on new loan production by only 21 bps. The liquidity constraints of non-banking financial companies (NBFC) could also begin to squeeze investment.

To boost economic growth sustainably and stimulate job creations (which averaged only 6 million a year during Modi's first mandate, even though the active population increased by 8 million a year on average), the new government must increase the general skills level of the population and develop infrastructure. Although the fiscal

1- Forecasts

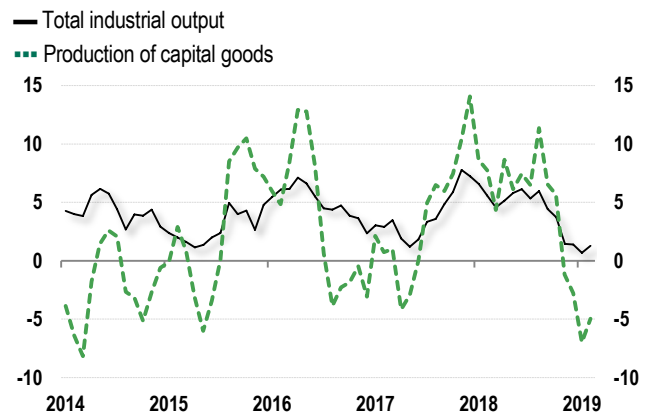
	2017	2018e	2019e	2020e
Real GDP growth ⁽¹⁾ (%)	7.2	6.8	7.1	7.3
Inflation ⁽¹⁾ (CPI, year average, %)	3.6	3.4	3.5	4.2
Central Gov. Balance ⁽¹⁾ / GDP (%)	-3.5	-3.4	-3.4	-3.2
Central Gov. Debt ⁽¹⁾ / GDP (%)	45.6	44.6	44.2	43.8
Current account balance ⁽¹⁾ / GDP (%)	-1.8	-2.1	-2.0	-2.2
External debt ⁽¹⁾ / GDP (%)	20.0	20.0	20.1	20.8
Forex reserves (USD bn)	409	393	440	465
Forex reserves, in months of imports	11.5	9.1	9.4	9.3
Ex change rate USD/INR (year end)	63.9	71.0	73.5	76.5

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

e: BNP Paribas Group Economic Research estimates and forecasts

2- Industrial output

y/y, 3-month moving average



Source: CEIC

deficit has declined sharply, the fiscal base is still too shallow to allow major expenditures.

■ Slowdown in lending by non-banking financial companies

The slowdown in investment can be attributed in part to the slowdown in lending by non-banking financial companies, and the increase in their cost of financing, which they carried over to the cost of credit. Despite the acceleration in bank lending since April



2018 (in conjunction with the consolidation of banks' financial situation), total lending growth slowed by 1 percentage point over the year to 10% y/y in April.

Since September 2018, the growth rate of NBFC lending has slowed sharply, to 13% y/y in Q4 2018/2019, from 24% in the year-earlier period. This trend reflects the financial troubles these institutions encountered following the default of *Infrastructure Leasing & Financial Services*. In May 2019, the central bank underscored the importance of these institutions in the financing of part of the economy¹ and encouraged banks to offset at least part of the sharp decline in financing via mutual funds and Treasury bill issues. The share of bank lending granted to NBFC increased by 1.4 pp over the past twelve months to 7.3% in April.

At the end of March 2019, the central bank esteemed that the financial situation of NBFCs was still solid on the whole, although it has deteriorated over the past 12 months. Non-performing loans (NPLs) accounted for 6.6% of loans outstanding (compared to 5.8% in the year-earlier period) and their capital adequacy ratio was 19.3%. In comparison, these ratios were not as healthy for the banking sector as a whole, even though they have improved significantly since March 2018: the non-performing loan ratio for banks was still 9.3%² and the capital adequacy ratio was 14.2%. To consolidate the situation of NBFC and reduce liquidity risk, the central bank decided to reinforce its regulations. Previously, NBFC had to comply with prudential regulations in terms of equity and provisions for risky assets. Starting in April 2020, they will also have to comply with liquidity ratios.

■ Public finances in 2019: revenue drops sharply

In fiscal year 2018/2019 (ended 31 March 2019), the government managed to reduce the fiscal and primary deficits by 0.1 and 0.3 percentage points of GDP, respectively. The fiscal deficit slipped to 3.4% of GDP, the lowest level since 2008. Yet this strong performance must be kept in perspective. As a share of GDP, government revenue declined by 0.3 pp compared to the previous year and accounted for only 8.8% of GDP (0.4 pp short of the Finance Minister's target in February), the worst performance ever recorded. This relative decline can be attributed almost exclusively to the reduction in tariffs resulting from the slowdown in world trade, while direct levies (notably on companies) increased (reflecting the improvement in corporate financial health). The revenue shortfall compared to the government's target is mainly due to disappointing VAT revenues, which though higher, accounted for only 2.4% of GDP, 1 pp short of target (already revised downwards in February 2019).

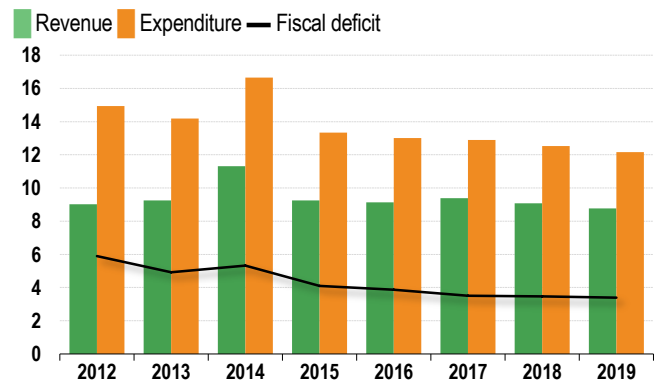
To reduce the fiscal deficit, the government had to cut back expenditure (excluding interest) for the fifth consecutive year, which came to only 9.1% of GDP, 1.5pp less than five years earlier. Although investment spending is still insufficient and below target, it nonetheless increased 0.1 pp to 1.6% of GDP.

¹ NBFC lending as a share of total lending was estimated at 14.8% in March 2019.

² For state-owned banks, the NPL ratio was still 12% in March 2019.

3- Public finances

% GDP



Source: Treasury, CEIC

Looking beyond the mixed performance of the fiscal deficit, the government debt ratio continued to decline to 47.9% of GDP. At the same time, however, State debt continued to rise according to Finance Ministry estimates, limiting the decline in the public debt, which is still holding at 67.3% of GDP.

■ Narendra Modi wins a very comfortable victory

The Bharatiya Janata Party (BJP), Narendra Modi's party, won an even more comfortable victory in the general elections of April-May 2019 than it did five years earlier. The BJP won 303 of the 542 seats in the lower house of parliament (up from 268 prior to the elections). The National Democratic Alliance (NDA), the coalition party, now holds 65.9% of the seats. The big question is whether the NDA will be able to win a majority in the upper house as well in order to implement new reforms (especially those concerning land ownership). Currently, the NDA holds only 34.7% of the seats. However, by the end of 2020, 43 seats are up for grab in States currently governed by the NDA. Narendra Modi could obtain a parliamentary majority within the next 18 months if his party stays in power in these States (following legislative elections to be held in the months ahead, notably in October in Maharashtra).

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Brazil

On a slippery slope

The Brazilian economy has hit a wall. Real GDP contracted in the first quarter and signs of weaknesses are accumulating: investment and exports have retracted, while consumer spending – despite being supported by credit – has slowed down. Business and consumer confidence have been hit by the slow progress of the reform agenda as well as the government's increasingly tarnished image. In a context marked by fears of recession, growth forecasts have been largely adjusted downwards. On a positive note, the Lower House approved the main text of the pension reform bill after a first round of voting. A final and second vote to approve amendments to the bill is expected to take place shortly. The bill is due for analysis in the Senate by August.

■ Cyclical air pocket

The slowdown of the Brazilian economy witnessed towards the end of 2018 has given way to a contraction of economic activity in Q1 2019 for the first time since Q4 2016. In seasonally adjusted terms, real GDP shrank by 0.2% q/q while it more than halved on a sequential year-over-year basis (0.4% in Q1 2019 vs 1.1% in Q4 2018).

On the demand side, this contraction was due to a fall in investment (-1.7% q/q) and a negative contribution of net exports (-0.4 pp). Consumer spending provided the main support to growth although it has slowed down over the past two quarters. The trade balance suffered particularly from a fall in mining exports as well as from the economic slowdown in Argentina (Brazil's 3rd largest trading partner). Investment continues to be affected by ongoing low capacity utilization rate at production facilities as well as uncertainty regarding the pace of reforms. The lack of dynamism in private investment is particularly problematic given the structural decline in public investment (less than 2% of GDP at present, from 4% in 2013).

On the supply side, the poor performance of the economy is primarily imputable to a drop in agricultural and industrial output. The fall in industrial production reflected the difficulties encountered in: (i) the mining sector (interruption of operations following the collapse of the Brumadinho dam; legal difficulties faced by global mining giant Vale), (ii) the manufacturing sector (weak internal demand and slowing global trade), and (iii) the construction sector (slow fall in inventories of residential and commercial property; decline in public infrastructure spending). The latest economic indicators do not currently show tangible signs of improvement such that the materialization of a recession at the end of the first semester cannot be ruled out.

When looking at advanced economic indicators, the IBC-Br Index from the Brazilian Central Bank (BCB) was down 0.5% in April, while the TCB/FGV Brazil LEI index from the Conference Board and the FGV was down 0.9% in May. While services and the automotive sector have experienced some improvements since April, order books in the manufacturing sector have continued to weaken. The slowdown in global trade should continue to weigh on industrial production, particularly given the resurgence of trade tensions between the USA and China. Even if business and consumer confidence indices have witnessed a slight uptick in June, they have broadly deteriorated since the beginning of the year on the back of

1- Forecasts

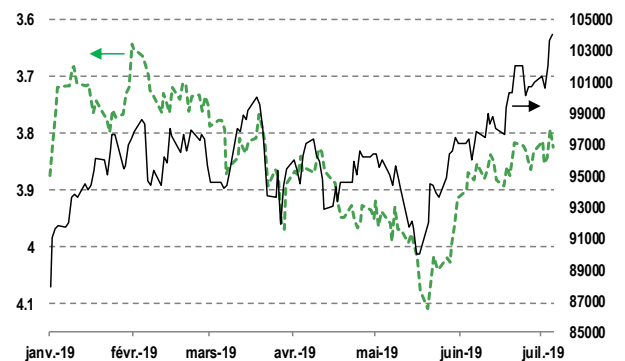
	2017	2018	2019e	2020e
Real GDP growth (%)	1.1	1.1	0.8	2.5
Inflation (CPI, year average, %)	3.0	3.7	3.9	3.9
Fiscal balance / GDP (%)	-7.8	-7.1	-6.9	-6.2
Gross public debt / GDP (%)	74	77	82	82
Current account balance / GDP (%)	-0.5	-0.8	-0.9	-1.4
External debt / GDP (%)	27	33	35	38
Forex reserves (USD bn)	373	374	385	380
Forex reserves, in months of imports	20	18	19	18
Exchange rate USDBRL (year end)	3.3	3.9	3.5	3.4

e: BNP Paribas Group Economic Research estimates and forecasts

2- Currency and equity markets

— Ibovespa Index - (rhs)

--- USDBRL exchange rate - (lhs inverted)



Source: Datastream, BNP Paribas

the slow reform agenda and perhaps more plausibly as a result of the government's increasingly tarnished image. In this context, the BCB has recently cut its growth forecast for 2019 to 0.8% from 2%.

■ Monetary easing in the works?

In June, the BCB held its policy rate unchanged at 6.5% for the 16th consecutive month. Inflation experienced a rise over the first half of 2019, with a reading at 4.7% y/y in May, from 3.8% in December. This increase was however largely cyclical. It was primarily driven by supply shocks which affected food and gasoline prices. The effects of these shocks have now largely dissipated and inflationary risks tied to economic activity remain largely contained.



The yield curve at the end of June suggested that the markets are expecting a monetary easing in the order of 75 to 100 basis points (bps) by the end of the year. Any rate cut from the BCB could, however, be contingent on the approval of the pension reform.

Foreign investors: surprisingly serene

Despite the cyclical downturn, the equity market has been riding a bullish trend since mid-May, gaining 14% (chart 2). This comes after the market experienced bouts of volatility through the first five months of the year. The BRL has also gained ground against the dollar since late May. Until then, the BRL had witnessed a steady depreciation against the USD during which it broke the 4 BRL per USD barrier for the first time since the pre-election period. Overall markets have continued to benefit from a steady flow of foreign investment. Foreign Direct Investment (FDI) – which intercompany loans represent an increasingly larger share – rose markedly over the first five months of the year (USD 35bn in 2019 from USD 27 bn in 2018). They continue to largely cover the current account deficit, which incidentally has stabilized at low levels (0.7% of GDP). Meanwhile, net portfolio investments by non-residents have also held up well, standing at around USD 4 bn over period January through May. *Pro memoria*, in 2018, non-residents were net sellers of Brazilian equities and bonds to the tune of USD 8.4 bn.

