ECOEMERGING

1st quarter 2023

IS THE RECENT RALLY IN EMERGING EQUITY MARKETS JUSTIFIED ?

ECONOMIC RESEARCH

BNP PARIBAS

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EDITORIAL

INERTIA

Over the past few months, the equity markets of the main emerging financial centres have shown a little more optimism. They are betting on a recovery in growth in China after the lifting of health restrictions, on the positive effect of the drop in commodity prices for importing countries and on the impact of US monetary tightening and the appreciation of the dollar to be less severe than expected. The first two arguments are uncertain and must be put into perspective. The financial shock is probably behind us. But its negative impact on investment will continue this year. Likewise, the acceleration of inflation in 2022 could have diffuse effects on household consumption, even if wages were to catch up.

Since October, stock prices in the main emerging markets have recovered, even though economic indicators (PMI, exports) remained depressed until December and the main financial institutions (IMF, World Bank) expect a sharp slowdown in growth or even a recession in 2023. The stock market recovery is limited for the time being, as the MSCI index has just returned to its 2019 level. However, it reflects the bet on a recovery in China after the lifting of health restrictions, the positive effect of the drop in commodity prices for importing countries, and a less severe impact than expected from US monetary tightening. Does it make sense ?

A recovery in Chinese activity should indeed occur by the end of the first quarter through a simple catch-up effect. However, uncertainty remains high about the development of the pandemic, especially if the elderly population is not being vaccinated very quickly.

Commodity prices have indeed fallen significantly since spring 2022 (-20% between March and December for the aggregate index of 69 commodities tracked by the IMF), but their level remains at a record high. In December 2022, the median increase was still 40% compared to the 2019 level and 22% of commodities had a price that was at least 80% higher than the 2019 level.

More generally, the shift in inflation rates, generally presented year on year, should not make us forget that price levels have continued to rise. For two-thirds of emerging countries, year-on-year changes in consumer price indices did indeed fall by 1.3 points in median terms in November or December from their high point in 2022, but the monthly increase was still 0.6% (also in median terms) in Q4 2022.

The question is whether wages will have caught up with the cumulative price increase of 2021-2022 in 2023. The indications in this respect are rather positive, although the data is still incomplete: for half of the countries for which wage statistics are available until the end of Q3 2022 or the beginning of Q4, a catch-up has already taken place.

Regarding changes in anticipation of the severity of US monetary tightening,, net portfolio investments in emerging countries have recovered significantly since August (+USD 69.6 billion between August and December, according to IIF estimates, compared with -USD 35.9 billion between January and July). As a result, the depreciation of emerging currencies against the dollar slowed sharply (-1% in median terms in H2 2022 compared to -7% in H1) and CDS premiums fell or remained stable in H2 (with the exception of Pakistan and Tunisia).

The financial shock of US monetary tightening and a stronger dollar is thus probably behind us. But, the consequences in terms of activity are still to come as stressed by the IMF director who announced at the beginning of the year that a third of economies are likely to experience a recession, particularly in Europe.

Companies in emerging countries will have to deal with the drop in external demand at least over the first part of the year and, for those operating in the commodities sector, with a deterioration in the terms of trade. In addition to these factors, there is an increase in financing costs. With a few exceptions, the cost of borrowing in dollars for large companies is currently significantly higher than in recent years (by at least 200 basis points compared to the pre-pandemic period), with the rise in the country risk premium adding to that of US government bond yields. Domestic interest rates are also well above their pre-pandemic level and small and medium-sized companies will probably not be able to pass on the cost of commodities to their selling prices.

As a result, in a context of uncertainty about demand, companies could follow a wait-and-see policy in terms of investment, even if, adjusted for consumer price inflation, real interest rates may seem attractive. According to the World Bank, investment growth in emerging countries outside China will slow again in 2023 to around 3% from around 4% in 2022 and almost 10% in 2021.

