ECO EMERGING

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Editorial

Rebound in portfolio investments: a not so passive management

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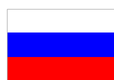

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Eco EMERGING

ECONOMIC RESEARCH DEPARTMENT

BNP PARIBAS

The bank for a changing world

Editorial

Rebound in portfolio investments: a not so passive management

After tightening in Q4-2018, external financing conditions in the emerging countries have eased since the beginning of the year. At the same time, there was a net upturn in non-resident portfolio investments, which shows that investors have a greater appetite for risk after the US Fed announced that it would pursue a cautious and flexible monetary tightening policy, and would pause the reduction of the Fed's balance sheet. The Institute of International Finance (IIF) even concluded that investors were overexposed to the emerging markets. According to the IMF, so-called passive fund management (ETF and other indexed funds) has either reached critical mass or at least has sufficient leverage to trigger financial market instability.

After tightening in fourth-quarter 2018, external financing conditions in the emerging countries have eased since the beginning of the year. Risk premiums on sovereign and corporate debt in foreign currencies, as calculated according to the JP Morgan and Crédit Suisse indexes, have fallen by 70 and 60 basis points (bp), respectively, from their peak in late 2018 and early 2019. B-graded counterparties (the most risky components) reported the biggest declines of 110bp and 140bp, respectively. At the same time, all of the emerging currencies appreciated against the dollar, with the exception of the Argentine peso and Turkish lira. Moreover, the market's main sovereign borrowers, such as the Gulf countries, easily placed their international bond issues.

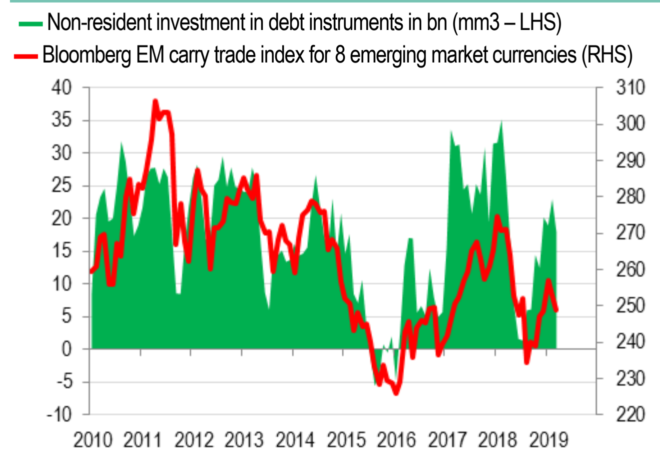
In general, non-resident portfolio investments have picked up robustly since the beginning of the year. According to preliminary IIF estimates, they amounted to USD 109 bn in Q1 2019 (USD 87 bn excluding investments in the Chinese equity markets), which is twice the amount for the period May-December 2018. Excluding China, it is nearly seven times higher. As the IIF points out, the rebound was concentrated in a few major emerging markets (South Korea, India, Indonesia and Mexico). This shows that investors have a greater appetite for risk after the US Fed announced that it would adopt a cautious and flexible monetary tightening policy in the United States, and would pause the reduction of the Fed's balance sheet. It also corresponds to an improvement in the returns on carry trade operations (see chart). After correcting for valuation effects, the IIF even concludes that investors are overexposed to the emerging markets (EM positioning overhang).

Passive management: an underlying current

Portfolio investment inflows naturally raise questions about the risks they pose in cases of stress on financial market stability in the receiving country. In the IMF's latest Global Financial Stability Report, the fund's economists present a detailed study of the potential risks associated with the development of Exchange-Traded Funds (ETF) and indexed funds, and so-called passive portfolio management in general[1].

According to the IMF, emerging market bond funds using passive management strategies (indexed to JP Morgan-Chase indexes) amounted to USD 800 bn in 2018. At first sight, this only represents a very small share of the total amount of the underlying debt (2% of the foreign currency debt compartment and 1% of the local currency sovereign debt compartment). In practice, however, passive management is also applied outside of the domain of ETF and indexed funds. According to the IMF, 70% of funds are influenced by benchmark indexes. Moreover, the USD 800 bn figure represents 40% of the cumulative flows of non-resident bond investments over the past decade. Passively managed equity funds account for a more consequential share of total capitalisation (10%), and probably most of non-resident equity investments.

The return of the carry trade



Source: Bloomberg – IIF

ETFs and indexed funds have either reached critical mass or at least have sufficient leverage to trigger instability in the bond or equity markets, and indirectly in the forex market through their change in market positioning[2].

First, indexed funds are very sensitive to the asset price factors common to all of the emerging markets (global factors), such as the direction of US monetary policy, the strength of the dollar, the level of volatility in the developed markets, and the ups and downs of Chinese growth[3]. Indeed, indexed funds consider the emerging

[1] Asset allocation strategies that replicate the structure of a benchmark index. JP Morgan-Chase indexes are used for emerging market bond funds.

[2] Other investor categories can introduce inertia (institutional investors) or to stand against the market consensus (notably hedge funds).

[3] The aggregate pair-wise correlation between benchmark-driven flows to individual emerging markets was about 80% compared with about 30% for overall portfolio based on BoP data.

markets as an asset category as a whole, and make little or no distinction between countries. As a result, the most fragile countries benefit from the same capital inflows as the more robust countries during risk-taking phases and from similar outflows during risk reduction phases.

Second, the revision methods used for the composition of country baskets that comprise the main benchmark indexes tend to cap the weighting of big issuers and swell the weighting of small issuers. As a result, the share of non-resident investment in local currency sovereign debt can be very high for small sovereign issuers.

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China

What lies behind the rise in corporate defaults?

Industrial enterprises were squeezed by tighter financing conditions in 2017 and early 2018, and then hit by a slowdown in production and revenue growth last year. These troubles have contributed to the deterioration of their payment capacity, resulting in a surge in defaults in the local bond market. The increase in defaults is an indicator of the financial fragility of corporates, and also seems to be going hand-in-hand with greater differentiation of credit risks by lenders and a certain clean-up of the financial sector. These trends are expected to continue in the short term as the authorities conduct a targeted easing of monetary policy. However, the persistence of the debt excess in the corporate sector will maintain high credit risks in the medium term.

Chinese corporates operated in a tough environment in 2018, squeezed first by tighter financing conditions and then by the slowdown in activity. As a result, their payment capacity has deteriorated while their debt burden has remained excessively high. In recent months, in response to the worsening economic growth slowdown, the authorities have introduced fiscal measures to stimulate demand and eased monetary policy. This accommodative policy stance is likely to be maintained in the short term, and economic growth is projected to slow only moderately in 2019. In this environment, how will corporate credit risks evolve?

A complex environment for industrial enterprises

Since the end of 2016, corporates have found it harder to access credit. The authorities tightened monetary policy from late 2016 to early 2018 and then have only cautiously loosened it since Q2 2018. In the meantime, they have also considerably strengthened the financial sector's regulatory framework. As a result, growth in total credit to the economy (social financing) has slowed gradually, before picking up slightly again in Q1 2019 (see chart 2). The weighted average bank lending rate increased from 5.3% at year-end 2016 to 6% in mid-2018, before easing again to 5.6% at year-end 2018.

The deterioration in global economic conditions has only compounded the impact of tighter credit conditions on Chinese growth. Corporates in the industrial sector have been hit hardest by the slowdown in activity resulting from the weakening in both internal and external demand. Industrial production growth dropped to a low of 5.3% y/y in January-February 2019, compared to a monthly average of 5.7% in September-December 2018 and 6.5% in January–August 2018. While global demand has been cooling, China's export manufacturing sector has been hard hit by US tariff hikes. The latest round of tariff increases (10% in September) had a severe impact: total exports contracted by 0.1% y/y in November-December 2018 and by 5.2% in January-February 2019 (although they rebounded again in March).

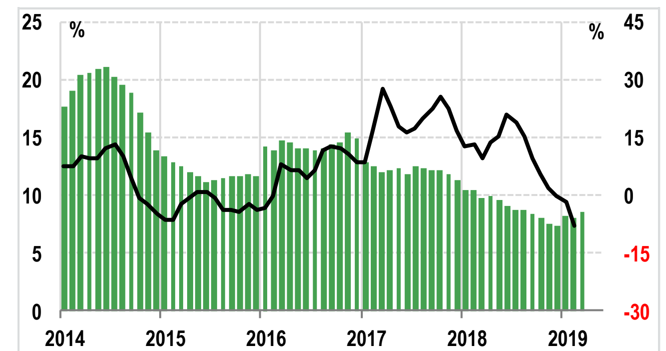
Industrial enterprises geared towards the domestic market have continued to be squeezed by the decline in real estate market transactions (which rose only 1.3% in 2018 and contracted 3.6% y/y in January-February 2019) and the slowdown in retail sales, especially in the durable goods and automobile sectors (vehicle purchases were down 3.1% in 2018 before plunging 15% in the first two months of 2019).

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	1.6	2.0
Actual fiscal balance / GDP (%)	-3.7	-4.2	-4.3	-4.5
Central government debt / GDP (%)	16.4	16.6	19.4	22.1
Current account balance / GDP (%)	1.4	0.4	-0.2	-0.6
Total external debt / GDP (%)	14.4	14.5	14.0	14.0
Forex reserves (USD bn)	3 140	3 073	2 950	2 880
Forex reserves, in months of imports	17.0	14.5	13.0	12.0
Exchange rate USDCNY (year end)	6.5	6.9	6.7	6.5

e: estimates and forecasts BNP Paribas Group Economic Research

2- Less credit, fewer profits



Source: PBOC, NBS

Weaker demand, lower production capacity utilisation rates in 2018 (after two years of improvement) and the decline in energy prices in the year-end period triggered rapid disinflation in the producer price index (+0.2% y/y in Q1 2019 vs. 3.7% in Q1 2018). In the past, corporate revenues have been very closely correlated with this index. As a matter of fact, profits of industrial enterprises have slowed since mid-2018 and then fell by 14% y/y in the first two months of 2019.

Increasing number of defaults

In this environment, the payment capacity of corporates has deteriorated. Supplier payment periods have lengthened and the number of late payments has soared, which has helped spread these difficulties throughout the economy. According to Coface data, the average duration of late payments increased in the majority of sectors, with transport and construction reporting the longest durations, at more than 100 days. Worse, there has been an increase in the number of ultra-long late payments (80% of which are never repaid), which has eroded the cash position of many corporates, notably in construction, automobiles, textiles, information & communications technology and transport.

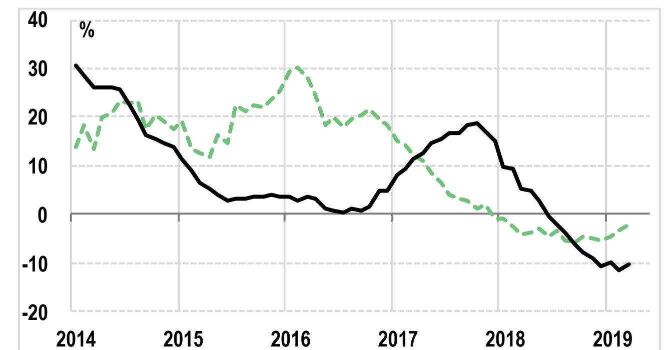
As to the repayment of debt, commercial banks reported a slight increase in non-performing loan ratios last year (to 1.83% from 1.74% at year-end 2017). The number of defaults in the local bond market increased more spectacularly, from less than 20 per year in 2015-2017 to about 40 in 2018 and 10 in Q1 2019. Several sectors were hit, and the energy sector in particular. The amount of defaulted debt is still limited (USD 16 bn in 2018, less than 0.5% of outstanding corporate bonds). Yet the surge in defaults indicates not only a deterioration in the corporate financial situation, but also a change in behaviour in the Chinese market (the first bond default did not occur until 2014). Moreover, not only private corporates are defaulting, but also a few state-owned enterprises, which signals that government support can no longer be taken completely for granted.

Therefore, while the rise in default risks is an alarming indicator of corporate fragility, it also seems to be accompanied by healthier lending practices. Moreover, other sources of vulnerability and risks of financial-sector instability have eased over the past two years, in response to the tightening of monetary policy and the strengthening of the regulatory framework. The decline in interbank financing has reduced the interconnections between financial institutions (banking and non-banking) and enabled them to deleverage. Shadow banking activities have also declined[1] (see chart 3). Meanwhile, the corporate sector began to report a slight decline in the debt-to-GDP ratio (estimated at 133% at year-end 2018, down from 137% at year-end 2017)[2]. However, this later trend is expected to be reversed in 2019.

An improvement in credit risk assessment?

Between economic growth and deleveraging, the Chinese authorities have switched priorities over the past few months: the current policy mix primarily aims to stimulate activity in the short

3- Attenuation of financial-sector instability risks



Source: PBOC, NBS

term. Growth in bank loans and bond issuance has accelerated slightly again since Q4 2018, and investment in public infrastructure has also been picking up. Moreover, fiscal stimulus measures introduced since early 2019 should also help economic growth to recover slightly, after bottoming out in the first part of the year. The easing of credit conditions should also help improve the cash position of corporates. Even so, default risks are still high, simply because of the persistence of corporates' debt excess. The number of defaults on the local bond market is likely to increase even further since the amount of debt reaching maturity for non-financial corporates will hit a record high in 2019 (USD 459 bn according to the Institute of International Finance).

At the same time, there should also be greater differentiation between different categories of borrowers. Firstly, the authorities are proceeding with a targeted easing of monetary policy: banks are notably encouraged (via directives or targeted financing facilities) to increase lending to private enterprises, SMEs and the healthiest companies. In addition, the increase in defaults seems to be prompting greater risk aversion and a better assessment of risks by creditors. As a result, financing conditions should continue to deteriorate for the most fragile companies. Lastly, reducing the risks of instability in the financial sector is still a key objective for Beijing, and the authorities are expected to maintain efforts to improve financial regulation and strengthen state-owned enterprises. The relative performances of financial institutions should continue to diverge as the big banks remain relatively solid and the others (small banks and non-banks) are hit by higher non-performing loans and the deterioration of their liquidity and capital adequacy ratios. Here too, even though the difficulties of certain institutions may well expose China to bouts of stress and volatility, they might also signal a move towards a healthier financing system.

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[1] The financing offered by shadow banking institutions is not monitored and supervised as closely as bank loans. Some of this financing is reported in official statistics of "social financing", for example trust funds and entrusted loans (intercompany loans intermediated by banks). Other shadow banking activities are excluded from these statistics (such as assets financed by wealth management products, loans by financing companies, microloans, online lending between individuals, etc.). All forms of shadow banking have contracted over the past two years.