Credit market: differentiated dynamics.

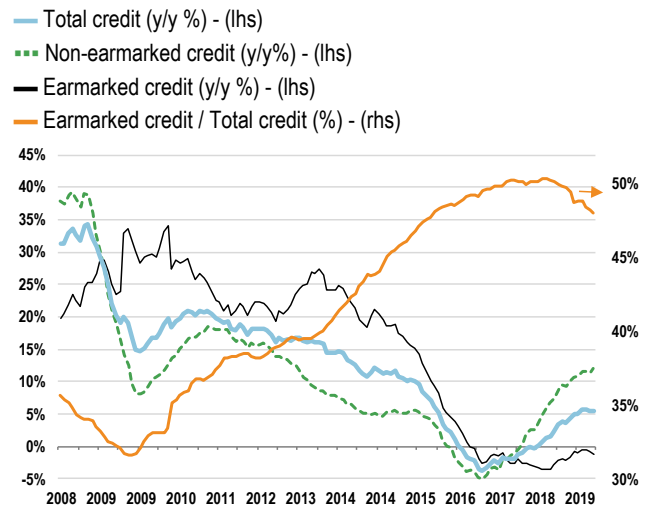
Despite favourable monetary conditions, credit growth has remained somewhat constrained. Since September 2016, the benchmark SELIC rate has been cut by 775 bps (from 14.25% to 6.5%). In real term the rate has also sharply fallen (from 7.7% in June 2017 to 1.8% in May 2019). In addition, in 2018, the BCB cut its reserve requirements on demand deposits from 40% to 25%. Yet, bank spreads have narrowed only slowly and remain elevated (19.2pp in May compared to 13.4pp in December 2013) and the average lending rate has in fact increased (from 23.2% in December 2018 to 25.2% in May). Since December, credit has been growing at an average pace of 5.5% (y/y). However most of the growth has been driven by households (+9.9% y/y in May) as lending to corporates remains very weak (1.7% y/y in May).

The growing share of household loans in banks' loan portfolios¹ is largely due to a contraction of earmarked credit² (45% of total credit). The latter has experienced a steady fall since Q4 2016 (chart 3) disproportionately affecting corporates (earmarked credit to corporates was down -9.6% y/y in May). This trend is also explained by corporates' increased reliance on the local bond market to access financing. With historically low interest rates, and abundant liquidity, corporates have taken advantage of investment funds and insurance companies' search for yield. The greater appetite for corporate bonds has resulted in higher corporate debt issuance volumes over the past two years.

¹ In May 2019, loans to households accounted for 57% of total outstanding loans, up from 47% at the onset of 2016.

² Earmarked credits are loans with regulated allocations and lower interest rates (subsidized lending). Interest rates are a function of a complex set of eligibility criteria.

3- Banking : credit growth



Source: BCB, BNP Paribas

An eventful political climate

The President's popularity as well as support for the government have continued to fall through June (Ibope survey). The government's image was particularly dented by accusations of collusion directed against Sergio Moro, the current Justice Minister and arguably the most central figure of the *Lava Jato* anti-corruption operation. In particular, recent revelations have called into question the impartiality of the judgment pronounced against former President Lula by Mr Moro during his time as a Federal judge. Meanwhile, the country has witnessed its first wave of mass demonstrations, most notably following budget cuts in education. The government has also faced its fair share of turnover. Three ministers have already lost their job, and Joaquim Levy, a former Finance Minister under Dilma Rousseff, left his position at the development bank, BNDES.

In recent weeks, aside from the free trade agreement between the European Union and Mercosur, the political newswire has been marked by notable progress regarding the pension reform. In particular, the amendments – proposed in June by the parliamentary rapporteur – to the original text were approved during a first vote on July 10th at the Chamber of Deputies (379 for and 131 against). Under the revised text, the overall fiscal result of the reform, including savings, would amount to BRL 910 bn over 10 years as opposed to BRL 1,200 bn under the government's original proposed bill (submitted in February). The text will now have to undergo a second round of voting (to approve amendments), either prior to the parliamentary recess (18th July) or sometime in August. The text will then go to the Senate where the same rules will apply (2 rounds of voting and required support from 2/3 of the senators, ie 49 out of 81). Better days – hopefully – await Brazil.

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Russia

Sluggish economic growth

Economic growth slowed sharply in the first 5 months of the year and the central bank has revised downward its forecasts. To boost activity, the monetary authorities lowered their key rates by 25bp in June at a time when inflationary pressures had eased slightly. The government also took major steps to stimulate the potential growth rate, which has declined constantly since 2008-09. Despite the increase in public spending, the government continued to generate a big fiscal surplus in the first 5 months of the year. Although these measures are a step in the right direction, they must be accompanied by the state's disengagement from the economy and better corporate governance to generate a substantial increase in potential growth.

■ Economic growth slowed sharply in Q1 2019

The economy slowed sharply in Q1 2019, with growth of only 0.5% year-on-year (y/y), down from 1.9% in the year-earlier period.

This slowdown can be attributed to two factors: 1) the decline in oil production, in compliance with its OPEC commitments (renewed in early July for another 9 months), and 2) a slowdown in household consumption, triggered by a 2-point increase in the VAT rate on 1 January 2019. Investment growth also decelerated to 0.5% y/y in Q1 2019, from 3.8% in Q1 2018, especially in the real estate and hydrocarbon transport sectors.

Although activity rebounded slightly in April, the economy slowed sharply again in May, and growth prospects are still looking downbeat. In May, automobile sales contracted for the fourth consecutive month (-2.2% y/y) and in June, manufacturing PMI, which reflects business leaders' expectations, was below 50 for the second straight month.

■ A boost from monetary policy

After peaking at 5.3% in March, inflation has eased. Prices rose 5.1% y/y in May. The monetary authorities lowered their inflation outlook by 0.5 pp and are now forecasting inflation of between 4.2% and 4.7% at the end of the year (close to the 4% inflation target).

To stimulate domestic demand, the central bank took advantage of this environment to lower its key rates by 25 basis points (bp) to 7.5% at its June monetary policy committee meeting. Monetary policy should remain accommodating in the months ahead.

Activity is expected to accelerate in H2 2019, buoyed by monetary easing and the increase in government investment. For the full year, however, economic growth should remain sluggish, and the central bank has revised downwards its growth forecast by 0.2 pp to 1-1.5%. Growth will fall short of its long-term potential, which has declined over the past 10 years.

■ Growth potential continues to decline

Russia's potential growth rate has fallen sharply, from 3.8% in 2008-2009 to only 1.5% in 2018. According to the World Bank, it could shrink to only 1.3% by 2022 unless the government manages to reverse this trend.

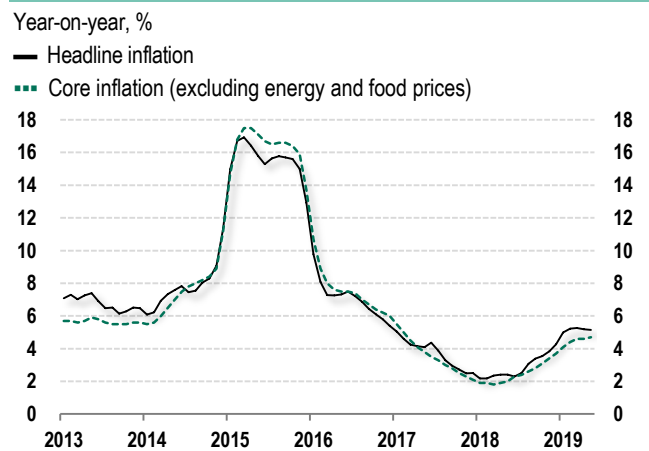
The slowdown in Russia's growth potential can be attributed to: 1) insufficient productive investment and 2) the decline in the labour force.

1- Forecasts

	2017	2018	2019e	2020e
Real GDP growth (%)	1.6	2.3	1.2	1.8
Inflation (CPI, year average, %)	3.7	2.9	5.0	4.0
Central Gov. balance / GDP (%)	-1.5	2.9	1.7	1.0
Public debt / GDP (%)	15.5	14.3	14.8	15.1
Current account balance / GDP (%)	2.1	6.9	5.9	4.3
External debt / GDP (%)	32.8	27.2	26.6	23.8
Forex reserves (USD bn)	356	375	428	445
Forex reserves, in months of imports	10.3	12.8	13.0	13.2
Exchange rate USDRUB (year end)	58.3	69.4	67.0	66.0

e: estimates and forecasts BNP Paribas Group Economic Research

2- Price increases are expected to peak in March



Source: CBR, CEIC

Following his re-election, President Putin announced several major reforms (*May Decree*) to stimulate potential growth. According to World Bank estimates, they could boost the potential growth rate by 1.2 percentage points by 2028. These measures include a gradual increase in the legal retirement age, an 11 pp increase in the investment rate to 34% of GDP by 2028, increased spending on healthcare, education and the quality of environment, and a more favourable demographic and migratory policy to counter population decline (first reported in Russia in 2018).



On 1 January 2019, the government began to raise the legal retirement age, a reform that should increase the potential growth rate by 0.3 to 0.4 pp according to the World Bank. In the first 5 months of 2019, spending on infrastructure, environmental protection and healthcare increased sharply, albeit without raising the total amount of public spending.

To stimulate private investment, however, the government must take its reform efforts much further by disengaging the state from the economy and improving the quality of governance. Although the overall business climate has improved¹, this mainly reflects improvements in the quality of infrastructure. In terms of governance, in contrast, Russia still scores fairly poorly. It ranked 162nd out of 211 countries in 2018 (which is only 5 ranks better than its score 5 years ago). Corruption, its main source of weakness, is still rampant: Russia ranks 138th out of 180 countries and is rated 28/100 by Transparency International. The World Bank estimates that an improvement in the business environment and state disengagement from the economy would boost Russia's growth potential by 0.3 pp.

■ Strong rise in the fiscal surplus

After reaching 2.6% of GDP in 2018, the fiscal surplus rose to 2.7% of GDP in the first 5 months of 2019. Increased spending as part of the economic development programme was partially offset by a decline in interest charges, which limited the total increase in spending to 5.3%, less than the nominal GDP growth rate.

At the same time, government revenues increased strongly, at an average annual rate of 13.7%, thanks to the increase in VAT revenue (+15.7%). The share of non-oil & gas revenues rose to 56.8%, 3pp more than in 2018. Oil & gas revenues only increased a moderate 6.9% due to cutbacks in oil production (in compliance with the OPEC+Russia agreement) and the decline in oil prices converted into roubles (-1.3% y/y in May). The government should continue to report a large fiscal surplus in 2019, albeit a smaller one than in 2018.

Government debt declined by 1.2 percentage points to only 14.3% of GDP in 2018.

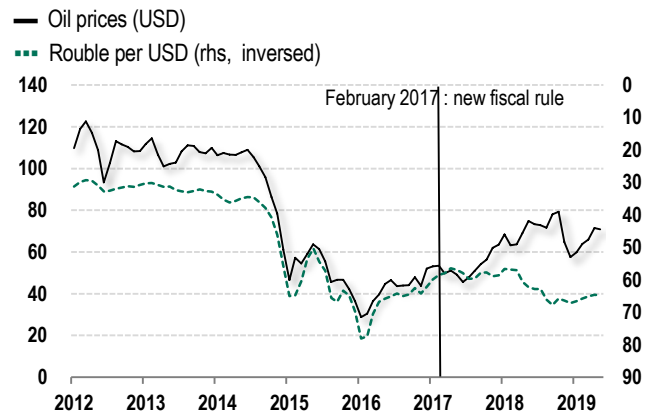
Moreover, thanks to the central bank's foreign currency purchases on behalf of the Ministry of Finance ministry, the National Wealth Fund (NWF) should end the year at USD 124.6 bn (up from USD 58.7 bn at the end of May 2019). By the end of the year, USD 66 bn in foreign currencies purchased in 2018 will be transferred to the NWF.

■ Consolidation of external accounts

The Russian economy is still highly dependent on commodity price trends and is vulnerable to a tightening of US sanctions. Nonetheless, its resilience has been strengthened significantly since 2017. Foreign reserves have been partially rebuilt, the external debt has diminished sharply and the correlation between the rouble and oil prices is not as strong as it was two years ago.