EMERGING COUNTRIES: EQUITY MARKETS AND ACTIVITY

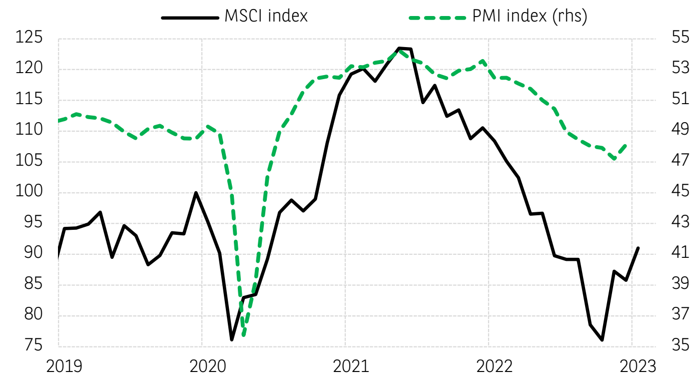

CHART 1 SOURCE: MSCI, S&P GLOBAL, BNP PARIBAS

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CHINA

FURTHER TURMOIL

The sudden and ill-prepared abandonment of the zero-Covid policy at the start of December 2022 has plunged China into further turbulence. The large epidemic wave has hindered production in the manufacturing sector and again delayed the recovery in private consumption and activity in the services sector. However, assuming that the pandemic starts to ease off in February 2023, domestic demand should finally rebound, helped by additional monetary and fiscal support measures. On the other hand, exports are likely to remain affected by the weakness in global demand. While the current account surplus should narrow in 2023, how capital flows will develop is more uncertain.

AN ABRUPT CHANGE IN COVID-19 POLICY

The recovery in economic activity following the lockdown period in spring 2022 has been fragile and uneven, and was interrupted in the last quarter of the year. Exports of goods and industrial growth, the main drivers of Chinese growth since 2020, have slowed down considerably in recent months. Exports (in value terms) contracted by -6.6% year-on-year (y/y) in Q4 2022, after an increase of +10.1% in Q3; and growth in industrial production (in real terms) slowed to +2.8% y/y in Q4 2022, after having picked up to +4.8% in Q3.

The manufacturing sector (and the electronics sector in particular) firstly adjusted its production in response to the rapid deterioration in export performance. In addition, the effect of tax incentives to buy cars abated, which led to a slowdown in car production. Finally, factories experienced significant disruption due to the Covid-19 pandemic. Until the beginning of December, this disruption resulted from the mobility restrictions imposed in various regions as part of the zero-Covid policy. Since December 7th, the very sudden and ill-prepared abandonment of this strict policy has plunged the country into further turbulence.

Most health restrictions were abruptly lifted, and these changes have caused a spike in the number of Covid-19 cases – not least because of the overly low levels of vaccination rates in the population and in older people in particular. The authorities have stopped the publication of data, but the various surveys and the overwhelmed hospitals have revealed the extent of the pandemic wave. The negative consequences for activity have been significant, with effects on production as a result of absenteeism in the workforce and effects on demand linked to the number of people falling ill and the fears of the Chinese given the risk of infection.

Activity in the services sector and consumer spending are therefore expected to need further time to recover. They remained depressed throughout 2022 in the face of strong headwinds, which may not ease rapidly over the very short term: constraints linked to the pandemic, a serious crisis in the property sector, deteriorating conditions in the labour market (the urban unemployment rate rose again in Q4 2022, reaching 5.6%), a slowdown in disposable income growth, and a significant confidence crisis among enterprises and households. The consumer confidence index, published by the National Bureau of Statistics, collapsed from 120 at the beginning of 2022 to 87 in the spring, reaching record lows, and has not recovered since then. In Q4 2022, services production fell by -0.9% y/y and retail sales volumes by -4% (vs. around +1% in Q3 2022).

MODERATE PICK-UP IN ECONOMIC GROWTH IN 2023

After a turbulent period, which could last until after the Chinese New Year in late January, activity driven by domestic demand should rebound and the easing of the pandemic is likely to be accompanied by a catch-up effect (this scenario assumes that vaccine coverage is expanded rapidly and that the consequences of the pandemic on the medical system are not out of control, forcing certain regions to reintroduce restrictions). In particular, households could use some of the extra savings accumulated during the pandemic. It is estimated that the household savings rate rose from 35% of disposable income in 2019 to 38% in 2020, before falling back to around 36% in 2021, and it is likely to have increased slightly again in 2022.