[2] Debt of the corporate sector excluding local governments and their financing vehicles.

India

Economic track record on the eve of elections

After nearly five years in power, Narendra Modi's track record is generally positive, even though the last year of his mandate was tough, with a slowdown in growth in Q3-2018/19. The main growth engines are household consumption, and more recently, private investment, thanks to a healthier corporate financial situation, with the exception of certain sectors. In full-year 2018, external accounts deteriorated slightly as a swelling current account deficit was not offset by foreign direct investment. A big challenge for the next government will be to create a more conducive environment for domestic and non-resident investment.

Robust growth in 2018 despite a slowdown in Q3-FY2018/19

In the third quarter of fiscal year 2018/2019 (October-December 2018), economic growth slowed to 6.6% year-on-year (y/y). This was in part due to a slowdown in government spending, while household consumption and investment continued going strong. Activity slowed in the primary sector but remained robust in the industry and the services sector. To stimulate growth, the Central Bank lowered its policy rates twice (in February and April 2019), taking advantage of mild inflationary pressures (+2.6% y/y in February 2019) and the end of US monetary policy tightening.

In calendar year 2018, economic growth rose to 7.4% (vs 6.9% in 2017), one of the highest growth rates in Asia. In comparison, growth was 5.2% in Indonesia, 6.2% in the Philippines, 6.6% in China and 7.1% in Vietnam. Despite India's solid performance, however, per capita income is still low at USD 2016.

Consolidation of corporate's financial situation

The situation of private non-financial companies has improved significantly. They are now in a more solid position than in 2011, when the corporate situation began to deteriorate.

Since 2014, Indian companies as a whole have been undergoing financial consolidation. The debt-to-GDP ratio fell by 5 percentage points to 57% in Q3 2018. According to central bank data, the interest charges of private listed non-financial companies have declined. They accounted for 22.3% of profits before tax in Q4 2018, down from more than 35% in 2014. Sales revenue growth has also accelerated strongly since year-end 2017, generating an increase in net earnings of nearly 25% in Q4 2018, despite an upturn in the total wage bill. As a result, profits before tax covered interest charges 4.5 times in Q4 2018, compared with only 2.8 times in 2014.

Yet in certain sectors the situation is still very fragile, notably in telecommunications and energy. According to Crédit Suisse [1], interest charges were higher than profits before tax for 96% of companies in the telecommunications sector and 58% of those in energy. The iron and steel sector had the highest concentration of loans at risk at the end of September 2018 [2] (34.2% of loans outstanding according to the central bank), but companies have managed to consolidate significantly their financial situation thanks to sales revenue growth and deleveraging. Profits before tax covered interest charges 11.7 times in Q3 2018, compared to 4.3 times in 2014.

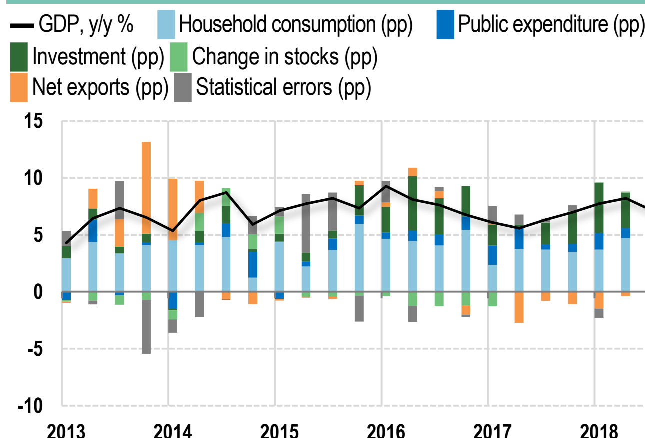
1- Forecasts

	2017	2018e	2019e	2020e
Real GDP growth (1) (%)	7.2	7.4	7.6	7.8
Inflation (1) (CPI, year average, %)	3.6	3.4	3.3	4.1
Central Gov. Balance (1) / GDP (%)	-3.5	-3.3	-3.2	-3.0
Central Gov. Debt (1) / GDP (%)	46.9	46.1	45.7	45.2
Current account balance (1) / GDP (%)	-1.8	-2.4	-2.3	-2.1
External debt (1) / GDP (%)	20.4	19.4	19.2	19.1
Forex reserves (USD bn)	409	393	410	418
Forex reserves, in months of imports	11.5	9.1	9.3	9.5
Exchange rate USDINR (year end)	63.9	71.0	72.0	73.5

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

e: estimates and forecasts BNP Paribas Group Economic Research

2- Economic growth slowdown in Q3-FY2018/19



Source: CEIC

Insufficient foreign direct investment

In 2018, for the first time since 2013, the balance of payments showed a deficit estimated at 0.2% of GDP (excluding changes in foreign exchange reserves). It can be attributed to a sharp increase in the current account deficit coupled with a decline in net capital inflows.

[1] *India Corporate Health Tracker*, February 2019.
[2] Sum of non-performing loans and restructured loans.

The current account deficit rose to 2.4% of GDP in 2018, a 0.9 point increase compared with 2017. The deterioration reflects the strong rise in the trade deficit, which rose 1.1 percentage points to 6.9% of GDP. Exports rose only 5.9% over the full year, while imports increased 12.1%, reflecting an upturn in investment and the oil bill.

At the same time, net capital inflows declined to only 2.2% of GDP in 2018 (from 3% of GDP in 2017). Net foreign direct investment (FDI) declined compared with the 2015-2016 peak, and represented 1.2% of GDP in 2018; this did no longer cover the current account deficit. As a result, the country is dependent on portfolio investment and thus exposed to international financial market volatility. Yet net portfolio investment outflows reached the equivalent of 0.4% of GDP in 2018. As net capital inflows were inadequate to cover the increase in the current account deficit, foreign exchange reserves declined by USD 20 bn and the rupee depreciated by 9% against the dollar in full-year 2018. Even so, foreign exchange reserves are still sufficient to cover the country's short-term external financing needs (1.3 times). Compared with 2013/14, corporates are also slightly less exposed to a revaluation of their debt thanks to the rupee's depreciation against the US dollar. The share of external debt denominated in USD accounted for only 45.9% of total debt at the end of 2018, compared with more than 63% five years earlier.

In Q1 2019, the balance of payments seemed to be healthier given the positive shift in the rupee and foreign reserves. In the first two months of the year, the trade deficit narrowed slightly thanks to the decline in imports.

One of the future government's objectives will be to stimulate further FDI in order to boost economic growth and reduce the country's dependence on volatile capital flows. Although the business climate has improved significantly during the Modi mandate, FDI flows are still mild and the stock of FDI accounted for only 14.3% of India's GDP at year-end 2018 (compared with 22.5% of GDP in Indonesia and 21.7% of GDP in China).

End of preferential tariffs with the United States?

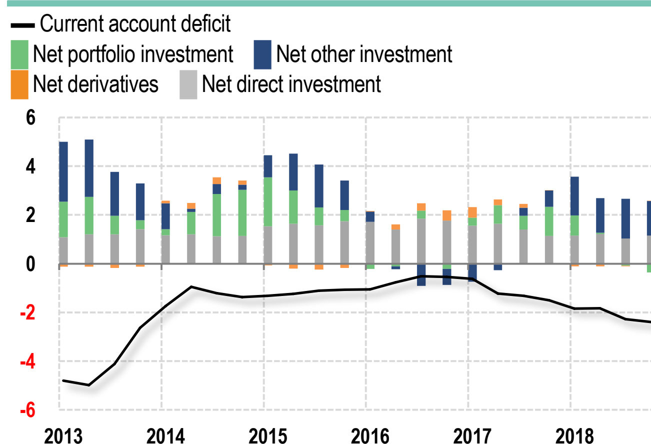
Since 1974, India has benefited from preferential tariffs for certain products exported to the United States under the framework of the Generalised System of Preferences (GSP), which aims to facilitate the development of emerging countries. President Trump announced that he might eliminate this advantage because sales of American products in India were heavily restricted, especially for medicines and basic necessities, such as milk.

Such a move would have only a moderate impact on India's economy. According to the US International Trade Commission, Indian exports to the United States as part of GSP amounted to USD 6.2 bn, 11.5% of exports to the United States, and the equivalent of 0.23% of GDP. These products include mechanical engineering, vehicles, iron and steel, chemicals and consumer goods.

Major challenges for the next government?

Between 11 April and 19 May, general elections will be held for the entire lower house of Parliament, and a new Prime Minister will be elected for the next five years.

3- Balance of payments (4-quarter sum, % of GDP)



Source: RBI

Although the Narendra Modi government's track record is generally positive, thanks notably to the introduction of the Goods and Services Tax (GST), the biometric coverage of the population (Aadhaar project) and a new corporate bankruptcy law, the next government will face several major challenges. Although per capita income has increased strongly in real terms (+6.8% a year on average over the past five years) and the poverty rate has declined, productive employment is still insufficient and informal employment is too high (81% of total employment according to the International Labour Organisation) to increase significantly the country's development.

The next government will have to create a more conducive environment for domestic and non-resident investment. These efforts must cover education (for all) and the labour market, by making it easier for women to find jobs, reducing hiring restrictions and lowering corporate costs in case of layoffs.

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Brazil

Delayed recovery

The hopes of seeing economic activity pick up following the election of Jair Bolsonaro have fallen. Some indicators point to a possible contraction in economic activity in Q1 2019 at a time where confidence indicators were seemingly improving. Meanwhile, the reform of the pension system – a cornerstone of President Bolsonaro's economic program – was presented to Congress in February where it is currently under discussion. Negotiations will likely be more protracted and be more difficult than originally expected. Indeed, since taking office, the popularity of the Brazilian president has sharply declined and relations between the executive and the legislature have strained.

A lethargic start to the year

In 2018, the economy grew at the same pace as in 2017, at an annual average rate of 1.1%. The year's growth performance was largely tainted by the truckers' strike and the general elections. Household consumption remained the main driver of growth thanks in particular to a rise in consumer credit, which spearheaded the recovery in credit growth (+5% in 2018) after two years of contraction in 2016 and 2017. Investment recovered some lost ground (+4.1% y/y) after declining for four years. Nonetheless, investment as a share of GDP remains well below its 2013 peak (17.4% versus 22.8% of GDP). Meanwhile, the contribution of net exports was negative (-0.5 pp) for the first time since 2013. The current account deficit (USD 14.5 bn) was contained (0.8% of GDP) and was largely covered by net FDI flows (USD 74.3 billion, or 4.1% of GDP). Due to the very slow pace of economic activity in Q4 (+0.1% q/q) the statistical carry-over for 2019 is weak.

Despite the upswing in confidence witnessed post-election, economic indicators have largely disappointed since the onset of the year. Industrial production remained flat over the first two months of the year (-0.8% m/m, in seasonally adjusted terms in January followed by + 0.7% m/m in February). Mining production fell sharply (-15% in February) following the break-up of the Brumadinho dam in late January. Idle capacities in industry remain high, which partly explains—alongside the drop in subsidized credit—why corporate credit growth is recovering only very slowly (+ 2% y/y in February). More surprisingly, retail sales have remained largely erratic despite the rise in real wages since November and the strong growth in consumer credit (+ 9% y/y in February). Against this backdrop, the labor market deteriorated (unemployment rose to +12.4% at the end of February against 11.6% in December). Finally, activity in the services sector has also slowed since January. More importantly, the central bank's leading indicator of economic activity (IBC-BR)—a monthly proxy for GDP—declined both in January and February (-0.3% and -0.7% m/m, sa), raising concerns about a potential contraction in GDP in Q1.

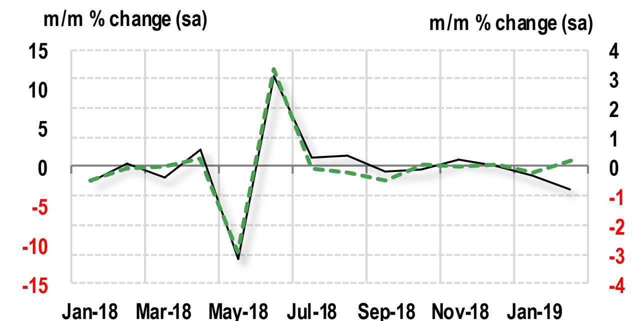
For now, financial markets have not yet adversely reacted to the weak performance of the economy. The stock market—which broke 100,000 points in March for the first time in its history—continues to perform well despite the sluggish business cycle. The risk premiums on sovereign debt remain around 250 basis points (bps) after dropping by nearly 100 bps since early September 2018. Meanwhile, the BRL which gained some ground against the US during Bolsonaro's first month in office (+ 6% in early February) has since returned to its level at the beginning of January. The currency however remains down 12% compared to a year ago.

1- Forecasts

	2017	2018e	2019e	2020e
Real GDP growth (%)	1.1	1.1	2.0	3.0
Inflation (CPI, year average, %)	3.0	3.7	3.8	3.6
Fiscal balance / GDP (%)	-7.8	-6.8	-7.2	-6.6
Gross public debt / GDP (%)	74	77	85	85
Current account balance / GDP (%)	-0.5	-0.8	-1.5	-2.4
External debt / GDP (%)	27	33	35	38
Forex reserves (USD bn)	373	374	380	377
Forex reserves, in months of imports	20.0	18.0	17.0	17.0
Exchange rate USDBRL (year end)	3.3	3.9	3.3	3.2

Source: National accounts, BNP Paribas

2- Monthly proxy for GDP (IBC-BR) has contracted



Source: Central Bank of Brazil, IBGE, BNP Paribas

At this point, hopes of seeing economic activity accelerate strongly are limited. Fiscal consolidation leaves no room for increased public spending, while the climate of watchfulness resulting from the fiscal reform will likely hold back investment decisions. External factors are not also particularly supportive: in addition to the slowdown in the global economy the shortfall resulting from the recession in Argentina is weighing on exports of capital goods, particularly in the automotive industry. On the flipside, loose financial conditions and the process of disinflation remain favorable to private consumption and credit growth. The benchmark rate has been at a historical low

(6.5%) for a year now. Meanwhile, inflation should remain contained below the Central Bank's target in 2019.