¹ Based on the Ease of Doing Business, Russia ranks 31st out of 189 countries (ahead of India and Indonesia).

3- Decline in the correlation between the rouble and oil prices



Source: Datastream

At the end of May, foreign reserves amounted to USD 405 bn, just USD 20 bn less than before the imposition of international sanctions in April 2014. They account for nearly 13 months of imports of goods and services, and cover 5.6 times the external debt maturing in less than one year.

After reaching 6.9% of GDP in 2018, the current account surplus rose to 8.9% of GDP in Q1 2019. It has increased rapidly over the past five quarters due not only to the increase in oil & gas exports (+0.7 pp to 15.9% of GDP), but also to other exported products (+0.7pp to 10.9% of GDP).

Total external debt was reduced by USD 52 bn over the past 12 months due to bank deleveraging and corporate debt reduction. The government's external debt increased but remains moderate, at 3.3% of GDP in Q1 2019.

The correlation between the rouble and oil prices has declined sharply, due notably to central bank purchases of foreign currency. In 2018, the rouble depreciated by 18% against the dollar, while oil prices rose 30.5%. The reduction in the correlation is also due in part to capital outflows between April and October 2018. In the first six months of 2019, the rouble appreciated by only 9% (despite portfolio investment inflows in Q1 and the central bank's foreign currency purchases), while oil prices rose by more than 17%.

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Turkey

Avoiding a relapse

Mired in stagflation, the Turkish economy might have to forego its “stop and go” tradition given the need for deleveraging in the private sector and a less favourable international environment. Disinflation continues but remains vulnerable to bouts of forex volatility. (Geo)political risks and the dollarization of the economy make monetary policy management more complex. A swelling public deficit and uncertainty about the direction of fiscal policy are sources of concern. Reducing the current account deficit will not suffice to reassure investors since capital inflows and foreign exchange reserves are both diminishing faced with the country’s substantial external refinancing needs.

Escaping stagflation

The IMF has revised downwards its 2019 GDP growth forecast for Turkey, from 0.4% last October to a negative 2.5% in April. The June consensus of economists (Bloomberg) calls for GDP to contract 1.5% this year. Our less pessimistic scenario is based on a year-end recovery, although there are still several downside risks linked to exogenous factors.

After a 3-quarter technical recession, GDP rebounded in Q1 2019 in line with expectations (+1.3% q/q, working day and seasonally adjusted data) although growth still contracted 2.6% year-on-year (y/y) due to major base effects. Household consumption increased 0.8% q/q in Q1 (wdsa), thanks to government measures to boost purchasing power in the run-up to the March municipal elections (wage increases, including a 26% increase in the minimum wage; a discount on electricity bills for low-income households; and a tax rebate for new car purchases) and bank lending by state-owned banks. Public consumption accelerated by 5.1%, but total investment (public and private) declined by 0.7% for the fourth consecutive quarter, notably due to financial troubles in the private sector. Foreign trade continued to make a positive contribution to GDP despite the 4.7% q/q drop in exports (imports were down 5.5%), which nonetheless increased by 4% y/y.

Although exports and tourism revenues were bolstered by the weak Turkish lira (up 12.1% and 9.4% y/y, respectively, in value terms in May), high-frequency economic indicators continued to look very downbeat in Q2. Industrial output (-2% y/y in 3 month-moving average in May) and retail sales (-5.1% in April) both stalled again. Sales of new automobiles plunged by 50% y/y despite the extension of the tax rebate. Since April 2018, manufacturing PMI has held below 50, the threshold between expansion and contraction. Business and household surveys indicate another dip in confidence in May and June compared to the first four months of the year. For more than a year, economic agents have continued to be “pessimistic” about economic prospects (score of less than 100). Bank credit has also contracted again over the past two months.

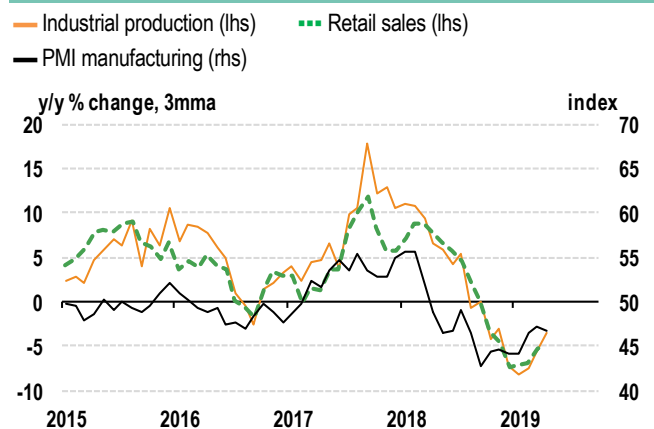
Conditions in the labour market continue to deteriorate. In a year, the unemployment rate has increased from 10.1% to 14.1% in March, and youth unemployment is now verging on 25%. Reflecting demographic pressures and the increase in the participation rate (52.9%), the total active population increased by 2% in a year, while the employed labour force declined by 2.5%. All in all, the number of registered unemployed workers surged by 41.5% to 4.5 million in

1- Forecasts

	2017	2018	2019e	2020e
Real GDP growth (%)	7.4	2.6	0.0	2.5
Inflation (CPI, year average, %)	11.1	16.3	16.3	11.0
Budget balance / GDP (%)	-1.5	-2.0	-2.6	-2.2
Public debt / GDP (%)	28.3	30.4	31.2	31.2
Current account balance / GDP (%)	-5.6	-3.5	-2.5	-3.3
External debt / GDP (%)	53.3	56.7	60.7	59.2
Forex reserves (USD bn)	82.6	72.0	69.0	68.0
Forex reserves, in months of imports	4.0	3.6	3.7	3.4
Exchange rate USDTRY (year end)	3.8	5.3	6.0	6.7

e: BNP Paribas Group Economic Research estimates and forecasts

2- Short-term economic indicators



Source: Turkstat, Markit, BNP Paribas

the year to March. The construction sector, one of the main economic growth engines in recent years, experienced a major bloodletting (employment declined by 26% over the past year). In the manufacturing and commercial services sectors, the decline in employment was limited to 1.9% and 1%, respectively.

The corollary of sluggish domestic demand was an ongoing slowdown in inflation. With mild food prices, the consumer price index (CPI) slipped to 15.7% y/y in June, from 18.7% in May.



■ Warding off dollarization

Constrained by the volatility of the forex market, the Central Bank of the Republic of Turkey (CBRT) has maintained its key 1-week repo rate unchanged at 24% since September 2018. The very high level of ex-ante real interest rates and the absence of a rate cut at the 12 June monetary policy committee meeting led to the firing of CBRT governor Murat Cetinkaya on 6 July.

The Turkish lira could come under pressure again. It appreciated 9% against the US dollar between early May and early July, after plunging 15% in March-April, undermined by geopolitical tensions and uncertainty about the real level of so-called “free” FX reserves (estimated at about USD 25 bn), due to the opacity of currency swaps between CBRT and the state-owned banks. Despite the rapid contraction in the current account deficit (USD 3.1 bn in January-May 2019 compared to USD 28 bn in the year-earlier period), capital flows have dried up (the financial account surplus declined from USD 18.5 bn to USD 3.2 bn over the same period), resulting in another reduction in FX reserves. Net outflows of portfolio investment (equities and bonds) by non-residents have reached USD 2.3 bn since March. Between May and December 2019, external debt servicing (principal plus interest) is estimated at USD 73 bn, the equivalent of gross FX reserves (excluding gold, but including the FX deposits of commercial banks).

CBRT is confronted with an increase in the dollarization of the economy (53% of bank deposits were in foreign currencies in June). Under these conditions, to support the lira, CBRT temporarily suspended its repo operations in May and lowered the maximum reserve requirement from 40% to 30% on deposits in the local currency to hard currency deposits. CBRT also took the prudential measure of raising the reserve requirement ratio on bank liabilities in foreign currency.

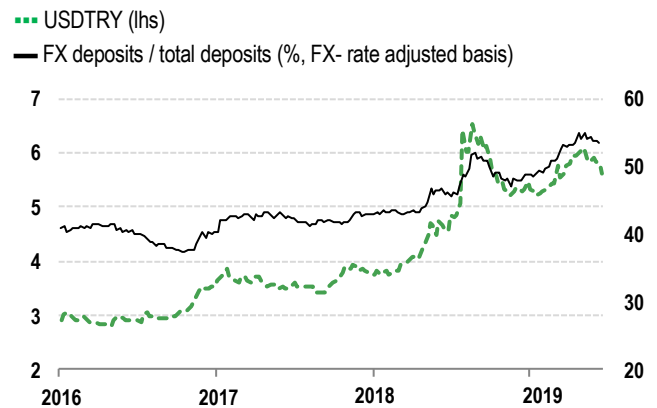
Although the regulatory and fiscal measures introduced to reduce the dollarization of the economy might seem to be coercive, they will probably remain ineffective, though necessary, without macroeconomic stabilisation. Only a credible monetary policy and the anchorage of inflation expectations will restore confidence in the Turkish lira as a store of value, a foundation of stability and the formation of solid domestic savings in local currency.

■ Public finances: hit the brakes rather than the accelerator

The conjunction of an expansionist fiscal policy over the past three years with recessionary economic conditions has triggered a rapid deterioration in the public accounts in recent months. Even though Moody's and Fitch further downgraded Turkey's long-term sovereign rating in foreign currency, public finances are not a major source of concern in the short term.

It remains to be seen, however, whether the post-electoral period will be propitious for fiscal tightening and structural reforms, or to the contrary, whether the deteriorated cyclical environment and possible US sanctions will lead to more counter-cyclical measures and/or

3- Nominal FX rate and dollarization of bank deposits



Source: CBRT, BNP Paribas

heterodox methods such as using FX reserves to cover the government's financing needs.

The government's target of a budget deficit of 1.5% of GDP this year, based on the hypothesis of 2.4% growth, already seems unrealistic. The government deficit exceeded 3% of GDP in the 12 months to May (80% of the full-year nominal deficit target has already been reached) and was nearly 5% of GDP based on the IMF definition, which excludes exceptional revenues (proceeds from privatisation, central bank profits, etc.). In the first five months of the year, revenues declined by 2.4% y/y in real terms, while primary spending increased by 13.5%. At the same time, interest payments have increased by 50% in five months, to 2.2% of GDP. The increase in interest payments on local currency debt reflects the indexation to inflation and the increase in the refinancing rate (to 22.2% from 13.4% a year earlier), while on foreign currency debt (50% of total debt), interest automatically increases due to the depreciation of the exchange rate.

Public debt accounts for only 31.5% of GDP, and its sustainability is not an issue. Yet debt outstanding is increasing rapidly (up 27% y/y in May), and public guarantees and contingent liabilities are factors to watch. The main explanation for the swelling debt is the increase in the deficit, and the second is the translation effect of the lira's depreciation on debt outstanding. The domestic debt profile has become riskier: 36% of securities are issued in foreign currency (mainly the EUR) and the average maturity of new securities is less than 29 months, compared to 59 months a year earlier. Since June, CBRT has opened an overnight liquidity line (at the repo rate -100 bp) for primary dealers, which is capped depending on their purchases of public securities. From January to March, the government preferred to borrow on the international markets, taking advantage of low interest rates, especially for euro issues (4.625% in EUR and 7.625% in USD). As a result, Eurobond outstanding has increased by 43% over the year, surpassing the annual net borrowing programme. Since March, sovereign spreads have widened by about 100 bp again to 500 bp.

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Romania

Mixed bag

Counter powers and institutional watchdogs have proved to be quite effective in stemming the government's business-unfriendly measures and attempts to undermine the Rule of Law. This may pave the way for a more pragmatic and predictable policy stance. Meanwhile, owing to weaker external conditions, a soft landing of the economy is expected in the coming quarters whereas domestic demand should remain dynamic. Despite the lower risk of overheating, macro imbalances must be monitored: inflationary pressure is lingering and the twin deficits may widen even further. The banking system has recovered from times of trouble, and the softening of the bank tax (and other "emergency taxes") provided significant relief for the business community.

■ Testing the system of checks and balances

Counter powers and institutional watchdogs (i.e. Parliament, the President, the Constitutional Court, the Central Bank, the European Union, the civil society and the business community) have been put to the test by the administration, which came to power in 2017. So far, they have proved to be quite effective in confining the government's attempts to implement controversial reforms and undermine the Rule of Law, which has improved since Romania's accession to the EU in 2007.