To encourage recovery, the authorities are considering a further strengthening of fiscal and monetary support policies. Their statements made at the end of the Central Economic Work Conference in mid-December announced measures to support private consumption and new measures in the property sector.

FORECASTS

	2020	2021	2022e	2023e	2024e
Real GDP growth, %	2.2	8.4	3.0	5.1	5.3
Inflation, CPI, year average, %	2.5	0.9	2.0	2.7	2.5
Official budget balance / GDP, %	-3.7	-3.1	-2.8	-3.2	-3.2
Official general government debt / GDP, %	45.9	46.9	50.7	53.2	54.5
Current account balance / GDP, %	1.7	1.8	2.4	2.0	1.5
External debt / GDP, %	16.3	15.4	15.6	15.5	15.1
Forex reserves, USD bn	3 217	3 250	3 128	3 050	3 040
Forex reserves, in months of imports	16.2	12.6	11.8	11.1	10.1

e: ESTIMATE & FORECASTS
TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

CHINA: WEAK FOURTH QUARTER OF 2022

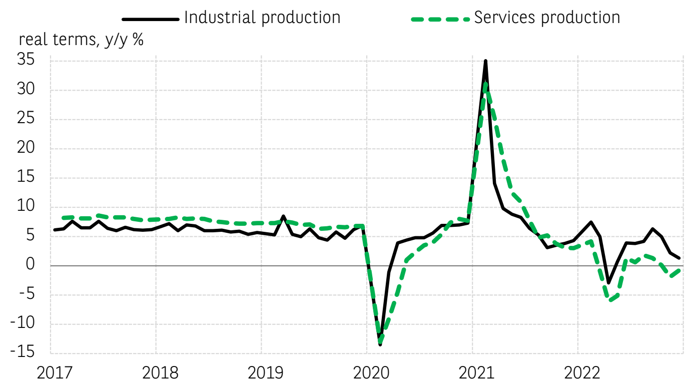

CHART 1 SOURCE: NBS, BNP PARIBAS

The objective of the authorities is to provide more short-term financing to the healthiest developers in order to mitigate credit risks in the financial sector and help them complete unfinished construction projects, as well as to boost household demand for housing (property sales volumes fell by another 32% y/y in December). With these support measures, and assuming that the health situation improves, the property sector should, at best, stabilise over the course of 2023.

The difficulties in the export sector are expected to persist over the short term because of weaker global demand. The slowdown in exports, coupled with a recovery in imports, should limit the recovery in real GDP growth expected in 2023. In addition, the trade and current account surpluses, which increased in 2022, are expected to narrow. The dynamics of capital flows are much more uncertain in the short term, which complicates forecasts about the yuan's exchange rate.

YUAN UNDER PRESSURE

The yuan depreciated rapidly in 2022 after more than 18 months of appreciation. It lost 11% of its value against the US dollar over the first eleven months of the year, and then regained 3% in December. The weakening of the yuan was firstly linked to the general strengthening of the dollar which has accompanied US monetary tightening since March. The depreciation of the yuan in nominal effective terms has in fact been much more moderate: the CFETS index (calculated by the China Foreign Exchange Trade System based on a basket of 24 currencies) fell by 5% over the first eleven months of 2022 before strengthening slightly in December. However, the weakening of the yuan was also the result of internal factors and dynamics in the balance of payments.

The current account surplus continued to increase in 2022, reaching USD 310 bn over the first three quarters (or +2.4% of GDP, compared with +1.8% in 2021), but the other components of the balance of payments deteriorated. Therefore, the sum of the balances of the financial account, the capital account and errors and omissions reached -1.9% of GDP over the first three quarters of 2022, compared to -0.7% in 2021. While US interest rates rose rapidly in 2022, China instead relaxed its monetary policy (moderately) in order to stimulate domestic demand, in the absence of strong inflationary pressures. The spreads between US and Chinese interest rates therefore reversed and widened sharply, which has significantly changed international financing conditions and capital flow determinants.