A peak at the state of public finances…

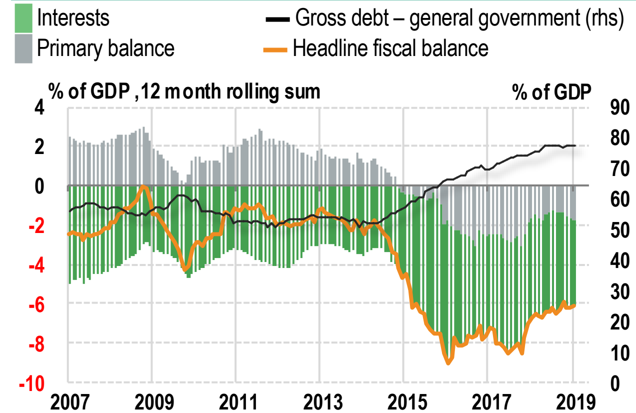
Brazil's fiscal accounts have largely deteriorated since 2014 when the primary balance (excluding interest payments on government debt) turned negative after 10 years in surplus. Over period 2014-2018, the central government' fiscal deficit averaged 6.8% while the primary deficit averaged 1.7%.

The deteriorating trajectory of the fiscal balance owes to cyclical factors (meagre recovery, revenues collapsing during the recession in 2015, 2016) but is mostly symptomatic of large structural imbalances which have led spending to grow 3 times as fast as GDP in the past 10 years. Spending has remained rigid owing to the incompressibility of mandatory social spending in particular social security and pension benefits which entitlements are protected under the constitution. The wage bill has also grown rapidly. Central government payroll has increased by 8% on average over period 2010-2017 accounting for about 4% of GDP. Costly indirect or direct subsidies are also to blame and have yet to be phased out. While the offering of subsidized credit through BNDES is being gradually phased out, the concurrent reduction of energy subsidies has remained politically sensitive. Subsidies associated with the truckers' strike (May 2018) is estimated to have cost the equivalent of 0.2% of GDP in 2018.

Despite the adoption of the spending cap[1] in 2016, the inability to alter the course of mandatory spending (social spending and pensions in particular) has meant that limited progress in terms of fiscal consolidation has been made. Given Brazil's structurally high interest burden (~ 5% of GDP), recurrent primary deficits have led to a sharp increase in public debt (+25 pp of GDP since 2013 to 77% in 2018).

The public debt burden is high but its financing does not currently pose a problem. Moreover, the profile of the debt has improved over time (longer maturities, low foreign-currency debt, better amortization profile, gradual replacement of floating rate instruments with fixed ones). The government also enjoys good coverage of its large financing needs thanks to the presence of a liquid domestic capital market. 96% of the public debt is domestic debt and is mostly held locally with ~11% held by non-residents at end 2018. Non-residents have continuously reduced their sovereign exposure since May 2015 when holdings reached a high of ~21%. Meanwhile, the monthly average borrowing costs of the central government on its domestic debt have eased (17.5 % in 2015 vs 10.6% in 2018) enabled by disinflation and the drop in the benchmark SELIC rate.

3- Overview of public finances



Source: Central Bank of Brazil, National Treasury, BNP Paribas

….as the pension reform bill is examined

The pension reform bill - introduced by the government in February is currently under discussion in Congress. The reform[2] projects fiscal saving in the range of USD 300 billion over 10 years (around 1.5% of GDP per year). A recent Datafolha survey reveals that popular support for the reform has improved (51% rejection vs. 71% in April 2017).

In all likelihood, the size of the fiscal savings will be revised downwards by at least one-third after negotiations in Congress. Recent tensions between the executive and Congress however have cast doubts about the government's ability to find the necessary support to approve the reform. To make things worse, President Bolsonaro's popularity - the main lever for pushing a fragmented Congress to form a qualified majority (3/5) - has been significantly challenged. A poll conducted by Ibope in March reports a drop in the President's approval ratings from 49% in January to 34% in March.

At best, the reform should help reduce the primary deficit by 0.7 to 1 pp of GDP, which on its own will be insufficient to stabilize the public debt.

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[1] According to the law, the non interest part of central government expenditure (ie primary spending) cannot grow faster than inflation for a period of 20 years. Penalties for not complying with the cap include the prohibition to grant adjustments to civil servants' wages, hire new personnel or generate additional expenditure.

[2] The new pension system which seeks to narrow the gap between workers in the public and private sectors would be rolled out over a 12 year transition period. The current proposal would (i) set the minimum retirement age at 65 for men and 62 for women for both public and private sector workers (ii) increase the length of contribution to social security, (iii) make important changes to how retirement benefits are calculated, (iv) align the rules applied to federal government civil servants with those of states and municipalities (v) eliminate certain discrepancies across professions (ie. teachers, police, military for instance benefit from early retirement rules).

Russia

Economic growth faces headwinds

Economic growth slowed in the first months of 2019, and is now close to its potential growth rate of 1.5% according to the central bank. A 2-point VAT increase on 1 January has strained real wage growth and sapped household consumption. Inflation (5.2% year-on-year in February) is still below the central bank's expectations, and the key policy rate was maintained at 7.75% following the March meeting of the monetary policy committee. In the first two months of 2019, investors were attracted by high yields on Russian government bonds, despite the risk of further tightening of US sanctions. The rouble also gained 5% against the US dollar in Q1 2019.

Growth acceleration in 2018 is not what it seems

Economic growth accelerated to 2.3% in full-year 2018 from 1.6% in 2017. Yet this strong performance must be kept in perspective. The acceleration can be attributed primarily to a slowdown in imports, which reflects slowing investment as well as household consumption, albeit to a more limited extent. As a result, net exports made a very positive contribution to growth in 2018 (+0.8 percentage points) after a negative contribution in 2017. All other growth components slowed. The slowdown in investment growth (+0.2% y/y in Q4 2018 vs +4.5% in the first three quarters) was partially due to less favourable monetary conditions. Corporate lending rates rose slightly (+60 basis points) as monetary policy was tightened.

Faced, on the one hand, with downward pressure on the rouble due to the risk of tighter US sanctions and, on the other hand, with higher inflation expectations following the VAT increase on 1 January 2019, the Central Bank of Russia raised its key policy rate by 25 basis points on two occasions, in September and December 2018, to 7.75%.

Economic growth is expected to slow in 2019. In the first two months of the year, economic indicators point to slowing growth. Industrial output slowed to 2.3% in the first two months of the year from 2.7% in Q4 2018, according to central bank estimates. It is nonetheless resilient thanks to the increase in natural gas and metal output. In contrast, oil production continued to slow in compliance with OPEC agreements.

Production of capital goods and consumer goods (excluding food products) slowed in keeping with a net slowdown in retail sales and the drop-off in automobile sales. The slowdown in household consumption is mainly due to the 2-point increase in VAT, which has strained real wage growth (+0.7% year-on-year in February 2019, compared to a 2018 average of +7%).

Even so, confidence indicators in industry are still looking upbeat. Survey results suggest that domestic orders accelerated in March while export orders continued to sag. According to the Central Bank of Russia, economic growth is now close to its long-term potential rate of 1.5%.

Inflationary pressure rises

Consumer prices began to accelerate as of July, reflecting the rouble's depreciation, price increases for certain commodities (agricultural products and oil) and an unfavourable base effect (notably for food prices). In December 2018, prices were up 4.3% year-on-year, compared to only 2.5% y/y in the year-earlier period. All products (food and non-food) were hit by this acceleration. Since the end of the year, price increases have accelerated (+1.2 percentage points to 5.2% year-on-year in February) due to the VAT increase, which accounted for nearly half of the recent price acceleration according to the central bank.

Non-resident investors return in first part of the year

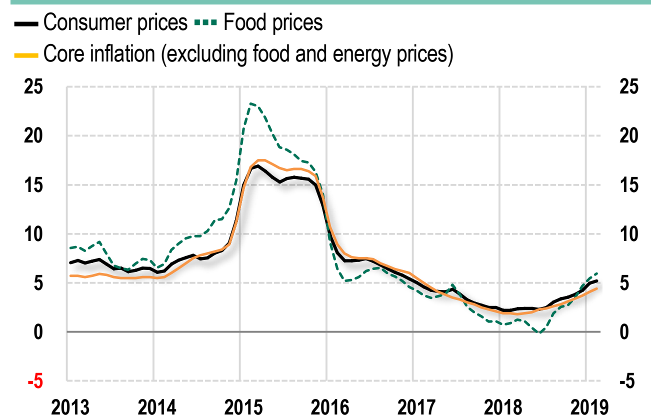
In 2018, the current account surplus swelled to 6.9% of GDP, up from 2.1% of GDP in 2017. Buoyed by increases in international oil and gas prices, the trade surplus rose 4.5 points to 11.8% of GDP.

1- Forecasts

	2017	2018e	2019e	2020e
Real GDP growth (%)	1.6	2.3	1.5	1.7
Inflation (CPI, year average, %)	3.7	2.9	5.1	4.1
Central Gov. balance / GDP (%)	-1.5	2.6	0.9	0.5
Public debt / GDP (%)	15.5	14.0	14.8	15.1
Current account balance / GDP (%)	2.1	7.0	4.5	4.0
External debt / GDP (%)	32.8	27.4	26.6	23.8
Forex reserves (USD bn)	347	375	418	435
Forex reserves, in months of imports	10.3	12.8	12.9	13.0
Exchange rate USDRUB (year end)	58.3	69.4	71.0	70.0

e: estimates and forecasts BNP Paribas Group Economic Research

2- Inflation (year-on-year, %)



Source: CBR

At the same time, imports declined slightly (-0.1% of GDP). The current account surplus covered the financial account deficit, which amounted to about 5% of GDP.

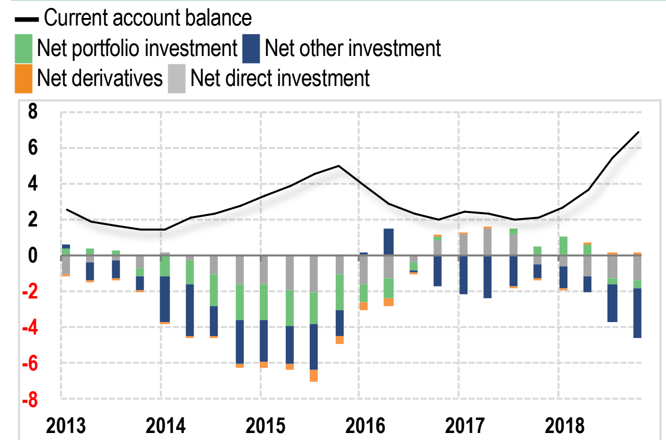
As a result, in full-year 2018, Russia's net external position increased by nearly USD 100 bn to the equivalent of 22.4% of GDP (compared with 17.3% the previous year). This change has reflected major capital outflows following the tightening of US sanctions in April 2018: stocks of foreign direct investment and portfolio investment declined by 6.2% and 9.5%, respectively. The improvement in the external position also reflects the contraction of loans (down 13%). Russia's external debt continued to decline in 2018 (by USD 64 bn) and shrank to only 27.4% of GDP (100% of exports) at year-end 2018, compared with more than 41% of GDP (157% of exports) in Q2 2016.
In the first two months of 2019, the current account surplus seems to have increased slightly due to the decline in imports, according to the central bank's preliminary estimates. Capital inflows accelerated despite the risk of tighter US sanctions. Government bonds held by non-resident investors increased for the second consecutive month, although they are still lower than in the previous year. In early March, non-resident investors held nearly 26% of government bonds issued in roubles. Non-resident investors were attracted by high yields on Russian government bonds at a time when interest rates are extremely low in Europe, and to a lesser extent, in the United States.

With the increase in oil prices since the beginning of the year and the decline in financial market pressures, the monetary authorities have begun purchasing foreign currencies again, which did not prevent the rouble from gaining 5% against the US dollar in Q1 2019. Foreign exchange reserves increased by USD 9 bn to more than USD 390 bn at the end of February, five times the amount of debt servicing from a 1-year horizon.

Risk of tighter US sanctions

In August 2018, Democrat and Republic senators Chris Van Hollen and Marco Rubio presented Congress with a bipartisan bill, Defending Elections from Threats by Establishing Redlines Act, also known as the Deter Act, which aims to sanction the Russian authorities suspected of US election interference in 2016. After the bill was rejected, the two senators submitted a new version on 3 April 2019 that was extremely similar to the previous one. The draft bill aims to sanction any country that influences US election results in any manner (based on the findings of an investigation by the Director of National Intelligence). If the law is adopted and Russia is found guilty of interference, US persons would be totally prohibited from purchasing Russian government bonds as well as bonds from companies owned or controlled by the Russian government. Sanctions would also be imposed on companies in the finance, energy and defence industries. Sberbank, VTB bank, Gazprombank, Vnesheconombank and Rosselkhozbank would be prohibited from making transactions with the United States. In the energy sector, any new investment by American entities would be prohibited. Lastly, any politicians or oligarchs implicated in US election interference would be prohibited from entering US soil and would be banned from making transactions with US persons.

3- Balance of payments (4-quarter sum, % of GDP)



Source: CBR

To date, there is strong dissension in Congress about the best measures to take against Russia, and President Trump is still opposed to them.

Even if legislation is adopted, over a 1-year horizon, it would not endanger the Russian government's external financing needs, which are estimated at a little under USD 80 bn.

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Poland

Trees don't grow to the sky

Economic growth rose to 5.1% in 2018, the highest level since the global financial crisis, with few signs of overheating. In 2019-2020, a less favourable cyclical environment in the eurozone and international trade tensions are bound to strain the Polish economy. Even so, domestic demand will remain relatively solid, bolstered by wage growth driven by labour market pressures as well as by the government's fiscal stimulus measures announced in February in the run up to European elections in May and legislative elections in October. Under these conditions, inflation is likely to accelerate and the twin deficits to widen, albeit without compromising the country's macroeconomic stability.

Past its peak

Poland's macroeconomic track record is impressive in 2018: GDP growth peaked at the highest level since 2007, the unemployment rate is historically low, inflation is tightly controlled, the fiscal and current account deficits are both small and the currency is stable.

Despite the economic slowdown in the eurozone (and in Germany in particular), which absorbs 58% of Polish exports, GDP growth held to a pace of 5% year-on-year (y/y) in the second half of 2018, after H1 growth of 5.2%. This uncoupling with the European economic cycle can be attributed to the strength of domestic demand (+5.5% in 2018, after +4.9% in 2017), while foreign trade continued to make a negative contribution to GDP due to the acceleration of imports (+7%), which outpaced exports (+6.2%).

Household consumption is a solid growth engine (+4.6% in 2018), although it slowed slightly in H2 (+4.4% y/y). Strong wage growth driven up by labour market pressures (see below) have bolstered household confidence, even though it too has dipped slightly in recent months. Lending to households has also accelerated continuously over the year (+7% y/y in 2018, after +2% in 2017).