For two years, the government has called into question the independence of the Judiciary and its effectiveness, notably with regard to its pet peeve: the National Anti-Corruption Directorate. This has resulted in bouts of political and social tensions and damaged the relationship between Brussels and Bucharest. The European Commission (EC) has threatened to trigger Article 7 of the EU Treaty as it previously did vis-à-vis Hungary and Poland. In December 2018, the government enforced a number of unexpected measures that were amended by Parliament in March-May 2019. This "emergency package" was adopted by ordinance without consultation with parliament, the Central Bank (NBR) or interest groups. It included changes in the mandatory pensions system, a cap on energy prices and a tax on energy/telecom companies and banks (see below). The announcement of the reform package triggered a 3% depreciation of the leu (RON) against the euro and a 15%-20% drop in the main stock market index.

The PSD-ALDE ruling coalition secured only 22% of the votes in the late May European parliamentary elections (vs. 46% in the 2016 national parliamentary elections). President Klaus Iohannis's right-wing PNL took the lead with 27% of the votes. Ahead of the next presidential election (November 2019) and parliamentary elections (end of 2020 or early 2021), the government may adopt a less controversial, more pragmatic/predictable policy stance, especially since PSD leader Liviu Dragnea was sentenced to prison for abuse of power.

■ Soft landing and lingering inflationary pressure

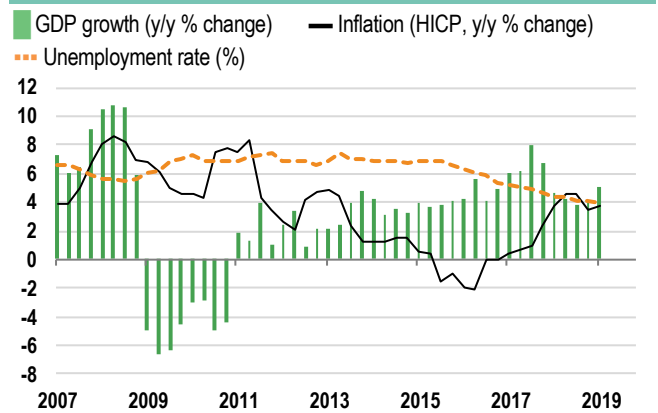
The gradual deceleration in GDP growth since its cyclical peak of 6.8% in 2017 has reduced the risk of overheating. Economic growth surprised on the upside in Q1 2019, reaching 5% y/y vs. 4.2% on average in 2018. But in the coming quarters, it is likely to converge with GDP potential estimated to be around 3%. Apart from a high base effect and the fading effect of pro-cyclical fiscal policy, the main driver of the slowdown is a less-benign global environment,

1- Forecasts

	2017	2018	2019e	2020e
Real GDP growth (%)	6.8	4.2	4.2	2.5
Inflation (CPI, year end, %)	1.3	4.6	4.1	3.7
Gen. Gov. balance / GDP (%)	-2.7	-3.1	-3.3	-3.3
Gen. Gov. debt / GDP (%)	35.2	35.0	35.1	35.9
Current account balance / GDP (%)	-3.3	-4.4	-4.7	-5.4
External debt / GDP (%)	51.9	49.3	48.6	47.7
Forex reserves (USD bn)	37.1	36.8	36.3	35.8
Forex reserves, in months of imports	5.4	4.9	4.4	4.1
Exchange rate EURRON (year end)	4.7	4.7	4.8	4.8

e: BNP Paribas Group Economic Research estimates and forecasts

2- Growth, inflation and unemployment



Source: National Institute of Statistics, Eurostat

notably the EU slowdown and uncertainty about global trade due to protectionism. Private consumption is expected to remain robust thanks to real income growth despite persistent inflationary pressure. Investment is likely to recover from the 2018 contraction thanks to a rebound in private sector investment and EU-funded projects. Still-dynamic domestic demand should go hand-in-hand with a negative contribution to the growth of net exports.

Annual inflation spiked to 4.1% y/y for HICP and 4.6% y/y for CPI on average in 2018. Against a backdrop of strong domestic demand and the still-positive output gap, CPI reached 4.1% y/y in May 2019



and core inflation accelerated to 3.2% y/y. Headline inflation is well above the upper bound of the NBR target of 2.5% +/- 1 percentage point. The NBR initiated a tightening cycle in early 2018 following the narrowing of the interest rate corridor around the policy rate in late 2017. It was raised on three occasions from 1.75% to 2.5% (last increase in May 2018), the first rate hikes since 2008.

Looking ahead, as the US Fed and the ECB have turned more dovish owing to concerns about a sharp economic slowdown, the NBR may refrain from tightening monetary conditions. The economists' consensus forecasts call for 2.7% policy rate as of end-2019 and 3% as of end-2020. Thanks to the support of the ruling coalition and the main opposition party, NBR Governor Mugur Isarescu was just reappointed for another five years with the objective of joining the euro area. In the meantime, wide twin deficits and political noise may generate pressure on the RON. Given the still high vulnerability of the government and the banking sector to currency risk, the NBR will probably intervene to smooth FX volatility.

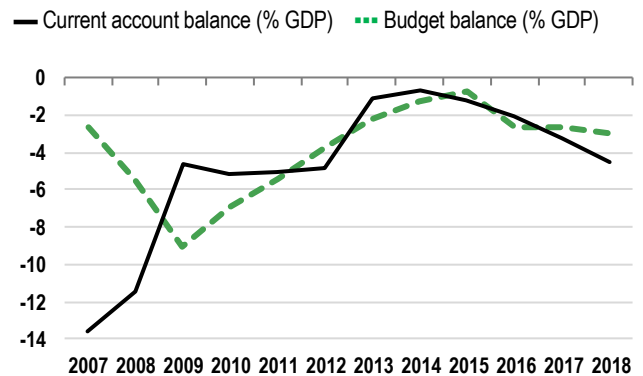
■ Twin deficits under scrutiny

Since 2016 the budget deficit has deviated from the medium-term structural target, triggering the EU commission's warning under the preventive arm of the Stability and Growth Pact. Fiscal policy has been loosened with tax cuts and public sector wage hikes. Meanwhile, dynamic domestic demand and rising commodity prices until end-2018 have contributed to a sharp widening in the trade balance deficit and the Current Account Deficit (CAD).

The external accounts deteriorated even further in the first four months of 2019 and are unlikely to improve in the short term. Strong wage growth has put pressure on unit labour costs and competitiveness as it has been well above productivity gains. Combined with EU funds, net foreign direct investments, which were dynamic in 2017-2018, may no longer offset the CAD. Romania's external liquidity position is not at risk in the short term as FX reserves provide a comfortable cushion and external financing requirements are manageable. The external debt-to-GDP ratio declined to below 50% thanks especially to the deleveraging of banks.

On the fiscal side, the 2019 budget targets a deficit equivalent to 2.8% of GDP owing to an unrealistic revenue growth forecast (+16% compared with circa 7% growth in nominal GDP). The sharp increase in spending on old-age pensions and the upcoming elections do not bode well for fiscal consolidation in the coming quarters. The deficit is likely to breach the threshold of 3% of GDP yet again, which might result in triggering the EU's excessive-deficit procedure. In this context, public debt is likely to increase gradually from a moderate level, while the low interest rate environment has allowed a reduction in debt servicing costs. The risks related to contingent liabilities in the banking sector have declined. Sovereign exposure to foreign investors is relatively high as non-residents hold almost half of government debt of which more than half is denominated in foreign currency (mostly euros).

3- Twin deficits



Source: Eurostat, NBR

■ Banks to go back to “business as usual”

The banking system has recovered from the times of trouble in 2013-2016. It is now well capitalised and profitable.

This reform would have been detrimental to the independence, flexibility and effectiveness of monetary policy, and it would have been a blow to the banking system's profitability, solvency and credit activity (see below). At the end of the day, the negative conclusions of a commission of experts from the NBR, the Ministry of Finance and the Banking Supervisory Authority led to the adoption of a watered-down bank tax (no link to ROBOR, the lower tax rate and narrower tax base).

The amendment to the bank tax provided strong relief: in view of the banking system's return on assets of 1.6% in 2018, the initial tax may have erased as much as two-thirds of annual profits.

Neither companies nor households are highly leveraged (the credit-to-the-private sector/GDP ratio is below 30%). Credit growth resumed in 2017-2018 thanks to low interest rates, the robust labour market and the government's policy of increasing home ownership. Credit is funded mainly by deposits. Despite higher inflation, the NBR has maintained the minimum reserve requirement ratios for banks' liabilities at 8%. Credit risk declined with total non-performing loans (NPLs) declining to 4.9% of total loans as of March 2019 from the peak of 22% in 2014. But the level of NPLs for companies remains high (above 10%), especially among SMEs. The surge in mortgage loans (mostly at variable rates) exposes banks to the real estate sector and a sharp increase in interest rates. Banks have repaid the bulk of their foreign debt, and the sector's net external position is now close to balance. Domestic “euroisation” remains a weakness with 35% of total loans and 30% of total deposits still denominated in foreign currency. Banks are (indirectly) exposed to currency risk via lending to domestic (unhedged) borrowers and to sovereign risk with government debt amounting to 20% of banks' total assets.

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Mexico

Disappointments

Mexico's economic growth prospects are deteriorating: slower growth in the US, fiscal austerity and low investment levels have dragged down growth in the last two quarters. The slowdown is likely to continue, despite support from consumer spending. The threat of trade tensions with the United States and the lack of clarity in Mexico's economic policy, as shown by the troubled implementation of its energy reforms, are adversely affecting the investment outlook. The increase in Mexico's medium-term sovereign risk has been recognised by Fitch, which has cut its sovereign credit rating. Fortunately, external vulnerability is limited.

■ Slower economic growth

The upturn in confidence inspired by the election victory of Andrés Manuel López Obrador (AMLO) and the signature of the new trade agreement with the USA has quickly ground to a halt. The government's policy hesitancy and the slowdown in global growth have already affected growth in Mexico, with the year-on-year increase in GDP falling from 2.6% in Q3-2018 to 1.7% in Q1-2019. Consumer spending continued to underpin growth in the first quarter of 2019. However, the contribution from net exports was barely positive, and those of investment and public spending were negative for the second straight quarter.

Growth is likely to slow substantially in 2019 and remain weak in 2020. Survey results are sending some fairly pessimistic signals for the next few quarters. Although consumer spending is set to continue supporting economic activity, consumer confidence has been falling steadily since the start of the year. Most importantly, business confidence is down significantly in 2019, with investment expectations showing a particularly steep decline, and has been lower than the average seen in the last five years. Growth forecasts collated by the central bank every month from a broad panel of analysts have also been downgraded since the start of the year. The average GDP growth forecast for 2019 was a mere 1.1% in June, down from 1.8% in December 2018.

■ Confusion about energy reform is increasing sovereign risk

As exemplified by Mexico's attempts to reform its energy sector, the lack of clarity in economic policy is likely to remain a drag on investment. When he was elected, AMLO was planning new reforms in the energy sector, aiming to increase oil production to 2.4 million barrels per day (bpd) by the end of his term of office in 2024 (up from around 1.7 million today). Mexico's production peaked at 3.4 million bpd in 2004. The new administration is planning to upgrade existing refineries, build a new one, and provide greater support to two state-owned companies (oil producer Pemex and electricity producer CFE). Finally, whereas measures taken since 2013 were aimed at promoting the involvement of private-sector investors (foreign and domestic) in the sector, that involvement is likely to be very limited in the next few years. Auctions of oil blocks have also been stopped (the fourth round was due to begin in February 2019) and the private-sector companies that won the previous auctions will have to carry out the promised investments within three years or lose rights to their blocks.

1- Forecasts

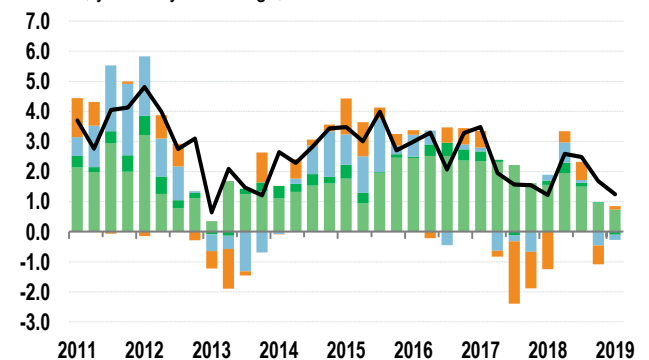
	2017	2018	2019e	2020e
Real GDP growth (%)	2.1	2.0	1.5	1.0
Inflation (CPI, year average, %)	6.0	4.9	4.1	3.9
Budget balance / GDP (%)	-2.2	-2.1	-3.2	-3.7
Public debt / GDP (%)	54.3	53.8	53.5	54.0
Current account balance / GDP (%)	-1.7	-1.8	-1.6	-1.5
External debt / GDP (%)	37.6	36.5	37.0	39.6
Forex reserves (USD bn)	170.5	171.4	171.7	173.0
Forex reserves, in months of imports	4.1	3.8	3.5	3.6
Exchange rate USDMXN (year-end)	19.7	20.0	18.6	18.0

e: BNP Paribas Group Economic Research estimates and forecasts

2- Slower growth

Contribution to growth, percentage points

■ Net exports ■ GFCF ■ Consumer spending ■ Public spending
— GDP, year-on-year change, %



Source: National accounts

So far, several measures have been announced, including a recapitalisation and lower taxation for Pemex, but overall they have been deemed to be "one-offs" and insufficient to arrest the sector's decline. The development plan for Pemex has still not been unveiled and, more broadly, structural measures for the sector as a whole have yet to be announced (and financed).