Against this backdrop, China has recorded large capital outflows, in particular due to interest rate arbitrage transactions. According to the balance-of-payments data, net portfolio investment outflows reached a record USD 261 bn over the first three quarters of 2022 (-2% of GDP). They resulted from an increase in net portfolio outflows from residents (whose net portfolio flows are structurally negative) and from significant net sales of Chinese securities (mainly bonds) by non-residents (whose net portfolio flows were negative over the first three quarters of 2022 for the first time since 2015, representing -0.8% of GDP). In addition, net direct investment (DI) flows remained positive but recorded a significant reduction. On the other hand, net outflows related to debt and other investments declined (in part thanks to the decrease in Chinese credit abroad). The risk of a massive capital flight is in fact contained by the existence of controls, which have been strengthened since 2015 and are notably aimed at limiting resident outflows.

Chinese enterprises that are most fragile and most dependent on foreign credit (especially property developers) have experienced difficulties because of the deterioration in international financing conditions. But

CHINA: DIVERGING INTEREST RATES

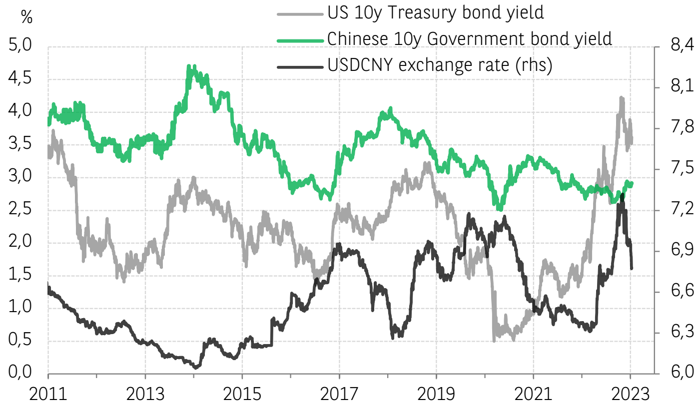

CHART 2 SOURCE: REFINITIV, BNP PARIBAS

the impact on China's overall capacity to cover its external financing needs is very limited. Indeed, despite the gradual opening up to foreign investors, China continues to have a low level of dependence on external financing. Its basic balance (current account balance and net DI flow) is structurally positive, its external debt is low (15% of GDP) and the participation of foreign investors in its financial markets continues to be modest despite its increase until 2021 (they accounted for 3% of the total stock of local bonds at the end of 2021 – but 11% of government bond stocks – and less than 5% of market capitalisation).

Furthermore, China has a very strong external liquidity position. Its foreign exchange reserves (USD 3128 bn at the end of December 2022) are sufficient to cover the external debt and to provide protection against episodes of capital outflows. Forex reserves have fallen only slightly in recent months, particularly as the central bank's direct interventions in the foreign exchange market to contain the depreciation of the yuan have been small. The central bank has preferred to use other instruments, with the aim for example of controlling certain forex flows of financial institutions, as well as prudential measures (the reserve requirement ratio on foreign-currency deposits was reduced to 6% compared to 9% at the end of 2021, and the foreign exchange risk reserve ratio for forward trading was increased to 20% at the end of September).

In the short term, dynamics in capital flows, and therefore in the exchange rate, are uncertain. The interest rate differential between the US and China is expected to decrease when the US Federal Reserve stops its monetary tightening cycle (which is expected by the end of Q1 2023) and China's economic growth outlook should improve. However, investors may remain cautious, as their confidence has been weakened in the past two years by China's zero-Covid policy, the crisis in the real estate sector, the rise in regulatory risk and geopolitical tensions.

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INDIA

GROWTH SLOWS BUT PUBLIC FINANCES SHOW RESILIENCE

The Indian economy coped well with the external environment in 2022, but slowed down mainly because of inflationary pressures. Over the fiscal year which will end in March 2023, the budget deficit could exceed the initial target, but the overrun should be marginal and the debt-to-GDP ratio should continue to fall. The government's refinancing risks remain contained. On the other hand, the tensions on external accounts are likely to remain relatively strong, mainly as a result of the fall in exports in an unfavourable international context. Nonetheless, the central bank should be able to contain the depreciation of the rupee. While foreign exchange reserves have fallen significantly, they are still sufficient to cover the country's external financing needs.