Investment rebounded by 7.3% in 2018 thanks to a strong second half (+9.9% y/y in Q3 and +6.7% in Q4). According to the Central Statistical Office (GUS), corporate investment was buoyant in all sectors of activity, regardless of company size. Yet it slowed slightly towards the end of the year, notably for the subsidiaries of foreign firms in a more uncertain European environment. After a period of rapid growth, residential investment was not as vigorous in H2 2018. The sector was hit by supply-side constraints linked notably to labour shortages and higher wages in the construction sector. For the past two years, new home prices have shot up by an average of 15% in Poland's 10 biggest cities. Lastly, public investment continues to benefit fully from EU structural funds.

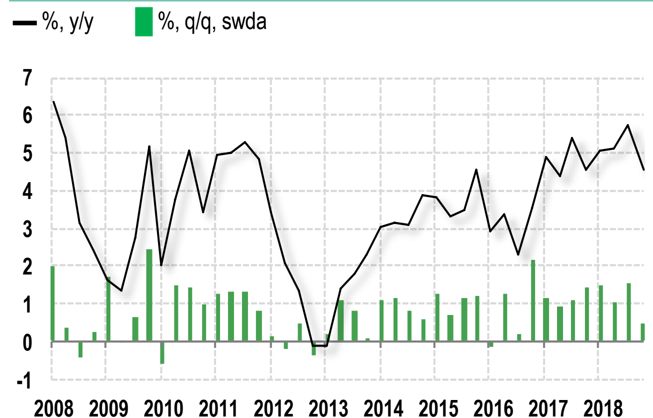
A corollary of the dynamic momentum of domestic demand, services increased strongly through Q3 2018, before dipping thereafter. Industrial output was driven by construction (+17% in 2018) and the manufacturing sector (+5.2% in 2018 and +6.1% y/y in the first two months of 2019). Yet manufacturing PMI has dropped below 50 since November. The production capacity utilisation rate (82%) has declined and exports have slowed, notably for intermediary goods, at a time when the automobile sector was disrupted by new anti-pollution standards. Another factor straining export competitiveness is the zloty, which many Polish companies now consider to be overvalued.

1- Forecasts

	2017	2018	2019e	2020e
Real GDP growth (%)	4.6	5.1	4.0	3.5
Inflation (CPI, year average, %)	2.0	1.7	1.9	2.4
Gen. Gov. balance / GDP (%)	-1.4	-0.9	-1.8	-2.4
Gen. Gov. debt / GDP (%)	50.6	48.7	47.3	46.7
Current account balance / GDP (%)	0.2	-0.7	-1.5	-2.5
External debt / GDP (%)	72.2	61.3	58.9	57.5
Forex reserves (EUR bn)	94.5	102.3	103.8	105.2
Forex reserves, in months of imports	4.8	4.8	4.5	4.3
Exchange rate EURPLN (year end)	4.2	4.3	4.3	4.3

e: BNP Paribas Group Economic Research estimates and forecasts

2- GDP growth



Source: GUS

Yet prospects are still promising

Deteriorating external conditions will strain Polish growth in 2019-2020. Yet buoyant domestic demand, bolstered by the fiscal stimulus measures announced on 23 February and a rather accommodating monetary policy, should help buffer a cyclical downturn. The deterioration of macroeconomic fundamentals is bound to be limited.

GDP growth is expected to slow to 4% this year and 3.5% in 2020, but should remain above the average for the other Central European countries (~3%). The fiscal stimulus, estimated at

between 1.5% and 2% of GDP over the next two years (PLN 40 bn a year), should bolster consumption via three key measures: 1) the Family 500+ programme, a family benefit of PLN 500 (around EUR 116) per child as of the second child, which will be expanded to include the first child, with no means testing, 2) a premium of PLN 1100 (around EUR 256) for pension holders, and 3) income tax cuts, including the exemption of taxes for the under-26 age group.

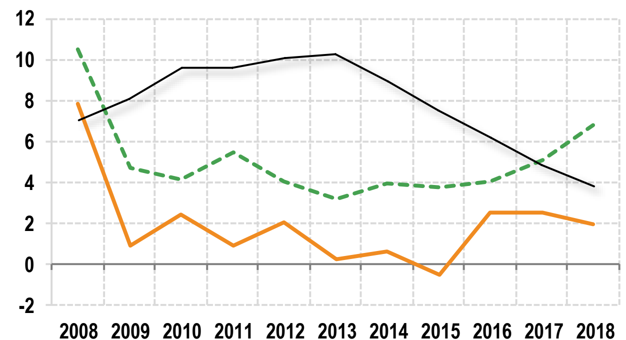
An expansionist fiscal policy will widen the general government deficit. Faced with concerns about public finance overruns, the government reiterated its commitment to maintaining the deficit below the threshold of 3% of GDP and thus may reign in public investment spending. Public debt is therefore expected to hold to a favourable trajectory in 2019-2020. With the approach of the European and legislative elections, the government seems to have arbitrated in favour of social welfare spending, which political benefits in the short term are stronger than those resulting from public investment spending. Yet the latter theoretically has a higher multiplier effect on economic growth than the former. As a result, the residual windfall of European structural funds in the last two years of the 2014-2020 programme (estimated at more than EUR 36 bn) might not be totally absorbed. All in all, total investment is expected to slow, even though corporate investment should remain buoyant.

Limited external imbalances and inflationary pressures

Poland's external accounts are not a real source of concern, even though the current account surplus evaporated in H2 2018 and the deficit is expected to widen in 2019-2020. The trade deficit will remain moderate and the services balance will continue to show a major surplus. Moreover, assuming foreign direct investment in Poland generates fewer profits, the large deficit on the income balance would diminish slightly. Foreign reserves provide a comfortable safety mattress covering nearly 5 months of imports and all of the country's short-term debt. At a time of persistently accommodating monetary policies in Europe and the United States, Poland is expected to remain attractive for non-resident investors, and the exchange rate should remain relatively stable despite certain (geo)political risks.

Inflation is expected to accelerate gradually after holding below 2% in 2017-2018 due to the decline in NAWRU, the non-accelerating wage rate of unemployment (see below), and to the decline in commodity prices in late 2018. The output gap, the difference between the potential GDP growth rate (estimated at 3.5%) and the actual GDP growth rate, will remain positive in the quarters ahead, while wages should continue to rise significantly in both nominal and real terms. Headline and core inflation will converge on the target rate of 2.5% in 2020. The Central Bank (NBP) might begin to raise its key policy rate moderately, after holding it at 1.5% since March 2015. However, NBP governor Adam Glapinski stated in early April that he did not expect a change in key rates before the end of the current monetary policy committee's mandate in 2022.

3- Labour market



Source: Eurostat, European Commission

Demographics, labour supply, wages and productivity: squaring the circle

The jobless rate has declined from 9% in 2014 to 3.8% in 2018 (Eurostat data). Full employment has resulted in a shortage of labour that is restricting production capacity, notably in construction and industry. However, productivity gains and the inflow of foreign workers, notably Ukrainians (about 1 million since 2014 thanks to simplified procedures for obtaining work permits for six non-EU countries) has limited the increase in unit labour costs and reduced NAWRU. In real terms, wage growth accelerated from 2.5% a year between 2010 and 2016 to 5.5% in 2018. Over the same period, labour productivity gains followed similar trends, rising from 4.5% a year in 2010-2016 to 6.5% in 2018 (IMF, *Country Report 19/38, Selected Issues*, February 2019). Yet the 12-month delay in reporting non-resident workers in official employment statistics has tended to play down productivity gains in recent years.

With European competition to attract skilled workers likely to intensify in the years ahead (especially with Germany), innovation and automation are seen as solutions for the shortages of labour supply and the search for productivity gains. Yet to curb Poland's slow demographic decline over the past two decades, strong-willed family and emigrant policies (including incentives for Polish emigrants to return home) will be crucial for boosting the country's growth potential and macroeconomic prospects in the medium to long term.

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Singapore

A model of sound public finance management

Singapore is highly vulnerable to contagion effects of US trade hikes on Chinese imports due to its large dependence on tech exports and integration Asian value chains. Exports have contracted since last November and economic growth has slowed. Monetary policy tightening, which started last year, should pause in the short term while the government is expected to increase public spending to support activity. Its fiscal room for maneuver is significant given the strength of public finances. This will also enable the authorities to continue to implement their strategy aimed at stimulating innovation, enhance productivity and improve Singapore's medium-term economic growth prospects.

Weakening exports

Economic growth slowed from 3.9% in 2017 to a still solid 3.2% in 2018 (table 1). Growth lost steam principally due to the contraction in investment and weakening support from the export sector. It is projected to decelerate further and reach 2.5% in 2019.

Total exports of goods declined by 0.3% year-on-year (y/y) in November 2018-February 2019, after increasing by 12.5% y/y in January-October 2018. Non-oil domestic exports have contracted by 6.5% y/y since November 2018 (graph 2). This has resulted from the slowing global tech sector as well as supply-chain disruptions and weakening exports to China in response to US tariff hikes. Singapore is highly vulnerable to US protectionist measures given its exposure to Chinese demand (13% of its exports, or 16% of GDP), large participation in the high-tech industry value chain (exacerbated by its role of regional trade hub) and limited diversification of its export structure (semiconductors account for about one-fifth of total exports). In the very short term, the export outlook remains weak; it will notably depend on the outcome of ongoing trade negotiations between the US and China.

As volume growth in imports of goods and services slowed to a greater extent than volume growth in exports, the contribution of net exports to real GDP growth was positive in 2018. However, weaker activity in the export sector has started to have spillover effects on the rest of the economy. In Q4 2018, it contributed to inventory destocking and falling investment in machinery & equipment (which declined by 4.1% y/y after four quarters of growth). Moreover, employment in the manufacturing sector reverted to its trend decline after expanding in Q3 2018.

Investment contracted by 3.4% in real terms in 2018, after rising 5.3% in 2017. The decline affected all main investment components, and most particularly the residential construction sector (-11.8%). Investment in machinery & equipment was first more resilient but started to contract in Q4 2018. In the short term, investors in the manufacturing sector will remain prudent as long as export prospects are darkened by protectionism threats. Private investment in housing construction should remain sluggish. However, public investment in construction projects is projected to rebound, thus helping total investment growth to stabilize.

Private consumption remained an important contributor to GDP growth in 2018 even though its real growth slowed to 2.4% y/y from 3.2% in 2017. Labor market conditions have remained tight, with still firm wage growth (+3.5% in 2018) and stable employment (supported by the services sector). In 2019, private consumption growth is likely to continue to slow, mostly due to spillover effects of the weaker export-sector performance on the labor market, lower wealth effects (as the property market has entered a new period of downward correction) and continued slight tightening in domestic financial conditions.

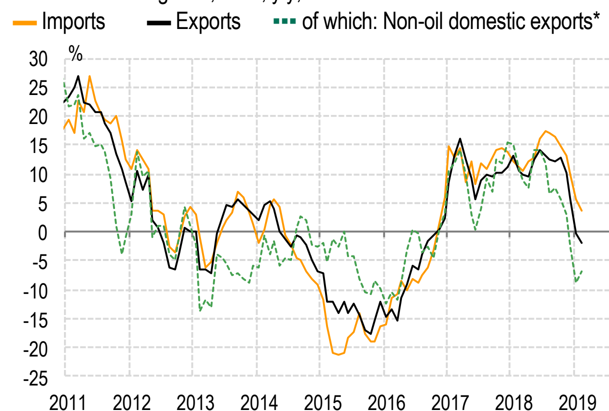
1- Forecasts

	2017	2018	2019e	2020e
Real GDP growth (%)	3.9	3.2	2.5	2.7
Inflation (CPI, year average, %)	0.6	0.4	0.9	1.0
Budget balance / GDP (%)	2.3	0.4	-0.7	1.0
Gross government debt / GDP (%)	108.0	112.2	115.0	118.0
Current account balance / GDP (%)	16.0	17.7	17.0	17.0
Forex reserves (USD bn)	280	288	296	321
Forex reserves, in months of imports	6.8	6.4	6.4	6.3
Exchange rate USDSGD (year end)	1.3	1.4	1.4	1.3

e: estimates and forecasts BNP Paribas Group Economic Research

2- Hit by the drop in tech exports

External trade of goods, USD, y/y, 3mma :



Source: International Enterprise Singapore

** Non-oil domestic exports mostly comprise electronic and chemical products. They represent 65% of domestic exports, which themselves account for half of total exports. The other half is made of re-exports.*

Monetary policy tightening may first pause

Short-term interest rates have increased slowly since late 2016, in line with US/global interest rates. The Monetary Authority of Singapore (MAS) also started to tighten its policy last year in response to modestly higher inflation pressures (graph 3). It increased slightly the appreciation slope of the SGD-NEER policy band in April and then in October (with no change to its width or central parity) raising it to 1% from 0% in 2016-2017[1].

Credit conditions have become slightly tighter. Growth in bank credit to the domestic private sector lost speed in 2018 after two years of slow recovery (it reached 3.9% y/y in real terms at the end of 2018 vs. 4.8% at the end of 2017). Moreover, in July 2018, the authorities introduced tightening measures to cool the property market (through higher stamp duties and reduced loan-to-value ratios). As a result, after a period of recovery from mid-2017 to mid-2018, property transaction volumes and mortgage loan growth decelerated in H2 2018, and property prices have followed suit.

The monetary policy tightening is likely to pause in the very short term, before resuming before the end of 2019. In fact, the increase in US fed fund rates should pause while the deterioration in external trade and lower global energy prices should lead the MAS to revise its short-term expectations compared to last October (to slower-than-previously expected inflation and less favorable labor market conditions).

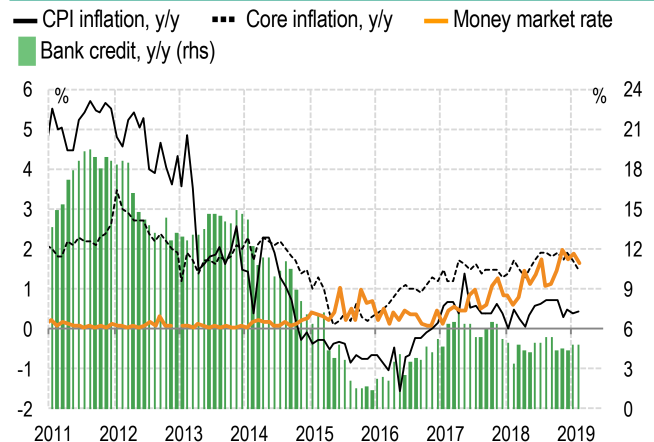
Fiscal policy should remain moderately expansionary

While monetary policy is aimed at supporting price stability, the authorities have recourse to fiscal policy measures to stimulate domestic demand in the short term and improve economic growth prospects in the medium term.