■ Tensions with the United States

Investor sentiment has also been affected by the recent trade tensions with the US. The US government has for the moment given up on its plan to impose customs duties on all Mexican goods, and



the Mexican government has promised to help the US combat illegal immigration. However, the threat of trade tensions will continue to drag down Mexico's growth outlook in the coming quarters.

The Mexican government's desire to maintain good relations with the US was strengthened in late June by the Mexican Senate, which comfortably ratified the new North American free-trade agreement with Canada and the US (USMCA). This makes Mexico the first of the three countries to ratify the agreement.

■ Question marks over fiscal discipline

Mexico's economic policy has remained tight since the start of AMLO's term of office. He has reiterated his campaign promises on several occasions: maintaining the fiscal discipline of the last few years (particularly by cutting spending), while introducing measures to reduce both inequality and corruption and to stimulate growth. However, the firm grip on spending since the start of 2019 results more from the need to shore up Pemex and by the difficulties involved in setting up certain projects than from genuine fiscal austerity.

Mexico's spending overshoot is likely to be limited again this year. However, sovereign risk is increasing. In early June, rating agency Fitch cut its sovereign rating on Mexico and Moody's placed its rating on watch with negative implication. Both agencies also cut their ratings on Pemex.

The resources allocated to Pemex and CFE are likely to prove insufficient. According to Moody's estimates, Pemex's funding requirement is between 1% and 2% of GDP per year. If Pemex's financial position does not improve in the next two years and if government transfers become a regular occurrence, Mexico's budget deficit could double between now and 2021, pushing up the public debt/GDP ratio even with nominal growth of 5%.

In addition, in early May ALMO ended the private-sector tender process relating to the plan to build a new refinery. The government now wants Pemex to handle the entire construction process. In early June, the Energy Ministry announced that the project would be completed by May 2022. Given Pemex's lack of experience (and that of the Energy Ministry) in this area, it is more than likely that the construction timeframe will be much longer and the cost much higher than anticipated, putting additional pressure on the public finances.

These recent announcements further highlight the contradictions in the government's stated priorities. Simultaneously achieving all of its targets—including a deficit target of 2.5% in 2019 and 2.1% in 2020 after 2.1% in 2018—seems to be impossible, especially since the government has promised to do so without increasing taxes or introducing new ones in the next three years.

■ No short-term threats to financial stability

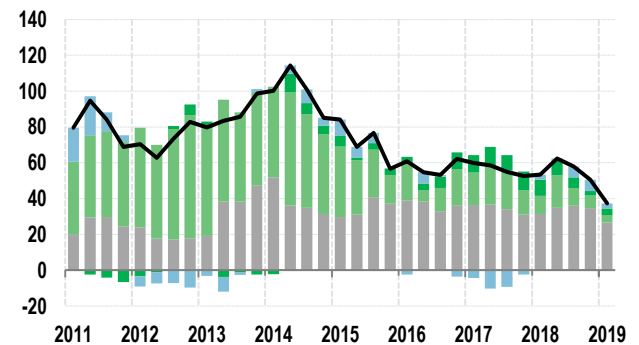
Mexico remains exposed to a downturn in investor sentiment, but the short-term consequences in terms of its external vulnerability remain limited. In the last four quarters, foreign capital inflows have diminished, but they remain comfortable (Chart 2). Most importantly, FDI flows have remained broadly stable during the period. Mexico

3- Limited external vulnerability

USD bn

— Non-resident capital inflows

■ FDI ■ Other investments ■ Bonds ■ Equities



Source: IIF

also has solid macroeconomic fundamentals: its monetary policy is credible and its current-account deficit and external debt are moderate, with the current-account deficit averaging less than 2% of GDP since 2010 and being fully covered by FDI inflows. The country has substantial currency reserves (almost USD 180 bn in June 2019, equal to around 4 months of imports). Even if investor sentiment were to deteriorate rapidly, Mexico has the resources needed to meet its external obligations.

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Indonesia

Strong resilience

Economic growth slowed in Q1 2019, but for the moment the economy seems to be fairly resilient to the decline in world trade. In the short term, dynamic household consumption, stimulated by measures to boost purchasing power, will continue to offset the slowdown in exports. In the longer term, real GDP growth is hardly expected to exceed 5-5.5%. After his recent reelection, it is vital for President Widodo to take advantage of his clear cut victory to push through the necessary reforms to stimulate foreign investment and foster growth, while reducing the country's dependence on volatile capital flows. Foreign direct investment has declined for the past six quarters and no longer suffices to cover a swelling current account deficit.

■ Economic growth decelerates slightly

After reaching 5.2% in 2018, real GDP growth slowed slightly to 5.1% in Q1 2019, reflecting in part the uncertainty in the run up to April's general elections, but also declining prices for some of Indonesia's export commodities in the midst of escalating trade tensions between China and the United States. Household consumption and government spending were both dynamic, while investment slowed after peaking at 33% of GDP in 2018. Exports contracted by 2.1% y/y, but this was largely offset by a sharp drop in imports (-7.8% y/y), triggered by a slowdown in investment. Infrastructure spending slowed due to delays in implementing key projects, while the slowdown in investment in machinery and capital goods was notably caused by international trade tensions.

Growth slowed in agriculture and manufacturing, with contractions in key commodity producing sectors (rubber and coal) and in transport equipment.

Yet household and business confidence indicators are still looking upbeat, even though the PMI in manufacturing sector decreased in June (50.6). Several factors will continue to boost household consumption, including purchasing power gains (thanks notably to mild inflationary pressures), a buoyant labour market and the increase in social welfare spending. Companies are confident, especially concerning their domestic order books.

In the medium to long-term, growth prospects are hardly expected to exceed the average of 5% reported over the past five years, which is well below President Widodo's target of 7% set during his first term in 2014. According to the IMF, the potential growth rate is unlikely to reach 6.5% by 2022 unless the new government steps up reform efforts to raise the level of education, to develop infrastructure further and to improve the business environment.

■ Public finances are still solid

Over the past five years, the Widodo administration has managed to consolidate public finances by reducing the share of rigid expenditures, notably oil subsidies.

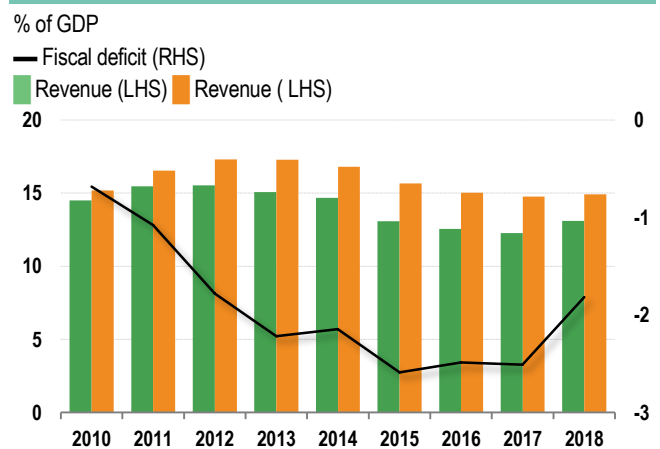
In 2018, the fiscal deficit was trimmed by 0.7 percentage points to only 1.8% of GDP, the smallest deficit since 2012. This improvement can be attributed to a 0.8 pp increase in the revenue-to-GDP ratio (to 13.1%), which halted a five-year decline. In 2017, President Widodo offered tax amnesty for repatriating revenues held

1-Forecasts

	2017	2018	2019e	2020e
Real GDP growth (%)	5.1	5.2	5.0	5.0
Inflation (CPI, year average, %)	3.8	3.2	2.6	3.0
Gen. Gov. balance / GDP (%)	-2.5	-1.8	-1.8	-2.0
Gen. Gov. debt / GDP (%)	29.0	30.1	29.8	29.2
Current account balance / GDP (%)	-1.6	-3.0	-2.4	-2.0
External debt / GDP (%)	34.7	36.2	34.6	34.0
Forex reserves (USD bn)	124	114	119	126
Forex reserves, in months of imports	6.2	6.0	5.4	5.4
Ex change rate US\$IDR (year end)	13 567	14 380	14 100	13 900

e: estimates and forecasts BNP Paribas Group Economic Research

2- Consolidation of public finances



Source: Finance Ministry, CEIC

abroad, and this programme apparently increased revenues by 0.3 pp.

At the same time, the government managed to limit spending increases to 14.8% of GDP, despite a 0.3 pp increase in energy subsidies and a 0.1 pp increase in interest expenses (which is still relatively small, accounting for only 13.3% of government revenues). Although the cost of subsidies has increased, it is still 2 points of GDP lower than it was before the Widodo government launched the reform in 2014. The temporary freeze on gasoline prices adopted in 2018 was lifted in 2019.



In the first five months of 2019, the fiscal deficit widened compared to 2018. This slight deterioration can be explained mainly by increased spending on social welfare and education.

Revenue has reached only 33% of the full-year target. Revenue increased only 6.3%, whereas the government is targeting a full-year increase of 11.5%. At the same time, expenditure has increased by 9.8% (34.7% of the full-year target). As part of its strategy to boost household purchasing power in order to stimulate consumption in the midst of a global economic slowdown, the government has sharply increased social welfare spending (+75%). One goal is to increase spending on education to 3% of GDP.

Despite the rapid narrowing of the fiscal deficit, government debt has increased 11.7% over the past twelve months to 30.3% of GDP in Q1 2019. This increase is partly due to a currency effect triggered by the rupiah's depreciation, as 41.5% of debt is still denominated in foreign currency. Short-term refinancing risks are limited because 89% of the debt matures in more than one year. Nonetheless, debt refinancing is still exposed to the volatility of international financial markets since non-resident investors still held 40.6% of government debt at the end of last year.

■ **External accounts are deteriorating somewhat**

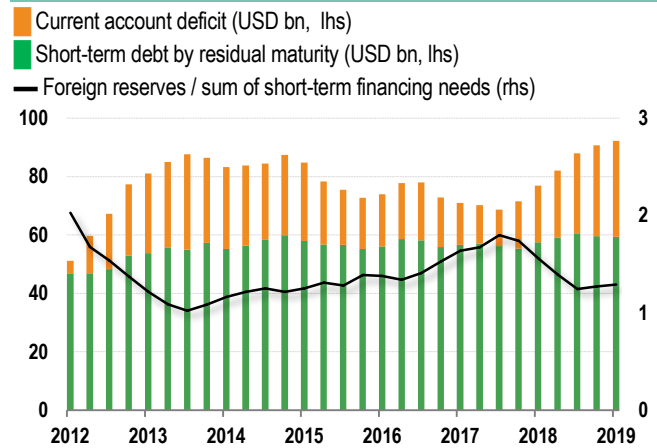
After three years of consolidation, Indonesia's external accounts eroded in 2018 due to higher oil prices and the decline in net capital inflows at a time of strong financial market volatility. Net capital inflows did not cover entirely the current account deficit, which was the highest since 2014 (3% of GDP compared to 1.6% of GDP in 2017). As a result, foreign exchange reserves declined by USD 9 bn between year-end 2017 and year-end 2018, and the rupiah depreciated by 5.7% against the US dollar.

In the first five months of 2019, the situation has stabilised. Foreign investment picked up and the trade deficit narrowed as the decline in exports (-8.7% over the first five months) was offset by a contraction in imports (-9.2%). Foreign exchange reserves and the rupiah have both remained stable since the end of 2018.

Indonesia is still vulnerable to commodity price fluctuations, which accounted for 57% of exports in 2018.

The deterioration in the external accounts since 2018 is not a real source of concern. Foreign reserves are holding at a comfortable level. At the end of May, they covered 1.3 times the country's short-term financing needs. In contrast, the decline in foreign direct investment (FDI) since 2015 is more problematic. In 2018, FDI represented only 1.9% of GDP, compared to 2.8% of GDP at the end of 2014, despite major efforts by the Widodo government to open up the economy. The decline in FDI increases the country's dependency on portfolio investment flows to cover the financing of its current account deficit. In Q1 2019, Indonesia's basic balance (sum of the current account balance and FDI) showed a deficit for the sixth consecutive quarter (0.7% of GDP).