EXPECTED SLOWDOWN IN GROWTH

In the second quarter of the 2022/2023 fiscal year which began on 1st April 2022, economic growth slowed to 6.3% year-on-year (YoY) after an exceptionally strong first quarter due to favourable base effects. Over the second half of the fiscal year, growth is not expected to exceed 5% compared to last year. Although domestic demand is expected to remain solid, it is likely to grow at a less sustained rate than in the first part of the year.

All the economic indicators confirm a slowdown since September-October 2022, although public investment should remain strong. In addition, while services sector activities remain dynamic, a contraction in industrial production was recorded last October, in conjunction with lower exports.

After reaching a high point in September 2022, at 7.4% YoY, inflation slowed to 5.9% YoY in November 2022, driven by a marked slowdown in food prices, while the increase in energy prices remained significant (+10.6% YoY). Therefore, although inflation stood below the target of 4% +/- 2 percentage points set by the monetary authorities, inflationary pressures remained strong, as evidenced by the rise in core inflation (prices excluding food and energy products), which stood at +6% YoY in November.

Although less exposed to the global economic environment than other Asian countries, India will not be spared by the expected recession in Europe and the US. Furthermore, monetary tightening (+225 basis points between April and December 2022) is likely to continue in the last quarter of the current fiscal year and weigh on the investment decisions of companies, even if their financial situation is much more solid than at the start of the Covid-19 pandemic. The government is expected to maintain an expansionary fiscal policy in order to develop infrastructure and support household purchasing power in a pre-electoral context (the general elections are scheduled for May 2024).

The risks to growth remain significant. The labour market has not returned to its pre-crisis levels. The unemployment rate remains high (8% in November) and the labour force participation rate, which measures the proportion of the population in work or seeking employment, remains structurally low (39.6% in November 2022), and lower than the pre-crisis level (42.7% at the end of 2019). A significant part of the population is not looking to enter the labour market. The situation is particularly concerning for youth. For example, the unemployment rate for young people aged 20–24 living in urban areas was 42% in October 2022.

At the present time the country has not been able to exploit its demographic advantage. According to the IMF, unless the government succeeds in significantly increasing job creation, particularly for young people and women, potential growth will be 6% by 2027, 0.5 percentage points lower than what was estimated before the Covid-19 outbreak. Conversely, if the participation rate rises, particularly in high-productivity sectors, and financial intermediation develops, then medium-term growth could reach 7%, according to the IMF.

FORECASTS

	2020	2021	2022e	2023e	2024e
Real GDP growth, % (1)	-6.6	8.7	6.9	6.1	6.3
Inflation, CPI, year average, % (1)	6.1	5.5	6.7	5.5	4.4
General Gov. Balance / GDP, % (1)	-13.9	-10.2	-10.0	-9.0	-8.1
General Gov. Debt / GDP, % (1)	89.4	84.1	83.5	83.6	83.6
Current account balance / GDP, % (1)	0.9	-1.2	-3.5	-2.6	-2.4
External debt / GDP, % (1)	21.5	19.5	19.6	19.8	19.9
Forex reserves, USD bn	579	618	545	560	575
Forex reserves, in months of imports	9.0	7.9	6.7	6.5	6.9

TABLE 1

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

INDIA: LABOUR MARKET

CHART 1

SOURCE: CMIE, BNP PARIBAS

ALTHOUGH FRAGILE, PUBLIC FINANCES SHOW RESILIENCE

In its budget drawn up around a year ago, the government forecast a reduction in the deficit from 6.7% of GDP to 6.4% of GDP for the fiscal year ending on 31 March 2023. As for the States, their objective was to reduce their consolidated deficit from 3.6% of GDP to 3.3% of GDP, which would have reduced the general government's deficit well below 10% of GDP (compared with 10.2% of GDP in 2021/2022).

The central government's budget deficit remained contained over the first seven months of the 2022/2023 fiscal year. Between April and October 2022, the fiscal deficit was only 45.6% of its annual target, a level well below previous years (over the past five years, on average the deficit was 70.9% of its annual target in the same period). It was therefore only 4.9% of GDP. The resilience of the public accounts over the first seven months can be explained by an increase in government revenues.

The increase in government revenues reflects a significant increase in levies on corporate profits (+27.7%) and taxes on goods and services (+31.5%), while revenues generated by international trade transactions fell (-18.8%) due to the drop in excise duties on imports of energy products; a decision taken by the government to contain the rise in prices caused by the conflict in Ukraine. Income from the tax on goods and services was the biggest source of income for the government (25.7%), reflecting the good performance of economic activity but also a significant improvement in the collection of taxes.