In FY18 (fiscal year from April 2017 to March 2018), the government reported a fiscal surplus of 0.4% of GDP, down from 2.3% in FY17. The FY19 budget will remain moderately expansionary and projects a small deficit of 0.7% of GDP. A broad increase in public expenditure is expected, including in welfare spending (especially health-related), infrastructure projects and support to SMEs. The FY19 budget does not include major revenue-raising measures, but an increase in the Goods-and-Services Tax (to 9% from 7%) was announced last year and is due to be implemented in 2021-2025.

In the medium term, the government plans a continued increase in structural public spending (infrastructure upgrade, education and health, innovation, etc.) in response to the ageing population and economic growth slowdown. The authorities pursue a strategy aimed at boosting productivity and making Singapore's economy shift towards an even more technology-driven and innovation-based growth model.

3- Very slight tightening in domestic credit conditions



Source: Department of Statistics, MAS, IMF

The government has a very comfortable leeway to absorb an increase in spending. It has long remained committed to a series of rules of fiscal discipline. Each administration has to keep a balanced budget over its five-year mandate. Borrowing proceeds can only be invested and not used for recurrent or operating expenditure, Moreover, the payment of interest on debt must be fully covered by returns on public investment.

This strict policy discipline has led to the accumulation of large buffers by the government, which posts a very strong net asset position. Its gross debt-to-GDP ratio seems high (112% in 2018), but the debt is in reality mostly made of non-tradable bonds issued for the national pension fund as well as government securities issued to develop local bond markets and Savings bonds providing individual investors with a safe long-term saving option. In addition, the government also has large public assets mainly managed by two Sovereign Wealth Funds (Temasek and GIC). The government does not fully disclose its public assets, but they are estimated to be very large and exceed the level of its debt. High returns on investment of the sovereign wealth funds allow them to be major contributors to government revenue. The government is therefore well equipped to face fiscal challenges in the medium term.

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[1] The SGD is managed through the Nominal Exchange Effective Rate (NEER), which is allowed to fluctuate within a band and its rate of appreciation is announced every six months by MAS. As the exchange rate is the monetary policy target and capital movements are free, domestic interest rates are mainly determined by foreign interest rates and fx market expectations.

Chile

A question of reforms

GDP growth rebounded in 2018, buoyed by higher copper prices and the renewed confidence of investors following the election of Sebastian Piñera. Over the course of his mandate, President Piñera's ambition is to implement fiscal policies that will boost growth and stimulate investment while consolidating public finances, but this could prove to be harder to achieve than expected. The president's party lacks a congressional majority, and is struggling to push through the fiscal and pension system reforms that have been presented so far. Even so, economic growth prospects will remain rather favourable over the next two years and fiscal consolidation should continue.

Growth rebounds in 2018

After reporting GDP growth of less than 2% since 2014, when a low investment rate and the loss of investor confidence exacerbated the effects of the decline in copper prices, Chilean growth rebounded in 2018 to 4%. Real GDP growth was particularly vigorous in the first half, rising 4.8% year-on-year (y/y). The main growth engines were copper exports, investment (+5% y/y, driven by the mining sector) and household consumption. Lower copper prices and the slowdown in non-mining exports strained activity in the second half.

Averaging 2.4%, inflation was mild in 2018, and has remained low since the beginning of the year (less than 2% on average in the first 3 months according to the new index based on 2018). Under this environment, the central bank should be able to pursue its prudent policy of normalising key rates, which were raised by 25 basis points on two occasions, in October 2018 and January 2019, to 3%.

Prospects for the next two years are rather favourable, even though GDP growth will slow slightly in 2019 and 2020, before levelling off at around 3.5% (the growth trend estimated by the central bank). Several factors will boost growth, including the improvement in the labour market and the steady realisation of numerous public and private investment projects, assuming they are completed on time. There are still major downside risks: an intensification of the US-China trade war and a sharper-than-expected slowdown in Chinese growth could strain copper prices and undermine growth. The diversification of the economy has been painfully slow, and the copper sector still accounts for nearly 10% of GDP, 25% of fiscal revenues and 50% of total exports.

The reforms in question

Excessive dilution of the government's proposed reform projects could undermine the vigour of domestic demand. President Piñera, the head of the centre-right Chile Vamos party (CV), is encountering a few difficulties just one year after taking the helm. Right after his election, the president announced that the priority of his mandate would be to simulate private investment and growth, while consolidating public finances.

Although Sebastian Piñera was elected with a comfortable lead over his rival heading the centre-left coalition, his party does not hold a majority in either of the two houses of parliament, and has had a hard time forming coalitions to support the government's actions.

The government has already been forced to make a few concessions by maintaining certain measures implemented by the previous administration, notable concerning education reform. The president also had to renounce plans to lower the corporate tax rate, one of his campaign promises.

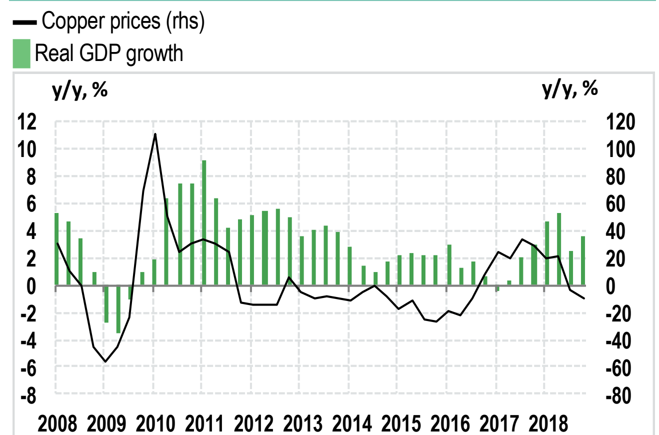
Last August, a vast fiscal reform project was presented that largely calls into question the measures taken by Michelle Bachelet in 2014. The main three measures propose to simplify and unify the existing tax regimes, modernise the fiscal administration (through the generalisation of online tax collection, for example) and stimulate private investment, by setting up a series of corporate incentives targeting SME in particular. The government said it hoped the

1-Forecasts

	2017	2018e	2019e	2020e
Real GDP growth (%)	1.5	4.0	3.6	3.2
Inflation (CPI, year average, %)	2.2	2.4	2.4	2.9
Central Gov. balance / GDP (%)	-2.8	-1.7	-2.0	-1.8
Public debt / GDP (%)	23.6	25.7	26.7	27.5
Current account balance / GDP (%)	-1.5	-3.1	-3.0	-2.7
External debt / GDP (%)	65.5	62.0	63.5	63.5
Forex reserves (USD bn)	39.0	39.9	39.9	40.5
Forex reserves, in months of imports	7.9	7.6	7.8	8.0
Exchange rate USDCLP (year end)	615	696	695	698

e : estimates and forecasts BNP Paribas Group Economic Research

2- Real GDP growth and copper prices



Source: National Accounts, LME

reform could be adopted as quickly as possible so that the measures could be integrated in the 2020 budget, but the text is still being debated by Congress.

In November, the government presented its pension system reform proposal. This announcement was expected since modifying the pension system has been at the centre of public debate for numerous years. Basically, the Chilean pension system is built around three core pillars: the first pillar, created in 1981, is a private pension system (the total value of private pension funds now accounts for nearly 70% of GDP). In 2008, during Michelle Bachelet's first mandate, a second "solidarity" or redistributive pillar was introduced, guaranteeing among others a minimum pension and subsidies for low income workers. Lastly, a third voluntary pillar authorises workers to round out their mandatory contributions with voluntary pension savings.

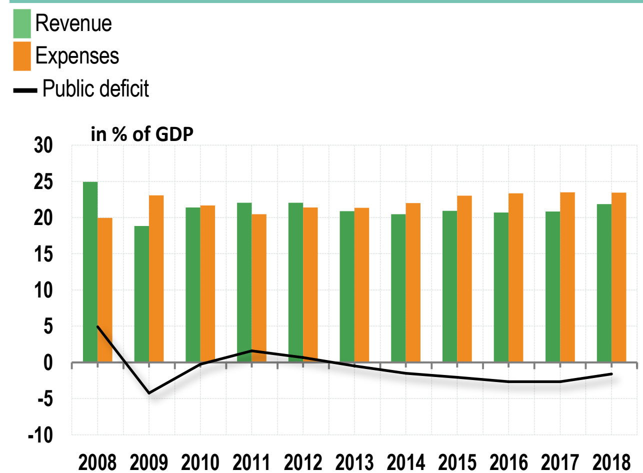
The pension system has encountered a lot of criticism. Several factors have diluted the amount of pension benefits, including an aging population, a low contribution rate (equivalent to 10% of the wages of Chilean employees, compared to an OECD average of more than 18%), high management fees (which significantly reduce the amount of benefits), and low wages. Moreover, the amount of the minimum pension and the subsidies for low-income workers are deemed to be insufficient.

The broad outlines of the government's proposals build on suggestions formulated by Michelle Bachelet's team during her second mandate in 2015, including the need to increase both the individual contribution rate (the reform calls for employers to increase the contributions made on behalf of their employees, bringing the total to 14% of wages) and the fund covering the "solidarity" pillar. Contrary to the proposed fiscal reform measures, the pension reform is closely aligned with the measures supported by the opposition party. Even so, the proposal is still stuck in debate.

Fiscal consolidation continues, but its scope is likely to diminish in the years ahead

In 2018, the fiscal deficit was reduced to 1.7% of GDP (from 2.8% in 2017), the lowest level since 2014[1]. Yet deficit reduction was mainly achieved through higher tax revenues derived from the mining sector, and through an exceptional tax on the Chilean mining group SQM. As the government promised, expenditures have been relatively stable as a percentage of GDP. The deficit could swell again in 2019-2020 (but hold close to 2% of GDP), since the additional revenue from the SQM tax was a one-off event that will not to be repeated.

3- Public deficit



Source : Ministry of finance

Fiscal consolidation is expected to continue in the medium term, even though the government seems to have very little manoeuvring room. According to the authorities, the impact of the fiscal reform should be neutral, while pension reform will gradually increase public expenditure to 1.1% of GDP (2018) in 2030. Of all the reforms the government is considering, this seems to be the most costly one, although the government intends to fund the increase in spending on a year-by-year basis.

According to the government's preliminary estimates, the structural deficit (defined by the medium-term fiscal rule) should steadily narrow to 1.2% of GDP in 2021. This reduction should lead to a mild consolidation, although to achieve this objective, the government did not specify whether new fiscal measures would be proposed or whether it would change the parameters used to estimate the fiscal deficit (i.e. the potential growth rate and the price of copper).

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[1] Since 2001, Chile's fiscal policy framework has been guided by a medium-term fiscal rule, which aims to reduce the volatility of growth through countercyclical policies. Application of the rule resulted in the accumulation of fiscal surpluses between 2001 and 2014, but since 2015, the decline in the potential growth rate and copper prices have led to an increase in the public deficit and debt.

Colombia

In search of a second wind

Colombia is coming off a four year macroeconomic adjustment, orchestrated by a large terms of trade shock following the end of the commodity super cycle in 2014. Colombia made a number of policy adjustments to deal with the shock and since 2017, the economy has largely corrected allowing the current account balance to narrow, the fiscal balance to improve and inflation to converge towards the target. However, the intensification of the Venezuelan migrant crisis is challenging fiscal accounts. President Duque's pledge to make adjustments to the 2016 peace agreement represents a source of risk to the security environment. Meanwhile, the economic slowdown has bottomed out in 2018. Growth is set to accelerate in 2019 but will remain modest.

Cyclical pickup in growth

In 2018, the economy's growth rate accelerated (+2.7% y/y) after decelerating continuously between 2014 (+4.7% y/y) and 2017 (+1.4% y/y)—its lowest level since the global financial crisis. Meanwhile, the upward adjustment to the minimum salary, the effects of el Niño weather phenomenon and FX pass through did not materialize into increased inflationary pressures as the CPI surprised to the downside (+3.2% y/y at end 2018), allowing the policy rate to remain unchanged since April 2018 at 4.25%. GDP growth was driven by solid private consumption growth (+3.9% y/y) which benefited from decelerating inflation, rising real wages, improving consumer sentiment (through H12018), and lower real interest rates. After dipping in negative territory in 2017, gross investment bounced back in 2018 (+3.5% y/y) driven by strong inventory accumulation. It accelerated strongly post elections on the back of an uptick in commodity prices, a greater availability of credit, a rebound in property investment and a recovery in construction. However, the consumer led demand recovery resulted in a sharp acceleration in imports (+8 y/y). Meanwhile, exports experienced a deceleration (+1.2% y/y from +2.5% in 2017) resulting in net exports acting as a significant drag on yearly growth.

Looking forward, the economy is set to gain speed (+3.5% in 2019 and 3.3% in 2020) but will remain below historical trend growth (+4.3%, over period 2000-17). The main sources of growth will be domestic. Household spending should benefit from increased bank lending and a gradual improvement in the labor market. Congress' decision to reject the government's proposal to broaden the VAT base should also support households' purchasing power. Lower corporate tax rates, recovering oil prices as well as the strong projected capital expenditure by Ecopetrol should, in the meantime, back an acceleration in investment. Government spending is set to moderate owing to a tight fiscal situation. Sentiment indicators though show a hesitant start to the year. Manufacturing PMI showed a print below 50 for the third consecutive month in March and consumer sentiment - while on a broadly increasing trend since November - remained in pessimistic territory in February.

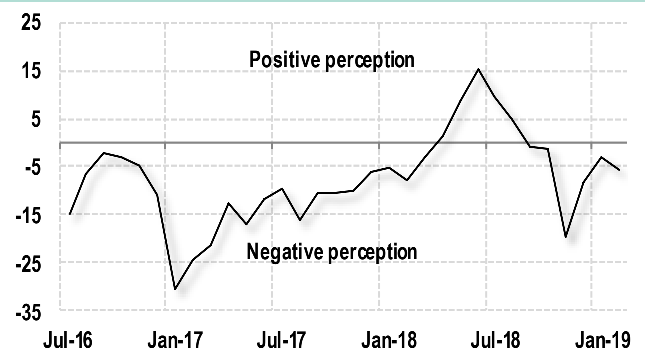
In the medium term, Colombia's growth outlook remains supported by a sound policy framework (credible inflation targeting regime, fiscal rule, active public debt management, and exchange rate flexibility). Colombia's invitation to OECD membership in May 2018 also testifies to its efforts towards structural reforms along several policy areas (labour, governance, trade, industry). Nonetheless important challenges remain in order to raise the economy's growth prospects, most notably large infrastructure gaps (in roads and ports), high commodity dependence, lagging economic diversification with dwindling competitiveness in manufacturing, elevated levels of job informality, as well as still high levels of drug related violence and organized crime.