3- Short-term financing needs are on the rise



Source: Bank Indonesia, CEIC

To reduce its dependency on volatile capital flows and stimulate economic growth, the country must attract more FDI. After President Widodo's re-election in April, the strategy for his second term will continue to focus on improving the business environment, creating special economic zones, and further developing infrastructure in order to stimulate industry and reduce the reliance on commodities. Yet Indonesia also needs to raise the level of education and encourage the diversification of exports. Considering his big victory in April's general elections, President Widodo should benefit from sufficient political manoeuvring room to drive through these reforms.

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Vietnam

A resilient export sector

Given its dependence on foreign trade and its integration within Asian supply chains, the Vietnamese economy is squeezed by the weakening in global demand and Sino-American trade tensions. Real GDP, exports and industry have all registered a growth slowdown in recent months. Yet Vietnam could also benefit from China's troubles: in the short term, it could benefit from some carry-over effects if merchandise is shipped directly to US businesses seeking to avoid the new tariff barriers. Vietnam could also benefit from new foreign direct investment projects of international groups seeking to manufacture outside of China. Moreover, Vietnam's external financial position is also expected to continue to improve.

Vietnam continues to report solid economic growth rates. Real GDP has increased at an average annual rate of 6.6% since 2014, higher than the 6.3% average recorded by Asian emerging countries as a whole. After peaking at 7.1% in 2018, the highest growth rate in the past ten years, economic growth has slowed slightly since early 2019. It reached 6.7% year-on-year (y/y) in H1 and is expected to slow further in H2. Given its high degree of trade openness, Vietnam is vulnerable to the weakening in global demand and the spillover effects of Sino-American trade tensions. The United States and China (including Hong Kong) each absorbed 20% of Vietnamese exports in 2018.

Yet economic growth prospects are still very favourable in the short and medium terms, driven by a strong domestic demand and the continued expansion of the export sector. The sector could even benefit from new foreign direct investments (FDI) by corporates seeking to establish production centres outside of China.

■ Sino-American tensions: a damper on exports...

Vietnam's export performance has deteriorated over the past year due to the weakening in global demand and the knock-on effects of higher US tariffs on imports of Chinese goods. Merchandise exports (in current dollars) rose only 7% y/y in H1 2019, vs. 13% in 2018 and 22% in 2017 (chart 2). US tariff measures have had a sharp impact since fall 2018, mainly via the spillover effect on regional supply chains, as well as through the indirect negative effects on global confidence, investment and demand. As a result, Vietnamese manufacturing growth slowed to 11% y/y in real terms in H2 2019, from 13% in 2018 and 14.4% in 2017.

However, on the whole, the manufacturing and export sectors are still posting relatively solid performances compared to the region's other economies, and Vietnam continues to win international market share (it accounted for 1.3% of total world exports in 2018). After hitting a low in Q1 2019, export growth has regained a bit of vigour in Q2. This slight upturn has also benefited the other countries integrated within Asian supply chains, but Vietnamese export growth has maintained its lead.

Vietnam's manufacturing export base has expanded steadily over the past ten years, largely supported by FDI inflows. Merchandise exports as a percentage of GDP increased from 67% in 2012 to 100% in 2018. Moreover, this expansion was accompanied by the diversification and continued rise in the value-added of exported products. Computers, electronics and phones now account for 33% of total exports, up from 17% at year-end 2011.

1- Forecasts

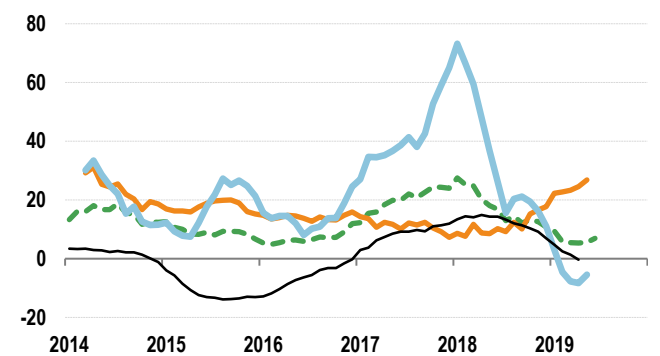
	2017	2018	2019e	2020e
Real GDP growth (%)	6.8	7.1	6.5	6.5
Inflation (CPI, year average, %)	3.5	3.5	3.1	3.3
Budget balance / GDP (%)	-4.8	-4.6	-4.5	-4.3
General government debt / GDP (%)	58.2	57.5	57.4	57.1
Current account balance / GDP (%)	2.9	2.4	2.1	2.1
External debt / GDP (%)	47.2	48.1	49.2	49.6
Forex reserves (USD bn)	49.1	55.5	65.0	74.0
Forex reserves, in months of imports	2.7	3.0	3.1	3.1
Ex change rate VND/USD (year end)	22 700	23 190	23 450	23 700

e: BNP Paribas Group Economic Research estimates and forecasts

2- A mild deterioration in export performance

Exports in USD, y/y, %, 6-month moving average

■ Vietnam's total exports ■ To the United States
■ To China & Hong Kong ■ Total world exports



Source: Vietnamese Statistics Office

■ ... but also an opportunity

Vietnam could benefit from the current troubles of Chinese exporters: in the very short term, by partially replacing Chinese exports by shipping manufactured or semi-manufactured goods directly to US companies seeking to avoid the new tariff barriers, and, then, by attracting investors seeking to move their production centres outside of China.

As a matter of fact, the slowdown in total export growth since November 2018 has been mainly due to the contraction in



shipments to China and Hong Kong (down 4.5% y/y over the period November-May) while exports to the United States surged by 24.7% y/y over the same period. This suggests that Vietnamese manufacturers have benefited from some carry-over effects.

Moreover, the recent increase in the number of FDI projects in the manufacturing sector (mostly initiated by China's and Hong Kong's corporates) also suggests that the relocation of some production centres outside of China should benefit Vietnam. Major Japanese and Korean groups have also recently expressed interest in increasing their production capacity in Vietnam.

Vietnam maintains several comparative advantages that should enable it to continue to attract foreign investors. It is already well integrated in Asian supply chains, wages costs are still competitive, and the authorities are slowly pursuing reforms that aim to consolidate macroeconomic stability, strengthen the institutional framework and improve the business environment (for the sake of illustration, Vietnam improved from 99th in 2013 to 69th in 2019 in the World Bank's Doing Business rankings).

Vietnam has also participated in many trade agreements, demonstrating the authorities' determination to promote free trade policy. Two examples are the Trans-Pacific Partnership (TPP), which partially took effect in early 2019, and the free trade agreement with the European Union, which should take effect by 2020. Vietnam is also participating in talks to harmonise all of the bilateral trade agreements between the ASEAN countries in order to create a broad regional partnership.

■ The external position is strengthening gradually but some vulnerabilities persist

Vietnam's current account balance has been in surplus since 2011. The trade surplus is the main component: it has averaged 5.7% of GDP since 2013 and peaked at 6.8% in full-year 2018 (chart 3). After rising in the first three quarters of 2018, the trade surplus has narrowed since Q4 2018 due to the erosion of its export performance. Given the high import content of exports, import growth also weakened, but continued to outpace exports, thanks to robust domestic demand.

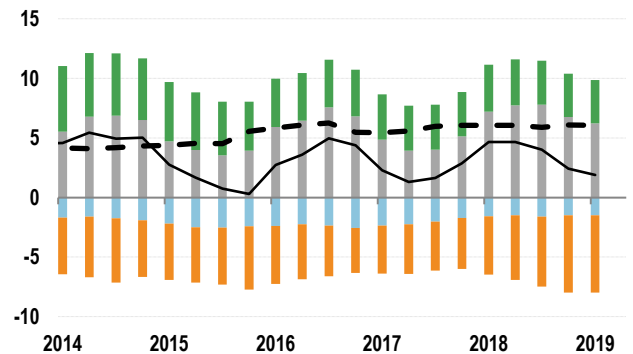
Transfers (international aid and remittances from the diaspora) are the second key contributor to the current account surplus. Despite a slow structural decline in recent years, net transfers are still solid and accounted for 3.6% of GDP in 2018. In contrast, the balance of primary income is negative and has deteriorated rapidly since 2017 (-6.5% of GDP in 2018), notably due to the increase in earnings repatriated by foreign enterprises. The services deficit is moderate (1.5% of GDP in 2018) and has improved slightly since 2017 thanks to the development of the tourism sector.

All in all, the current account surplus narrowed from 2.9% of GDP in 2017 to 2.4% in 2018 and is projected at 2.1% in 2019. This mild deterioration is due to both external shocks (slowdown in merchandise exports) and structural factors (increase in earnings repatriated by foreign groups, which the export sector depends heavily on). Assuming the export base continues to widen, the

3- A very comfortable basic balance

% of GDP, 4-quarter moving average

--- Net FDI — Current account balance ■ Trade balance ■ Services
■ Balance of primary income balance ■ Balance of secondary income



Source: State Bank of Vietnam

current account surplus should stabilize or even pick up slightly in 2020.

Vietnam has benefited from a largely positive basic balance (current account balance + net FDI) for several years, and its reliance on external debt has thus remained very moderate. Yet its foreign debt stock has increased in recent years, mainly due to private-sector debt, including inter-company loans. The external debt-to-GDP ratio rose from 40% in 2012 to 48% in 2018, and the debt servicing burden has remained all the more moderate since export revenues have increased strongly (it was estimated at 5.3% of exports of goods and services in 2018).

The external liquidity position has also improved but remains fragile. Foreign exchange reserves have more than doubled since 2012 to USD 55 bn at year-end 2018, but they do not yet cover more than three months of imports of goods and services. Therefore, foreign exchange reserves do not provide a comfortable buffer against external shocks. But they are projected to continue to increase in 2019-2020.

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Saudi Arabia

First signs of recovery

The Saudi economy has recorded weak performances over the past three years. It has had to deal with the combined impact of reforms undertaken as part of the Vision 2030 plan and rather unfavourable oil market conditions, which have eroded public finances. Non-oil GDP growth has been slowing since 2016 due to sluggish domestic demand. Activity should pick up gradually in 2019 thanks to fiscal stimulus efforts and the steady normalisation of the labour market. Under this environment, fiscal deficits are accumulating, but the government's solvency is still solid.

The non-oil economy has been entered in a slowdown for roughly the past three years. Non-oil GDP growth has averaged 1.2% a year since 2016, compared to 5.7% in the period 2011-2015. This can be attributed to the deterioration in public finances, which has led to sharp cutbacks in public spending since 2015. Accelerated efforts to drive through labour market reforms have also strained economic activity. In 2018, real GDP growth was 2.2%, thanks mainly to a 2.8% increase in oil GDP.

Oil GDP is expected to decline

As OPEC's largest member, Saudi oil production is closely linked to the oil cartel's production decisions. The ongoing rise in US oil production since 2016 -- the US became the world's leading oil producer in 2018 -- has forced OPEC+Russia to maintain a restrictive quota policy to bolster prices. The July 2019 quota agreement renewed the production cuts approved last December. This agreement runs through March 2020, which means Saudi oil production should remain stable this year at about 10 million barrels per day (mb/d), compared to 10.3 mb/d in 2018. As a result, oil GDP (roughly 40% of total GDP) should decline by about 1.7% in 2019.

A sharp economic slowdown

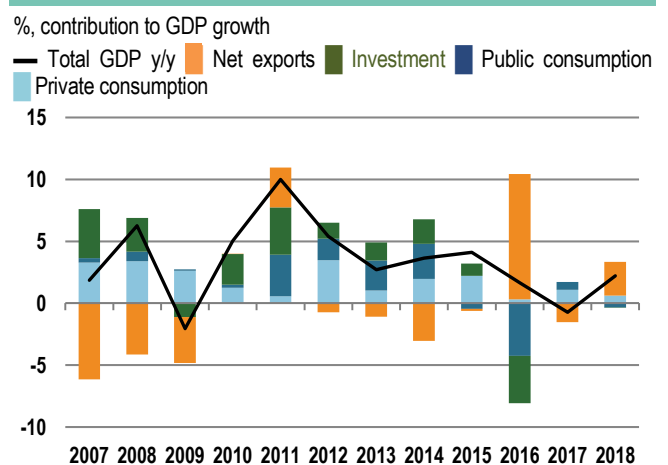
The non-oil economy has been idling since 2016. The sharp slowdown is due to the virtual stagnation of non-oil public sector GDP, and the acceleration of labour market reforms. In the past, public expenditure has been the main growth engine of Saudi domestic demand. Due to an unfavourable oil cycle, spending was cut in 2016 and 2017 to reach 36% of GDP, down from 41% in 2015. Saudization, the Saudi nationalisation scheme for the labour market (in which Saudi nationals replace expat workers in the non-oil private sector), has been stepped up over the past two years. The presence of non-Saudi workers has fallen sharply and is even forbidden in some retail sectors (jewellers or telephone service providers for example), which were traditionally owned by expats. At the same time, taxes were applied to expats and their families. This triggered an exodus of numerous expats and the consolidation of some sectors of the economy. Since early 2017, 1.8 million expats have exited the labour market. As a result, the total population of the country has declined by about 5% in two years. At the same time, employment has increased very slowly for Saudi nationals. The total number of working Saudis has increased slightly since year-end 2018 since private sector job creations have grown at a faster pace than the decline in public sector employment. These trends have obviously had negative consequences on domestic private demand,

1- Forecasts

	2017	2018e	2019e	2020e
Real GDP growth (%)	-0.7	2.2	1.1	2.9
Inflation (CPI, year average, %)	-0.9	2.5	-1.7	1.8
Central. Gov. balance / GDP (%)	-9.2	-4.6	-8.1	-8.2
Central. Gov. debt / GDP (%)	17	19	28	35
Current account balance / GDP (%)	1.6	9.3	3.5	3.5
External debt / GDP (%)	23	25	30	34
Forex reserves (USD bn)	497	497	499	504
Forex reserves, in months of imports	30	28	28	27
Exchange rate USDSAR (year end)	3.75	3.75	3.75	3.75

e: BNP Paribas Group Economic Research estimates and forecasts

2- Economic growth slumps



Source: Ministry of the Economy and Planning, BNP Paribas

which rose only 2% on average between 2016 and 2018, compared to an average of 5.9% in 2011-2015.

A few signs of recovery in 2019

This negative momentum seems to have begun to turnaround since the beginning of the year. Real GDP growth slowed to only 1.7% in Q1 2019 (vs. 3.6% in Q4 2018) due to weak export growth (+5.1%), which contributes more than 45% of total GDP. Yet there seems to have been a rather net upturn in private consumption (about 35% of total GDP), which increased 4.8%, compared to 1.8% in full-year



2018. Private consumption will benefit from public sector wage increases, which employs about 45% of working Saudi nationals. Household lending rose only feebly (1.8% y/y in March 2019).

As to the labour market, according to the latest figures for Q1 2019 the number of working Saudis has increased since Q3 2018 (+2000 persons), thanks notably to the dynamic momentum of female employment. The number of working expats has also picked up since Q4 2018 (+224,000 persons). As to public spending, the government is clearly committed to an economic support policy with a private sector stimulus package equivalent to 7% of GDP spread over four years. According to Q1 data, public sector wages and investment rose 8% and 12%, respectively. This support should continue throughout the year with a nominal 9% increase in the total provisional budget. In real terms, the fiscal stimulus is even more significant since we are forecasting negative inflation in 2019 (-1.7% on average). From a sector point of view, some leading indicators (cement production, ATM withdrawals and import letters of credit) signal ongoing growth of non-oil GDP in Q2 2019.

All in all, we are forecasting non-oil GDP growth of at least 3% in 2019 (compared to 2.1% in 2018). As a result, total GDP growth is estimated at 1.1% in 2019 before accelerating to 2.9% in 2020.

■ The cost of housing drags down inflation

Reflecting the sluggish economy, year-on-year price inflation has been negative since the beginning of the year (-1.5% y/y in May 2019). In 2018, prices rose 2.5% on average (compared to -0.8% in 2017), mainly due to the introduction of VAT and cutbacks in fuel subsidies in early 2018. In 2019, we expect the consumer price index to trend downwards (-1.7% on average), mainly due to the ongoing decline in house prices. The housing, water and energy component contributes 25% of the CPI basket. The rental sub-component declined 6.8% on average in the year to May 2019. At this stage, however, it is too early to talk about a deflationary situation. According to our estimates, core inflation (excluding housing and food) averaged 1.8% in May.

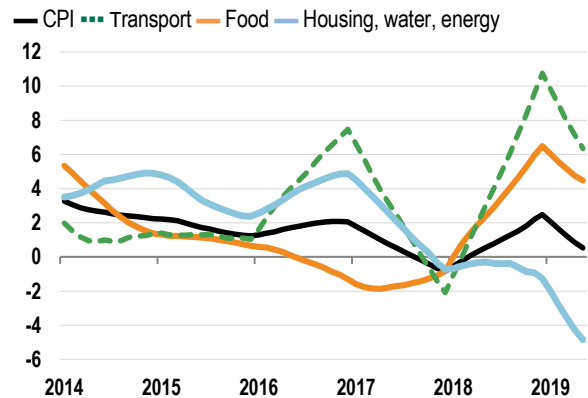
Given the brighter growth prospects in 2019, and with the halting of the decline in the number of working expats in the country, consumer prices should begin to pick up again in 2020. Moreover, to reduce the dependency of public finances on oil price trends, the government will continue its policy of increasing non-oil revenues (VAT, for example) and reducing fuel subsidies, in order to move closer to market prices. This should also help boost prices. Consequently, our outlook calls for consumer price inflation to average 1.8% in 2020.

■ Public finances deteriorate

Fiscal deficits have been recurrently high since 2014 due to higher fiscal spending and a less favourable oil market for Gulf oil producers. Deficits will remain high in the years ahead given the constraints on oil production and expectations of price stability on the one hand, and the need to stimulate economic activity on the other. The fiscal breakeven price currently stands at more than USD 85 per barrel (benchmark Brent), which is much higher than market prices (USD 66/b on average in H1 2019). Our outlook calls

3- Cost of housing pulls down inflation

%, annual average



Source: SAMA, BNP Paribas

for the deficit to reach 8.1% of GDP in 2019 and 8.2% in 2020. Slower spending growth and higher non-oil fiscal revenues (currently about 30% of total revenues) should reduce the deficit to 7.5% of GDP in 2021. The government plans to return to a balanced budget by 2023. The observed increase in the share of non-oil revenues is a positive factor that should make this easier, however the economy is still highly vulnerable to oil prices fluctuations. Controlling fiscal spending is still the key to reaching this goal.

Despite the accumulation of deficits, public finances are not in danger for the moment. Government debt is moderate (at an estimated 28% of GDP in 2019). Moreover, it is offset by major government assets (about 75% of GDP by adding government assets of the Saudi Arabia Monetary Authority (SAMA) and the estimated assets of the Public Investment Fund). Saudi Arabia has also become a regular issuer on the Eurobond market. Considering the current appetite of investors, Saudi Arabia will continue to benefit from very favourable financing conditions.

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United Arab Emirates

In search of a second wind

Economic growth has slowed for the past three years. OPEC+'s restrictive policy is curbing oil production. Non-oil GDP has been hit by sluggish tourist traffic, which has eroded domestic demand, notably in Dubai. In the short term, in the midst of a slowdown in world trade, the only factor that is boosting growth is the current preparations for Expo 2020. In this environment, consumer price inflation is negative, pulled down by the persistent slump in house prices. Fiscal policy remains cautious and offers little support for growth.

The feeble rebound in real GDP growth in 2018 (+1.7% compared to +0.5% in 2017) confirmed the sluggishness of the UAE economy. All of the components of domestic demand declined, both consumption and investment. This meagre GDP growth was due solely to a decline in imports and a slight upturn in exports at a time when hydrocarbon production was on the rise. In 2019, with OPEC+ renewing its restrictive policy¹ and with the non-oil economy showing no signs of a recovery, prospects are still looking morose.

Oil GDP growth faces headwinds

In the midst of the slowdown in global economic growth, and given the dynamic momentum of US oil production, OPEC policy is likely to remain restrictive in the quarters ahead. In early July, the group of OPEC+ countries decided to renew the production levels adopted at year-end 2018. As a result, UAE oil production is expected to remain unchanged in 2019 at about 3.05 million barrels a day (mb/d). On average, this represents a 2.4% increase in production compared to 2018.

In 2020, our central scenario calls for the stability of oil GDP in the UAE (equivalent to about 30% of total GDP). World oil supply will continue to be influenced by US production, which is unlikely to encourage the OPEC+ countries to ease significantly their restrictive policy. Looking beyond factors pertaining to the oil market, the main risk to oil GDP is geopolitical. Rising tensions in the Strait of Hormuz since the beginning of the year have led to low-intensity attacks on maritime shipping routes. These incidents highlight the vulnerability of the Emirate's oil outlets. Production is essentially located in Abu Dhabi (96% of total production) and is shipped via the Strait of Hormuz. In case of a blockade, the pipeline between Abu Dhabi and the port of Fujairah can transport 50% of production. These two alternatives for transporting oil products were hit by attacks that caused minor damage. Although a complete blockade of transport channels is unlikely, the risk of a temporary rupture has increased.

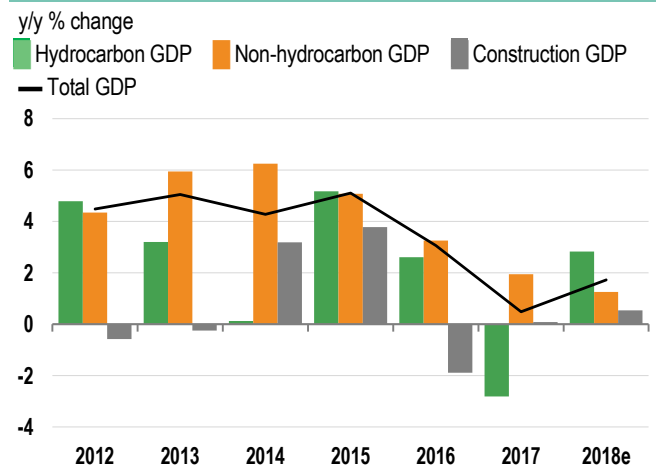
In the medium term, assuming OPEC's policy eventually changes, the national oil company ADNOC has ambitious targets: to boost daily production to 5 mb/d by 2030, develop the petrochemical industry, and increase natural gas production in order to achieve self-sufficiency.

1- Forecasts

	2017	2018	2019e	2020e
Real GDP growth (%)	0.5	1.7	2.4	3.2
Inflation (CPI, year average, %)	2.0	3.1	-1.8	1.0
Gen. Gov. balance / GDP (%)	-1.7	1.8	0.2	0.9
Gen. Gov. debt / GDP (%)	20	17	17	16
Current account balance / GDP (%)	7.0	12.0	11.0	11.0
External debt / GDP (%)	67	64	66	66
Forex reserves (USD bn)	95	100	105	107
Forex reserves, in months of imports	6.8	6.6	6.5	6.5
Exchange rate USDAED (year end)	3.67	3.67	3.67	3.67

e: BNP Paribas Group Economic Research estimates and forecasts

2- Slow economic growth



Source: Federal Competitiveness and Statistics Authority, BNP Paribas

Mixed outlook for the non-oil sector

Growth in the non-oil sector was unusually weak in 2018 at 1.3%, the lowest growth rate since the 2009 crisis. The slowdown can be attributed to several factors, notably the lacklustre regional environment, the introduction of VAT on consumption, the negative indirect effects of the Qatar embargo and the dollar's appreciation,

¹ OPEC+ is mainly comprised of OPEC members + Russia.



which might have had an unfavourable impact on tourism. Short-term prospects are still uncertain, and economic signals are contradictory.

In June 2019 the PMI index reached 57.7, confirming its rebound since end-2018. This was the exception, however, and the other economic indicators are all trending downwards, notably in Dubai, which is by far the Federation's most diversified economy. Passenger traffic at the Dubai airport has slowed continuously since 2016. In Q1 2019, full-year growth was virtually nil (+0.2%). The sharp slowdown in the tourism sector confirms the trend observed since 2016. We can also see a significant decline in spending by tourists. According to the central bank, revenue per overnight stay declined by 7.6% in 2018, resulting in feeble retail sales growth. This is the Emirate's biggest economic sector (12%) after the extractive industries (30%). Growth was the slowest in the past two years (0.1% and 0.5%, respectively).

Activity in the construction sector is still trending upwards, notably as projects are completed for the World Expo 2020. This is likely to be the main growth engine in 2019. Construction sector lending remains the most dynamic segment of bank lending to the private sector (+8% y/y in March 2019). Excluding projects pertaining to Expo 2020, however, the property sector has been hit by ongoing price declines since 2016, due to a chronic over supply.