1- Forecasts

	2017	2018e	2019e	2020e
Real GDP growth (%)	1.4	2.7	3.5	3.3
Inflation (CPI, year average, %)	4.3	3.2	3.2	3.6
Fiscal balance / GDP (%)	-3.6	-3.1	-2.4	-2.6
Gross public debt / GDP (%)	46.6	46.1	44.1	45.7
Current account balance / GDP (%)	-3.4	-3.8	-4.0	-3.8
External debt / GDP (%)	40.3	41.9	42.6	43.5
Forex reserves (USD bn)	47	48	48	49
Forex reserves, in months of imports	10.1	9.2	10.0	10.0
Exchange rate USD/COP (year end)	2952	2958	3021	2922

e: estimates and forecasts BNP Paribas Group Economic Research

2- Consumer confidence index (points)



Source: Fedesarollo, BNP Paribas

Fiscal challenges linger amid new tax reform

Colombia's fiscal accounts are expected to face mounting pressures despite recently passing a sixth tax reform in 10 years. The reform[1]

[1] The reform which introduced new measures to increase tax collection was principally marked by tax incentives for the corporate sector to help promote private investment, one of President Duque's main campaign goals. Alongside a reduction in the VAT for capital goods, the corporate income tax will be cut by 1 pp annually to

failed to tackle a number of structural fiscal ailments, namely rigid spending (~85% of spending is mandatory), high dependency on oil and most importantly lift long term revenue intake (tax revenues as share of GDP have stagnated since 2011 at ~14%). In fact, congressional bargaining resulted in the reform projecting only half as much revenue as expected in the original bill (~0.7% of GDP). Moreover, the concurrent lowering of the corporate tax rate should result in an estimated 1% of GDP loss in revenues annually. This is coming at a time where pressures on public finances are mounting due to the fiscal impact of the Venezuelan migrant crisis (estimated at +0.5% of GDP annually). In April, this has led the fiscal rule committee to adjust the fiscal deficit targets for 2019 and 2020 to 2.7% and 2.3% of GDP. Given the shortfall in revenues, public borrowing requirements will increase but should be easily covered thanks to strong appetite for Colombian debt both from domestic lenders and foreign investors (as evidenced by relatively low sovereign risk premia on external debt with 5 year CDS at 107 bps in April).

Slowing investment flows

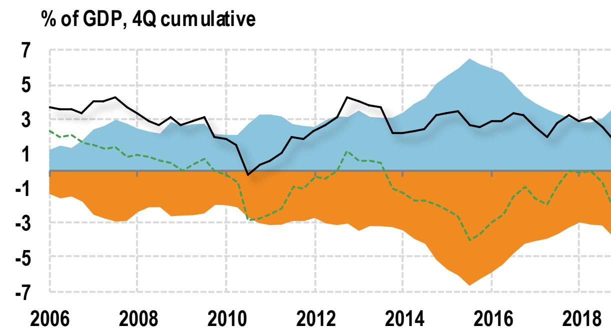
Colombia's current account deficit narrowed through 2017, adjusting relatively rapidly since deteriorating strongly in 2015 (-6.4% of GDP). Strong import growth in 2018 partly reversed the trend as the CAD widened to 3.8% of GDP. The continued recovery in domestic demand coupled to a slowing global economy should come at the expense of a rising CAD in 2019.

In 2018, net FDIs failed to cover the CAD owing in part to inward FDIs slowing to their lowest level since 2010 (~USD 11bn vs USD 14.5bn on average over period 2011-17). The external financing shortfall was covered by new debt commitments in the form of loans predominantly contracted by the private sector. The rising levels of external debt (42% of GDP in 2018 vs 27% in 2014) underscores an increased vulnerability to tightening external financing conditions. Colombia also remains vulnerable to a sell-off resulting from shifts in investors' sentiment. The stock of portfolio liabilities held by non-resident has increased by 14% on average since 2012 (~24 of GDP in 2018). Non-resident holdings of local currency sovereign bonds are sizeable (at ~25%) and foreign investors also represent more than 1/3 of total market traded volumes in the local stock market. In 2018, portfolio inflows slowed down significantly (USD 349 mn vs USD 7.8bn in 2017) resulting in net outflows by non-residents of USD 1.2bn. In the local stock market, foreign investors were net sellers for the first time in 7 years.

The authorities have recently taken steps to mitigate exposure to a sudden stop in external financing. In September 2018, the Central Bank announced a programme to accumulate reserves through the sale of put options—a course of action it had already resorted to in the past. Colombia also has a precautionary Flexible Credit Line (USD 11.4 bn, 3.3% of GDP) in place with the IMF through 2020. Colombia's external liquidity position remains comfortable (representing ~ 9 months of imports and covering close to 2/3 of the stock of portfolio investment). Above all, the flexibility of the

30% by 2022 from 33% in 2019. The reform also catered to foreign investors by cutting tax withholdings for offshore sovereign bond investors from 14% to 5%.

3- Balance of payments



Source: Central Bank of Colombia, BNP Paribas

exchange rate will remain Colombia's first line of defence against external shocks. Meanwhile, the fate of external accounts will stay largely tied to oil prices (oil represents ~40% of exports, and attract over 1/3 of FDI).

Headwinds on the political front

President Duque has faced multiple headwinds since stepping into office in August 2018. His government's difficult relationship with Congress required a significant watering down of his ambitious tax reform bill. Student protests over education spending, popular resistance over his proposals to cut gas and energy subsidies and the fallout from the corruption scandal with Brazilian construction firm Odebrecht also hurt his approval ratings. Meanwhile, drug trafficking and crime have been on the rise. The number of coca plantations has also surged since 2013 and illegal armed groups and drug gangs have continued to fight over former FARC territories. The intensification of the political crisis in Venezuela and the large inflow of migrants have also been a source of tensions on society and public services. The violent attack perpetrated by the Ejercito de Liberacion National (ELN) in January against a police academy in Bogota (killing over 20 office cadets) has meanwhile fueled concerns about a possible deterioration in the security environment at a time where President Duque is revisiting the legislation implementing the peace accord with the FARC[2]. While the move to revisit the peace deal is in line with President Duque's campaign promises, and echoes widespread popular discontent over certain provisions of the 2016 agreement, altering the agreement creates a risk that demobilized combatants might once again take up arms. President Duque's pledge to focus on structural reforms to boost GDP growth above 4% may be contingent on his ability to first safeguard peace.

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[2] President Duque announced in March a partial veto of a law governing the transitional justice system, the so-called Special Jurisdiction for Peace (JEP) on the grounds that the terms of the JEP are too lenient.

Nigeria

The growth engine is still jammed

Nigeria is having a hard time recovering from the 2014 oil shock. Although the economy has pulled out of recession, growth remains sluggish at 1.9% in 2018. Moreover, the central bank's recent decision to cut its key policy rate is unlikely to change much. With inflation holding at high levels, it is still too early to anticipate further monetary easing. Defending the currency peg is another constraint at a time when the stability of the external accounts is still fragile. Between soaring debt interest payments and the very low mobilisation of public resources, there is only limited fiscal manoeuvring room. It is hard to imagine a rapid economic turnaround without the intensification of reforms.

The beginning of the year was dominated by the presidential election held on 23 and 24 February. In what was expected to be a tight race, Muhammadu Buhari, the incumbent, won a clear-cut victory with 56% of the vote, compared to 41% for his main rival. Shortly thereafter, the monetary authorities lowered the key policy rate by 50 basis points (bp). Although there is no apparent link between these two events, the central bank's decision might signal a change in economic policy goals towards greater support for growth after a first mandate focused essentially on strengthening the external position. Yet there is very little manoeuvring room. Without any structural reforms, the recovery is bound to be slow.

Key policy rate cut: a symbolic move

The Central Bank of Nigeria (CBN) surprised the markets by lowering its key policy rate from 14% to 13.5% at the end of March, the first move since July 2016. Although inflation has stabilised at 11%, this is nonetheless higher than the monetary authorities' target range of 6-9%. There is even a risk that inflation could rise again if the public sector minimum wage is raised from the current level of NGN18000 currently (USD 60 at the official exchange rate) to NGN30000 (USD 98). It is difficult to assess the impact of this measure given the numerous obstacles to its implementation, starting with the very delicate financial situation of numerous states.

According to the governor of the central bank, the monetary policy easing is supposed to boost economic activity by stimulating bank lending. At this stage, however, we think the decision is mainly symbolic. First, issuance of CBN bills is the main tool used by monetary authorities to manage liquidity. Since 2016, interbank rates have regularly surpassed the key policy rate, diluting the signals it transmits. Second, transmission channels to the economy are limited. Nigeria not only has a low bank penetration rate, but the oil shock has also weakened the financial system, and the correction phase is not yet complete. The growth of lending to the private sector was still a negative 2.6% at the end of February. Although they have begun to improve, financial soundness indicators are still deteriorated. Especially, the doubtful loan ratio remains high at 12.4%, compared to 3% at year-end 2014.

In a context of strong risk aversion for the banks, monetary policy will surely have to be more accommodating to have an impact. But the room for manoeuvre is thin. In addition to latent inflationary pressure, the fact that non-residents hold nearly 30% of bills issued by the central bank implies that yields must be high enough to maintain their attractiveness. An abrupt surge in short-term rates in

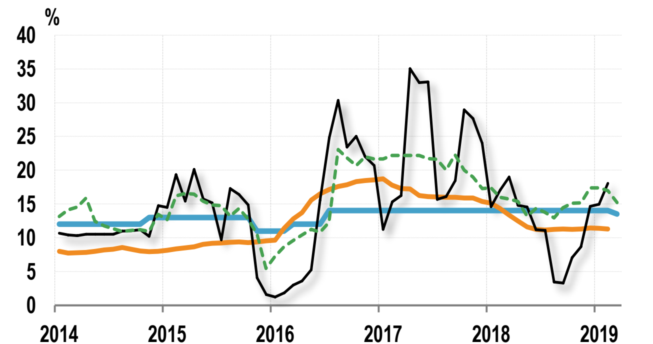
1-Forecasts

	2017	2018	2019e	2020e
Real GDP growth (%)	0.8	1.9	2.2	2.5
Inflation (CPI, year average, %)	16.5	12.1	11.5	11.0
Gen. Gov. balance / GDP (%)	-5.3	-4.9	-4.7	-4.0
Gen. Gov. debt / GDP (%)	18.9	21.3	23.7	25.3
Current account balance / GDP (%)	2.8	1.2	1.5	1.1
External debt / GDP (%)	19.4	19.8	18.9	17.8
Forex reserves (USD bn)	39.6	42.9	46.1	48.9
Forex reserves, in months of imports	9.3	7.2	8.4	8.2
Exchange rate USDNGN (year end)	305	305	305	305

e: BNP Paribas Group Economic Research estimates and forecasts

2- Monetary environment

Key policy rate — Inflation (y/y) — Interbank rate (3-month moving average) ··· 12-month Treasury bond yields



Source: Central bank

the second half of 2018 (interbank rates and Treasury notes) was a stark reminder of the persistent fragility of Nigeria's macro-financial situation.

Macroeconomic stability: still fragile

The strengthening of external accounts came to a sudden standstill in 2018. Not only did the current account surplus contract sharply, to 1.2% of GDP in 2018 (vs. 2.8% in 2017) due to a surge in imports of services, but Nigeria was also hit by massive capital outflows as of April (USD 9 bn according to the IMF), the impact of which was only partially offset by a new USD 2.86 bn Eurobond issue in November, after February's issue of USD 2.5 bn. Foreign reserves shrank by

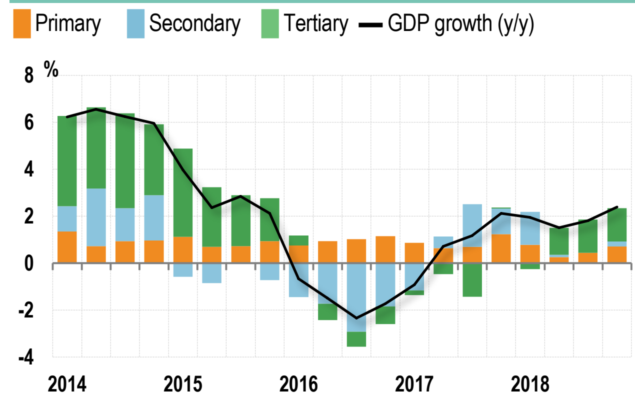
10% in the last 9 months of 2018, ending the year virtually flat after doubling between October 2016 and year-end 2017.

Pressures have eased since the presidential election. In the month of March alone, foreign reserves increased by USD 2 bn. The 100bp decline in 1-year Treasury notes indicates the return of non-resident investors to the local debt market. By removing uncertainty about naira trends, Mr. Buhari's victory seems to have been decisive for restoring attractiveness. Under the current system, several exchange rates co-exist, with a 20% spread between the official exchange rate, set at NGN/USD305 (used for oil product imports and external debt servicing) and the NAFEX rate, which fluctuates around NGN/USD360 (70-80% of transactions). Despite the distortions this dual system implies, president Buhari and the CBN governor do not favour converging the two rates, which they believe would mainly have an inflationary effect. Moreover, foreign reserves are still high (covering 7 months of imports of goods and services at year-end 2018) and the current account should continue to run into a slight surplus. Everything suggests that the status quo will be maintained for the next two years.

All in all, we do not think the stability of the external accounts is at risk in the short term, although the situation is still fragile because portfolio investment are making up an increasingly big share of capital flows.

However, the public finance situation continues to be a source of concern. Very low progress in improving tax collection makes any prospects of a rapid consolidation of the public accounts a distant possibility. The government's consolidated revenues fell to an all-time low of 5.6% of GDP in 2016, but have since recovered somewhat thanks to the rebound in oil prices. Even so, they only amounted to 8.7% of GDP in 2018, one of the lowest rates in Sub-Saharan Africa. The current oil market environment does not raise much hope for potential fiscal gains. Yet the state also faces other major financial headwinds. The widening of the budget deficit since 2014 has been accompanied by an increase in the cost of debt on the domestic market. Interest payments now absorb more than 20% of government revenues, up from 9% in 2014. The government is trying to circumvent the problem by borrowing more on the international financial markets. This would seem to be a coherent strategy given the favourable financial conditions (about 6% vs 15% on the domestic market) and the low level of public debt in foreign currencies (5% of GDP), but it will expose public finances to currency risk. Above all, with a budget deficit remaining above 4% of GDP in 2019-2020, the government will continue to cover a large part of its financing needs on the domestic market at interest rates that are bound to remain high (due to inflationary pressures and the necessity to defend the currency peg). Consequently, there is reason to doubt the authority's capacity to go ahead with majors economic projects. Public investment amounted to only 3.3% of GDP in 2018, which is also extremely low compared to the other African economies. Given the need to clean up public finances, this figure could even drop below 3% by 2020.