At the same time, external factors are likely to place a negative strain on activity in the short term. The Emirates are a major logistical base for regional trade (essentially with Asia and the Middle East). Re-export activities account for about 60% of total non-oil exports. Even though the US-China trade war will not have a direct impact on UAE growth, the decline in world trade will reduce the Emirate's logistics activities. In volume terms, world trade rose at an average monthly rate of only 0.5% in Q1 2019, compared to 3.6% in Q1 2018. Rising political tensions in the region is another factor that will continue to strain growth. The Dubai economy is dependent on the services sector and foreign investment, notably in the property market, which makes it especially vulnerable to the deterioration in the regional political environment.

■ Economic policy provides little support

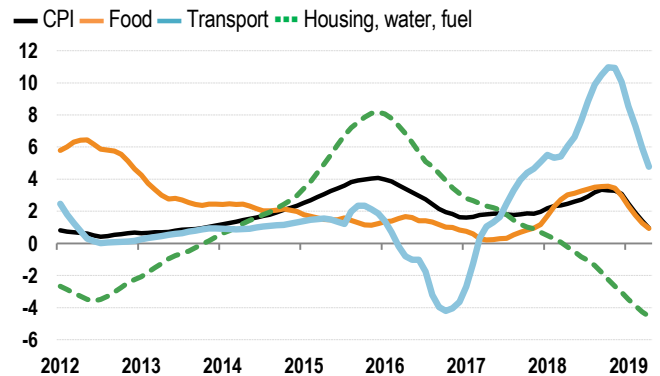
In the midst of a morose economy, economic policy measures are unlikely to be significant support factors. The 2019 budget is expected to support growth, but without triggering a major recovery in public expenditures. The main government measures target improvements in the business environment, notably for foreign investment. In terms of monetary policy, the growth of bank lending could get a boost from the decline in central bank rates. With the dirham pegged to the US dollar, the slight decline expected in US rates in 2019 should reduce the cost of financing.

■ Deflationary environment

Feeble activity in the non-oil sectors and a depressed property market have created deflationary pressures. Inflation was still positive at 3% in 2018, mainly due to the introduction of VAT at the beginning of the year. In 2019, we are looking for a decline in overall consumer price inflation to an average annual rate of about 1.8%.

3- Broad decline in consumer prices

%, average annual rate



Source: Federal Competitiveness and Statistics Authority, BNP Paribas

The housing and energy component, which accounts for a third of the composition of the consumer price index, declined 4.5% y/y in April 2019. Similarly, transport and food prices have been trending downwards since the beginning of the year. The decline in housing prices should continue to negatively weigh on the overall index at least through the end of the year.

It is hard to determine whether the Emirate's sluggish economic activity is due more to structural factors (decline in attractiveness for tourists and investors) or to cyclical ones (economic slowdown in the Gulf region, geopolitical tensions). Growth seems to be in the process of normalising, notably in Dubai. The current situation could strain the quality of bank assets, due notably to their exposure to the construction and housing sectors (25% of private sector loans). Moreover, if growth continues to slow over the long term it could strain the performance of government-related entities, which are very active in the sector and heavily leveraged.

Nonetheless, the UAE economy continues to benefit from solid fundamentals, both in terms of public finances and external accounts. Recent consolidation movements at various levels (banking, sovereign funds) and a cautious economic policy have bolstered the country's medium-term prospects.

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Tunisia

A fragile stabilisation

The Tunisian economy has begun to show signs of stabilisation. Inflation is falling, exchange rate pressures are easing and the government finally managed to uphold its commitment to fiscal consolidation in 2018. Yet the country's prospects are still very fragile. Although the support of international donors is reassuring, the persistence of major external imbalances exposes the economy to shocks. Bank liquidity is already under pressure due to the tightening of monetary policy, and the high level of public debt calls for further reduction in budget deficits that could be hard to achieve. Above all, economic growth is still sluggish.

Tunisia will hold general elections in a few months that will be decisive for the consolidation of its democratic transition. Although the outcome is uncertain amid an increasingly fragmented political landscape, the roadmap is rather clear for future leaders: they must boost a sluggish economy, halt the surge in public debt and strengthen Tunisia's external-account stability. On the positive side, signs of stabilisation are finally seen after several years of overruns. The overall picture, in any case, is still very fragile.

■ Monetary policy: a necessary but difficult tightening

Inflation is still high at 7%, but has declined since the peak reached in June 2018 at 7.7% (chart 2) thanks to the tightening of monetary policy. Since February 2018, the key policy rate has been raised by 275 basis points (bp) to 7.5%. For the first time in three years, real interest rates are negative. The Central Bank of Tunisia (CBT) has also tightened refinancing conditions for banks and has capped the loan-to-deposit ratio at 120%.

Although the CBT has clearly shown its determination to fight against inflation, it has very little manoeuvring room. The overall volume of CBT refinancing has peaked since the beginning of the year (TND 16 bn, up from TND 10 bn one year earlier, with almost ¼ made of 24-hour marginal loan facilities), which leaves the banks highly sensitive to monetary policy tightening. It is not surprising that money market rates have soared to historical highs of nearly 8%, and that lending growth to the economy has slowed sharply. At the end of May 2019, banking credit growth had slipped to only 6.8% y/y, compared to 13% in early 2018. Expressed in real terms, lending growth even slipped into negative territory in May, for the first time since November 2003.

Inflationary pressures are likely to remain high. Fluctuations of the Tunisian dinar (TND) call question. After depreciating by nearly 30% against the euro in 2017-2018, the TND has been resilient since the beginning of the year. Over the past three months, it has even strengthened 6% against the single currency. One explanation is the dynamic momentum of tourism. After a long period of stability, the 16% depreciation in the real effective exchange rate over the past two years has partially reduced the over-valuation of the currency. Yet considering the magnitude of external imbalances, the dinar's upward momentum seems unsustainable. The Central Bank of Tunisia might have to tighten monetary policy further if new currency pressures arise.

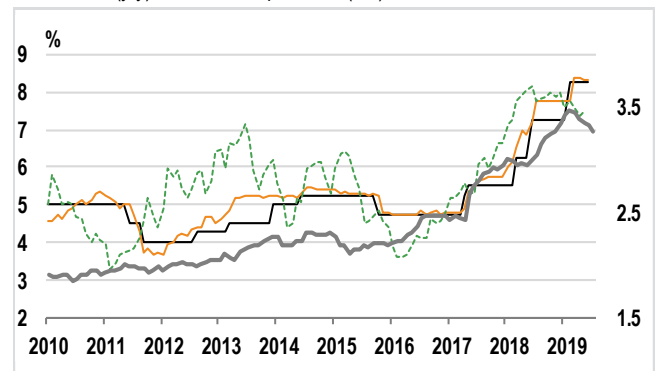
1-Forecasts

	2017	2018	2019e	2020e
Real GDP growth (%)	1.9	2.5	2.0	2.5
Inflation (CPI, year average, %)	5.3	7.3	7.0	5.7
Central Gov. balance / GDP (%)	-6.2	-4.8	-4.3	-3.6
Central Gov. debt / GDP (%)	70.5	77.0	78.1	77.8
Current account balance / GDP (%)	-10.2	-11.2	-9.7	-8.5
External debt / GDP (%)	84.0	84.6	95.3	96.3
Forex reserves (USD bn)	5,6	5,3	5,9	6,7
Forex reserves, in months of imports	3.0	2.6	2.9	3.1
Exchange rate USDTND (year end)	2.48	2.99	3.15	3.30

e: BNP Paribas Group Economic Research estimates and forecasts

2- Monetary environment

— Key policy rate — Money market rate
 - - - Inflation (y/y) — TND per Euro (rhs)



Source: CBT, INS, Datastream

■ External imbalances are still very high

Tunisia's external position is the main source of macroeconomic vulnerability. After reaching a record high of 11.2% of GDP in 2018, the current account deficit could finally begin to narrow this year. Even so, it will still hold at very high levels, at about 9% of GDP. Several factors continue to strain external-account dynamics. Despite currency depreciation, exports are still hit by the collapse of phosphate production and the ongoing loss of market share in Europe, by far its biggest trading partner. Although the tourism sector has rebounded strongly since the 2015 terrorist attacks, it



now generates fewer revenues than in the past (USD 1.5 bn in 2018, down from USD 2.1 bn in 2014) despite an increase in the number of tourists. The ongoing decline in national hydrocarbon production also limits the gains generated by lower oil prices on the import bill. Net oil imports accounted for half of the current account deficit in 2018, up from 16% in 2010.

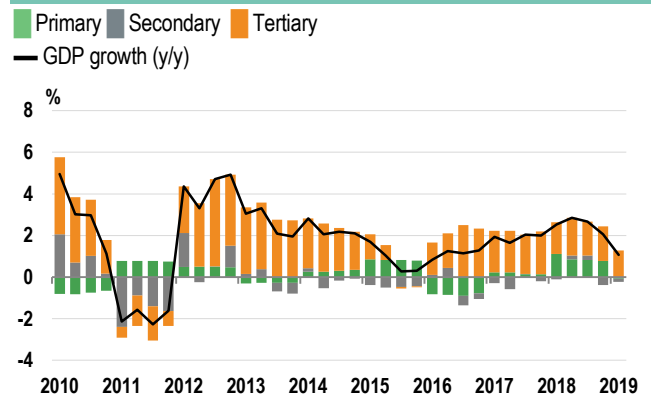
The recent conclusion of the sixth tranche of the IMF programme provides grounds for relief. Net flows of foreign direct investment (FDI) have been stable at 2-2.5% of GDP, but they only account for 20% of the current account deficit. By keeping the IMF programme on track, not only is Tunisia ensured of the support of other international donors but this also paves the way for an upcoming Eurobond issue of EUR 500 mn, which should be sufficient to cover external financing needs. Yet, with foreign exchange reserves now below the warning threshold of three months of imports of goods and services and a sizeable major current account deficit, the economy is still highly exposed to exogenous shocks.

■ Public finances: progress must be kept in perspective

The consolidation of public finances also promises to be difficult, even though some reforms are beginning to bear fruit. According to preliminary estimates, the fiscal deficit was cut from 6.2% of GDP in 2017 to 4.8% in 2018 thanks essentially to the increase in tax revenue (+1.2% of GDP). Ambitious goals have been set for 2019, with a deficit reduction target of 3.9% of GDP. We do not think this target will be met due to pressures created by the electoral campaign. Even so, the fiscal deficit should continue to narrow to 4.3% of GDP, which would mark a break from the fiscal overruns of recent years. However, nothing guarantees that the authorities will be able to maintain the cap in the longer term.

Contrary to IMF recommendations, the government granted wage increases to public sector employees for an estimated cost of 0.5% of GDP in 2019 and 2020. Although new cutbacks in energy subsidies should help absorb part of the cost, the decision further accentuates the rigidity of public spending. Despite a freeze on hiring since last year, the public sector payroll could absorb nearly 65% of fiscal revenues in 2019, up from 54% in 2010. To meet their fiscal commitments, the authorities could have no option but to use public investment as an adjustment variable, to the detriment of economic activity. Above all, the government debt trajectory is still not showing any significant signs of improvements. Government debt (77% of GDP) is a source of concern, although the high share of debt contracted on concessional terms (63% of foreign currency debt) has helped limit the debt servicing cost so far. Significant contingent liabilities also arise from government guarantees for financially challenged state-owned companies (15.6% of GDP). Moreover, government debt is exposed to exchange rate fluctuations (75% of the debt stock is denominated in foreign currency). Lastly, external assistance from international donors is supposed to cover 60% of domestic financing needs in 2019 and 2020. Although the risk of disruption is rather limited, disbursements are subject to conditionality, which reduces the government's manoeuvring room in the absence of any alternative sources of financing (the local capital market is shallow).

3- Sector contribution to growth



Source: INS

■ Economic prospects: towards a mild recovery

Q1 figures confirmed Tunisia's economic difficulties. After a mild recovery over the past two years (+2% in 2017 and +2.5% in 2018), real GDP growth slowed to 1.1% in Q1 (see chart 3). With the exception of tourism, most sectors have stalled (construction) or contracted (agriculture and manufacturing). Although public-sector wage increases effective since March should boost household consumption as of Q2, the overall impact on growth will be small. With GDP growth estimated at 2% this year and 2.5% in 2020, the Tunisian economy will not be in a position to bring down the official unemployment rate, which has culminated at 15%. Looking beyond exogenous factors (regional instability, weak European demand) and security risks, which are all very real, it is critical to accelerate structural reforms to improve growth prospects. The challenge is daunting. Between 2010 and 2018, the investment rate fell by 5 points to 20% (compared to 28% in Morocco). It is also very telling that Tunisia has lost 50 places on the World Economic Forum's global competitiveness ranking over the same period, illustrating the fundamental problems the authorities must face.

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