3- Sector contribution to growth



Source: NBS

Growth prospects: towards a slow recovery

Under these circumstances, how can Nigeria revive its economy? The country may have pulled out of recession in 2017, but growth remains sluggish at 1.9% in 2018. Excluding the net rebound in the momentum of the Information and Communication Technologies sector as of Q2, the overall picture is even more deteriorate, with real GDP growth of only 0.9%, vs. 1.1% in 2017.

Moreover, the IMF does not foresee any significant improvements. Even though the start-up of production at the Egina oil field adds an extra 200,000 barrels per day (10% of national production), economic growth will pick up only slightly, to 2.5% in 2020, before levelling off thereafter. At this growth rate, real GDP per capita will continue to contract. According to the IMF, another scenario is also possible. Through the intensification of reforms, Nigeria could reach its potential growth rate to 4.5% in the medium term, assuming the macroeconomic and external environment were to stabilise. This roadmap has been clear for some time and boils down to two priorities: 1) improving the business climate, including in the oil sector, and 2) upgrading infrastructure. But, during President Buhari's first term, only limited progress was made in these two areas.

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Kenya

Better macroeconomic stability

After the appeasement of political tensions in the aftermath of the presidential election rerun, the improved political environment has led to a stabilization of Kenya's macroeconomic situation. The president's "Big Four" agenda for boosting growth and development spending will shape economic policy during the next five years. But the Kenyan sovereign still faces the serious challenges of fiscal consolidation and the high government debt level that weighs on investors' appetite for risk. In the meanwhile, the recent High Court suspension of the contentious policy issue of an interest rate cap on bank lending should probably speed up a further agreement with the IMF, which is vital to reduce the borrowing cost burden in a context of increasing financing needs.

Buoyant growth, low inflation and stable currency

Kenya's economic growth has strengthened thanks to receding political tensions after the prolonged 2017 election cycle. Moreover, the new Kenyatta government has outlined four major priority areas for development over the next five years[1] in order to increase growth potential and create a middle-income economy.

According to the National Bureau of Statistics estimates, during the third quarter of 2018, real GDP growth reached 6.0%, compared with the low point of 4.7% in Q3 2017. The recovery in 2018 was driven by the strong performance in the agricultural sector (+6% y-o-y in the first nine months of 2018) due to improved weather conditions, resilient growth in the services sector (+7% y-o-y) and the rebound in activity in the manufacturing sector (+2% y-o-y) coming from stronger electricity and water supply.

The easing of political uncertainty has restored confidence in the economy, as evidenced by the greater stability of the shilling. The stability of the Kenyan shilling (KES) firstly is due to the narrowing of the current account deficit, itself the result of improved receipts from services, strong inflows from tea and horticulture exports and resilient diaspora remittances, which have compensated the increased dollar demand for manufacturing and energy imports. Moreover, it reflects the strong direct investment inflows which reached USD 925 million in 2018 (1.3% of GDP, +38% y-o-y).

Hikes in tariffs on power in mid-2018 and tax rises imposed in September of that year put upward pressure on energy costs at end-2018, although declines in oil prices provided some relief. The inflation rate rose slightly to 4.3% in March 2019 (from the low point of 4.0% in August 2018), but favourable rains and broadly stable food prices have maintained inflation rate within the central bank's target range of 2.5%–7.5%.

Moderate inflation and the stable shilling allowed the central bank to ease the monetary policy in 2018, which allowed a slight decline in interest rates compared with the same period in 2017[2].

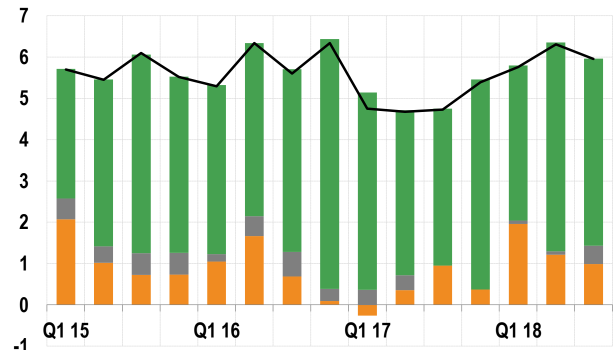
[1] The so called "Big 4" agenda includes food and nutritional security, affordable housing, increased share of manufacturing, and universal health coverage.
[2] In January 2019, weighted interest rates on commercial bank loans averaged 12.5% compared with 13.7% in the corresponding period of 2018.

1-Forecasts

	2017	2018	2019e	2020e
Real GDP growth (%)	4.9	6.0	6.1	6.2
Inflation (CPI, year average, %)	8.0	5.0	5.6	5.0
Cent. Gov. balance / GDP (%)	-8.5	-6.8	-6.3	-5.0
Cent. Gov. debt / GDP (%)	57.6	58.5	59.6	58.0
Current account balance / GDP (%)	-6.3	-5.7	-5.4	-5.1
External debt / GDP (%)	33.4	35.4	36.1	35.2
Forex reserves (USD bn)	7.3	8.2	8.7	8.8
Forex reserves, in months of imports	4.5	4.9	5.2	5.2
Exchange rate USDKES (year end)	103	101	103	104

e: BNP Paribas Group Economic Research estimates and forecasts

2- Manufacturing rebound and resilient services growth



Source: National Bureau of Statistics, BNP Paribas

Low fiscal credibility and high borrowing needs

Kenya's public accounts suffer from low fiscal policy credibility up to 2017 and rising government debt. Budget deficits averaged 8% of GDP in the past five years because of expansionary fiscal policy driven by several factors (implementation of the 2010 Constitution, elections, drought relief and the large social program planned for the implementation of the "Big Four" program throughout the president's new mandate).

In 2018 a significant fiscal adjustment was achieved with the fiscal deficit declining to 6.8% of GDP from 8.5% of GDP in 2017. This was achieved primarily by reducing development expenditure (by

2.7 percent points of GDP) in a context of a significant decline in revenues (15.5% of GDP against 16.3% the previous fiscal year). In an attempt to compensate for the decline in revenue, the authorities adopted some measures in September 2018[3]. However, in January 2019 the Treasury published a draft budget with higher deficit targets (6.3% of GDP in 2019 and 5% in 2020 compared with previous projections of 5.8% and 4.7% respectively).

The revised deficit targets will translate into higher public debt (expected to reach 59% of GDP in 2019). Interest payment has reduced the fiscal room as they represent 21% of fiscal revenues in 2018 vs. 13% two years earlier. Albeit manageable, this implies more borrowing from both external and domestic sources. Domestically, the government announced the issuance of KES 50 bn (1% of GDP) in 10 to 20-year Treasury bonds in April to finance the 2018/2019 budget.

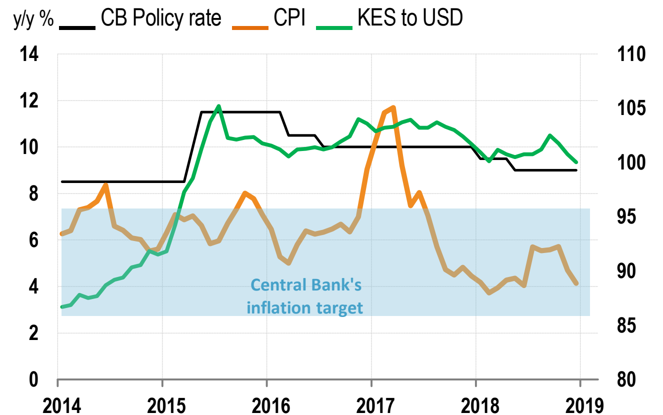
The government is also preparing to launch a third sovereign bond for about USD 2bn in 2019 (after the first USD 2.75 bn bond issue in 2014 whose five-year portion of USD 750 million will be repaid in June this year and a second bond USD 2 bn issue in February 2018). But the precise timing will depend on market conditions since risk appetite for Kenyan sovereign risk has deteriorated so far with current sovereign spreads rate at 490 compared with 280 at beginning 2018. Treasury is looking to roll over maturing debt and issue USD 1 bn syndicated loan for new cash. The increasing recourse to private borrowing increase both exchange rate and refinancing risks.

In order to contain external borrowing costs, the government recently restarted discussions with the IMF to try to obtain a new loan agreement in 2019 after the expiration of the previous IMF stand-by arrangement in September 2018[4].

Banking sector: improvements in the offing

One of the policy changes that the IMF has been pushing to reach a new agreement has been the removal of the controversial law capping lending rates on bank loans[5]. The cap has negatively affected lending to small and medium-sized enterprises, although private-sector credit was already experiencing decelerating growth

3- Low inflation and stable KES allow monetary easing



Source: Central Bank, National Bureau of Statistics, BNP Paribas

due to structural constraints (such as inadequate provisioning and reporting and corporate governance deficiencies) and economic headwinds.

De facto, the lending rate cap has reduced the access to credit for small businesses as banks prefer to lend to the government and large companies leading to a distortion in the credit allocation so far.

While the legal provision on deposits was removed last year, the Nairobi High Court suspended the implementation of the lending cap in March 2019 citing unconstitutional sections that disrupt the relationships between banks and customers. The law has been suspended for 12 months, but loans should continue to be priced at the current capped rate to give parliament time to reconsider the unconstitutional sections.

During 2018, banks' gross loans increased by 5.4%, with about 16% for government loans. With average interest currently at 13% against 10% rate for government T-bills, growth in credit to the private sector remains subdued (+3% y-o-y in January 2019), and the banking system's non-performing loan ratio remains high (12.5% in January 2019). Overall liquidity in the system improved thanks to a notable rise in gross deposits (+12.6% y-o-y in January 2019).

The lifting of the loan-rate cap will certainly increase interest rates on lending in the medium term. According to the World Bank, this measure may boost private-sector credit through reestablishing of lending support (consumer and mortgage loans) to households with a positive impact on the private consumption. In the meantime, the move could favor and speed up the signature of a credit agreement with the IMF.

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[3] The Finance Act 2018 amendments clarify the applicability of the capital gain tax on insurance companies and expand the definition of deemed dividend's scope. It increases several withholding taxes (bank and phone money transfers, bottled water, high capacity petrol and diesel vehicles) and creates new ones (on sugar confectionary and internet data services) while a contribution to the National Housing Development Fund is now deducted from employees' gross monthly emoluments.

[4] In 2016 a stand-by agreement of USD 1.6 bn was signed with the IMF. In March 2018 the government benefited from a 6-month extension in exchange for: i) fiscal consolidation, ii) a better monetary transmission mechanism and iii) revocation of the interest cap law. In September 2018, the government was not able to secure another extension due to some sticking points like the removal of the interest cap law.

[5] The Banking Amendment Act was introduced in September 2016 following concerns about banks' high lending rates. It set the maximum interest rate chargeable for a credit facility at no more than four percent of the base rate of the central bank and the minimum interest rate granted on a deposit to at least seventy percent of the base rate.

Egypt

The challenges of the agricultural sector

Due to the country's economic development, the agricultural sector is in relative decline as a share of GDP. Moreover, investment in agriculture is fairly sluggish. Yet the sector still plays a decisive role in food security in Egypt, a country where demographic growth is strong and households are highly sensitive to food prices. The agri-food sector also has an impact on macroeconomic fundamentals, including inflation, foreign trade and the public accounts. For Egypt, like the rest of the region, water resources are a major issue. Yet in Egypt's case, this issue is especially crucial given the uncertainty that looms over the waters of the Nile and their availability for agriculture in the medium term.

A key economic sector in relative decline

Egypt's key macroeconomic indicators have improved significantly since 2016, thanks to the implementation of monetary and fiscal reforms and financial support from official donors. Although vulnerabilities remain, it is the second round of reforms that now draws our attention. These reforms should help reinvigorate economic growth and create jobs. From a sector perspective, positive trends have been registered in the energy and tourism sectors. Less attention is being paid to the agriculture sector, even though it is a key component of the Egyptian economy. Agriculture, and the agri-food industry in general, are a source of revenue, a factor of economic vulnerability and a way to boost medium-term economic growth prospects.

The agricultural sector accounted for 11.4% of GDP in December 2018. Its economic weight has declined structurally, from 16.5% of GDP in 2002 to 12.5% in 2012. In real terms, GDP of the agricultural sector has grown at an average rate of 3.2% since 2003, compared to 4.4% for total GDP. The main crops are rice, corn, wheat, cotton and sugar cane. The sector employs about 14.5% of the active population. Although private producers produce virtually all of production, the public sector still plays a key role, notable through the supply of inputs, loan distribution and the management of irrigation systems. Confirming the sector's relative decline, agriculture attracted only 4.2% of total investment in 2016/2017. Yet to reduce their dependence on imports in the face of persistently strong local demand, some agri-food companies are pursuing vertical integration of the production process by investing in modern production units. This strategy, combined with deliberate efforts to set up water efficient production processes, should trigger an acceleration in agricultural investment in the medium term. Like the rest of the non-hydrocarbon economy, the sector attracts little foreign direct investment (FDI). In 2016/2017, it attracted only 0.6% of total FDI, which remains concentrated in the hydrocarbon sector (61% of the total).

The agricultural sector contributes to the Egyptian economy at two levels: it ensures part of the nation's food security at a time of fierce demographic pressures, and to a lesser extent, it brings in export revenues.

According to the EIU indicator[1], Egyptian food security ranks 61st out of 113 countries. Among the key factors of food security, two strong points are the quality of infrastructure (ports, storage) and the low volatility of national production. Food production in Egypt is not very vulnerable to climate variations due to the predominance of irrigation in the production process (thanks to the use of the Nile's waters, and to a lesser extent, ground water). Primary farm production (unprocessed) covers 91.5% of national demand[2].

1- Forecasts

	2016	2017e	2018e	2019e
Real GDP growth (%)	4.2	5.3	5.5	5.8
Inflation (CPI, year average, %)	23.3	21.5	13.8	10.8
Gen. Gov. balance / GDP (%)	-10.4	-9.5	-7.5	-6.1
Gen. Gov. debt / GDP (%)	96	103	89	88
Current account balance / GDP (%)	-6.1	-2.4	-2.2	-1.8
External debt / GDP (%)	17	34	38	38
Forex reserves (USD bn)	31	44	47	52
Forex reserves, in months of imports	5.5	7.2	7.2	7.6
Exchange rate USDEGP (year end)	18.1	17.9	17.5	18.5

(*) Fiscal years T-1/T (July-June)

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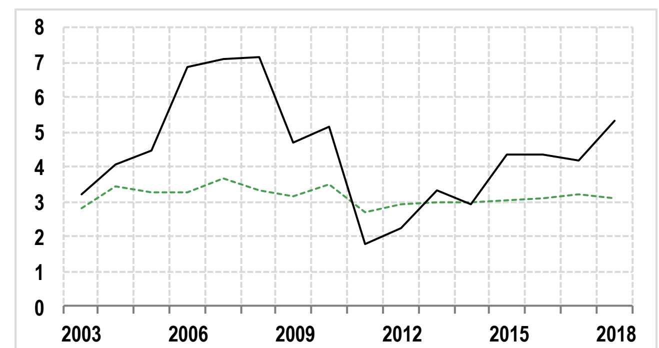
2- Real GDP growth (%)



Source: BNP Paribas

[1] Global Food Security Index 2018, The Economist Intelligence Unit

[2] *Beyond the business case for agricultural value chain development. An economy-wide approach applied to Egypt*. WP 18, March 2019, IFPRI

Primary production exports are low as a share of total production (2.7% in 2015), while agricultural exports account for only 8.7% of total exports of goods.

A source of macroeconomic vulnerability

The external accounts for primary agricultural goods and food products show a structural deficit. In 2017/2018, this deficit amounted to USD 7.6 bn, or about 20% of the total trade deficit (11% for grains alone). Egypt is one of the world's largest grain importers, given the size of its population (about 100 m inhabitants) and the central role that grains play in the average diet (Egyptians are the world's largest consumers of wheat on average). This dependency increases the economy's vulnerability to food price fluctuations. A sharp rise in grain prices tends to trigger social unrest, as was the case in 2008.

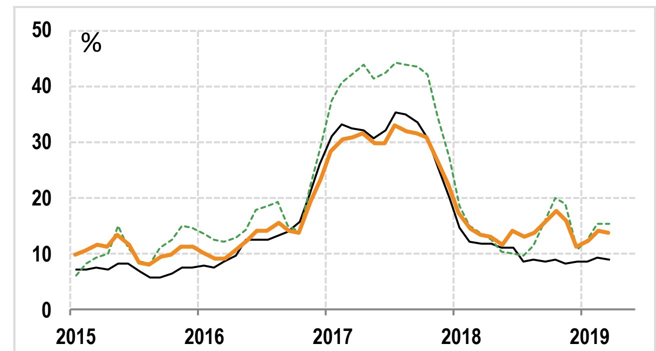
The inflationary impact of food price trends also makes it hard to implement the central bank's inflation targeting policy, even though the core index (which excludes the most volatile food products) is an important indicator. In addition to specific factors linked to economic reforms (currency flotation, cutbacks in subsidies), food pricing trends make a big contribution to consumer price inflation. Given the low seasonality of farm production, food price inflation is due either to the increase in world grain prices, or to the rigidities and lack of competition in the national agri-food market. Food prices account for 40% of the consumer price index and are highly volatile. In March 2019, the average annual inflation of food prices was 13.5%, more or less equivalent to the general price index (13.7%).

Food subsidies were not affected by the fiscal reform programme. To the contrary, to boost household purchasing power, food subsidies virtually doubled in value over the course of 2017/2018 and account for 8.6% of primary fiscal expenditure (1.8% of GDP). They should continue to rise moderately in the medium term.

Outlook: water issues

Agricultural sector prospects are dominated by the problem of water resources. The Nile covers 90% of the country's water needs (all usages combined), and agriculture uses about 85% of these water resources. Intensive use of the Nile's waters is likely to be called into question by Ethiopia's construction of the GERD [3] further upstream. With an estimated cost of USD 5 bn, the dam will serve notably to supply Africa's largest hydroelectric power plant, with an output capacity of 6 gigawatts. For the moment, it is hard to estimate the dam's impact on Egyptian food production. Egypt and Ethiopia have not reached an agreement on a common impact study[4]. Yet with 95% of Egypt's population concentrated along the banks of the Nile, and given its essential role in food production, a decline in the river's water flow is bound to have major, negative consequences. Food production will certainly be hit by greater soil salinity and lower yields. Moreover, the start-up of the Ethiopian dam will significantly reduce the power generation capacity of the

3- Consumer price inflation (y/y)



Source: BNP Paribas

Aswan dam, located downstream from GERD[5]. Aswan provides about 4.3% of the country's total power generation capacity.

At the regional level, bilateral talks have advanced since 2014, but no agreements have been reached for the moment. At the national level, the government is implementing measures to preserve water resources. It is encouraging rice imports again to reduce water-intensive rice crops. Alternative water resources are also being developed, such as greater use of groundwater, the development of desalination plants and better waste water management. Yet this policy will surely be expensive in terms of imports (by limiting more water intensive crops), energy consumption (water desalination is very energy intensive) and investment.

Although the agricultural sector seems to have been somewhat side-lined by recent economic developments and reforms, it is nonetheless a core component of Egypt's macroeconomic stability.

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[3] Grand Ethiopian Renaissance Dam
[4] *Bridging the gap in the Nile waters dispute*, Africa Report n°271, 20 March 2019, International Crisis Group.
[5] *Egypt sees end to water tension with Ethiopia: is it in denial?* 21 September 2018, MEES

Kuwait

Oil revenues ensure solid fundamentals

Real GDP growth will remain weak this year due to expected cut in oil production. Non-oil GDP should get a boost from public expenditure, especially investment spending, and from a slight growth in private consumption. Inflationary pressures could increase slightly but will remain moderate. High fiscal surpluses are funnelled into the sovereign funds, which guarantee the Emirate's long-term solvency. Faced with this situation, the government has little incentive to set up fiscal consolidation measures. High and recurrent trade and current account surpluses ensure the stability of the dinar.

Moderate rebound in non-oil activity

Economic activity has been sluggish since 2017. The main reasons are the oil sector's weighting as a share of GDP (about 60% of total GDP) and the constraints squeezing domestic consumption. A few signs of a rebound in non-oil GDP can be seen in 2019.

As an OPEC member[1], Kuwait is bound to follow the cartel's production policy. In 2018, crude oil production averaged 2.74 million barrels/day (mb/d), compared to 31.8 mb/d for the OPEC countries as a whole. In 2019, oil production should decline slightly to an average of 2.71 mb/d. After increasing 1.3% in 2018, oil GDP should fall by almost 1% this year. At last December's meeting, the OPEC+ group, which is comprised of the cartel members plus other oil producing countries, mainly Russia, decided to reduce oil production to boost prices and limit the risk of an oil supply glut at the global level. Oil production is expected to increase in the medium term, even though the national oil company KOC's plan to develop production capacity seems difficult to meet. The plan calls for production capacity to be increased to 3.65 mb/d in 2023, from the current level of 3.15 mb/d. Refining capacity might also be increased by more than 30% by 2025.

The main growth engines of non-oil activity are public expenditure (which largely determines household consumption), infrastructure projects and the real estate sector (about 11% of non-oil GDP). After two years of relatively tighter fiscal policies in 2016 and 2017, non-oil activity rebounded mildly in 2018 (+2.5% in real terms). In 2019, a moderate increase in current fiscal spending (+2.5% in value) should continue to boost private consumption (30% of GDP). Major transport and energy sector projects are slated to begin in 2019. Moreover, after a depressed period, the real-estate business seems to have picked up again since mid-2018, even though this trend has yet to be confirmed. All in all, real non-oil GDP growth is estimated at 3% this year, up from 2.5% in 2018.

Assuming that oil prices decline slightly, total GDP growth could reach an estimated 0.7% in 2019 before accelerating to more than 2.5% in 2020 and 2021, thanks to an upturn in oil production, a mild rebound in investment and the support of public and private consumption.

[1] Kuwait has the world's 6th largest proven oil reserves.

1-Forecasts

	2017	2018e	2019e	2020e
Real GDP growth (%)	-3.4	1.8	0.7	2.6
Inflation (CPI, year average, %)	1.2	0.5	1.5	2.0
Budget balance / GDP (%)	8.8	12.3	6.2	4.9
Gross government debt / GDP (%)	21.0	14.0	19.0	23.0
Current account balance / GDP (%)	5.9	12.9	6.0	4.5
Forex reserves (USD bn)	34	38	38	41
Forex reserves, in months of imports	7.0	7.6	7.3	7.5
Exchange rate USDKD (year end)	0.3	0.3	0.3	0.3

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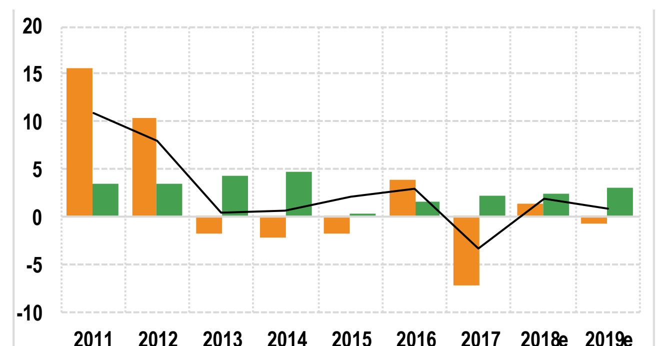
2- Real GDP growth (%)



Source: BNP Paribas

Subdued inflation

Consumer price inflation has been subdued since 2017, due notably to depressed real-estate prices. The sector's weighting on the consumer price index exceeds 30%. In 2018, prices rose 0.5% on average, while the index's real estate component has contracted by an average of 1.1%. In the recent period, the main source of price increases can be directly linked to fiscal policy. The cut in energy subsidies in 2017 triggered a significant increase in transport costs. The quasi-peg of the Kuwait dinar to the US dollar severely restricted monetary policy and the range of tools available to fight inflation.

In 2019 and 2020, inflation could rise slightly (estimated at 1.5% and 2%, respectively), stimulated by a mild recovery in the real estate sector. In 2021, prices could accelerate towards 2.5% with the possible introduction of VAT. A substantial increase in oil prices could also trigger an acceleration in inflation in the medium term, by stimulating private consumption via the intermediary of public spending. For the moment, we have not integrated this scenario into our forecasts.

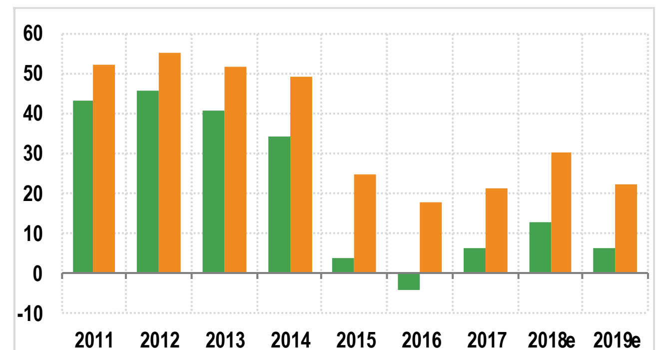
A very comfortable fiscal situation despite the lack of reforms

Public finances are highly dependent on oil revenues, and this situation is unlikely to change in the medium to long term. Oil revenues account for about 75% of total fiscal revenues, while investment-related revenue (sovereign funds) accounts for about 20%. Non-oil tax revenues are very low. Kuwait was the Gulf country hit the least hard by the decline in oil prices in 2015-2016. Given the size of oil revenues with regard to spending, the fiscal breakeven oil price (Brent reference) is among the lowest in the region (roughly USD 55/b). After the country swung into a fiscal deficit in 2015/2016[2] (-1.3% of GDP), fiscal consolidation efforts have been fairly limited, primarily for political reasons. For the year 2019/2020, the fiscal surplus is expected to swell to 6.1% of GDP, and to average 4.8% of GDP in 2020 and 2021.

Despite a very high fiscal surplus, which averaged 12% of GDP between 2013 and 2017, government debt has risen since 2015. It is expected to rise to 19% of GDP at year-end 2019/2020, compared to 4.7% of GDP in 2015/2016. This debt reflects the government's willingness to continue accumulating public assets while benefiting from favourable interest rates in the international markets. The government calculates its overall fiscal balance after allocating 10% of total revenues to sovereign funds. Moreover revenues generated by sovereign fund investments are not taken into account in the calculation of fiscal revenues. The adjusted fiscal balance shows a significant deficit (12% of GDP in 2017/2018). Since 2015, the fiscal deficits, calculated according to the government's definition, have been financed through bond issues on the local and international markets (a total of USD 8 bn in international bonds were issued in 2017), as well as through withdrawals from sovereign funds.

Given the amount of government assets, Kuwait's fiscal solvency is very comfortable. KIA manages these assets, which the IMF estimates at USD 403 bn in 2018/2019, a little more than 3 years of GDP. KIA supervises two distinct funds: the reserve fund for future generations (with about USD 346 bn in assets), which is funded via the annual transfer of 10% of fiscal revenues, and the reserve fund (with USD 57 bn in assets), which collects any fiscal surpluses.

3- External accounts (% of GDP)



Source: BNP Paribas

High trade surpluses

Export revenues are mainly made of oil export revenues (90% of the total). Kuwait has a recurrent and high trade surplus (16% of GDP between 2013 and 2017). In 2018, the current account surplus is estimated at 12.8% of GDP. Given the less favourable prospects for oil prices relative to 2018, the current account surplus could drop to 6% of GDP in 2019. Capital flows are dominated by the reinvestment of oil revenues in the international financial markets. The Kuwaiti economy attracts little foreign direct investment given the lack of opportunities. Between 2013 and 2017, FDI averaged the equivalent of 0.5% of GDP.

The central bank had foreign reserves of USD 37 bn in 2018, the equivalent of 7.4 months of imports of goods and services. The coverage ratio has been relatively stable over time at more than 6.5 months, even when the oil cycle is less favourable. As a consequence foreign liquidity is very comfortable and external solvency is solid, the external debt is moderate (43% of GDP in 2018) and largely offset by the amount of public assets in foreign currency.

All in all, the Kuwait economy is still highly dependent on the oil cycle and fiscal expenditure. The solidity of public finances and the external accounts is holding up well in a more uncertain oil environment.

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[2] The fiscal year ends in March.

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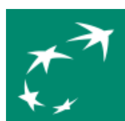

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