In terms of public expenditure, the government has adopted a policy of supporting growth, despite limited fiscal room for manoeuvre. In particular, it has been able to continue with its policy of developing infrastructure. Over the first seven months of the fiscal year this expenditure was around 55% of its annual target.

The central government's deficit target is likely to be exceeded given the slowdown in growth and the high level of investment expenditure over the rest of the fiscal year. This expenditure is therefore expected to be around 3% of GDP over the entire fiscal year compared to only 1.6% of GDP before the Covid-19 pandemic. Furthermore, in an attempt to limit the impact of the sharp rise in international commodity prices on households and farmers, the government has significantly increased the subsidies on food prices and fertilisers. The food aid programme was extended until the end of 2022. The additional cost brought about by the higher subsidies is estimated at more than 0.7% of GDP for the full fiscal year.

Interest payments on debt remained a major item of expenditure (22.4% of expenditure between April and October 2022 was spent on interest), up 22.4% over the first seven months of the current fiscal year compared to the same period last year. However, although still very high, the ratio of interest expenditure to revenue decreased slightly for the second consecutive year. Interest payments represented 34.7% of revenues in the first seven months of the year, compared to a high of 40.2% in the 2020/2021 fiscal year. Nonetheless, this positive trend could deteriorate over the short term given the rise in yields on government bonds against a backdrop of a tighter monetary policy. Over the first six months of the current fiscal year, the average rate of return on bonds issued by the government rose from 6.6% at the beginning of the year to 7.3%.

In the short and medium term, the consolidation of public finances is expected to continue. Despite the prospect of the general elections in May 2024, the government has reaffirmed its commitment to reduce its central deficit to 4.5% of GDP by the 2025/2026 fiscal year. Furthermore, although debt levels remain high, the refinancing risks are contained.

Over the first part of the fiscal year, the deficit was financed almost exclusively by the issue of debt securities on the domestic market. After reaching a high of 89.4% of GDP during 2020/2021 the debt ratio should fall for the second consecutive year, to 83.5% of GDP in March 2023. In the medium term the debt level is likely to remain consistently above the pre-crisis level. However, refinancing risks remain contained. Debt has a long maturity (11.9 years on average) and debt securities for one year or less make up only 7.9% of total debt. Furthermore, debt is almost exclusively denominated in local currency (only 6.1% of debt is denominated in foreign currency) and more than 93% is held by residents.

INDIA: RBI'S MONETARY POLICY

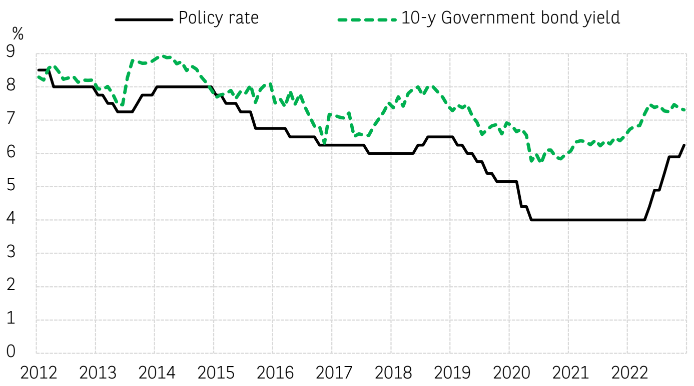

CHART 2 SOURCE: RBI, BNP PARIBAS

EXTERNAL ACCOUNTS STILL UNDER PRESSURE

External accounts have been under pressure since the start of the conflict in Ukraine. As a net importer of raw materials, India has seen its energy bill rise significantly, even though it very quickly substituted a large part of its oil imports from the Middle East with oil from Russia (the price per barrel of Urals oil has been on average USD 30 less than the price of Brent since March 2022). Between April and September 2022, the trade deficit reached 8.9% of GDP (compared to 5.1% of GDP a year earlier) and the current account deficit was 3.9% of GDP. The latter was only partially covered by foreign direct investment. The widening of the current account deficit could have been much greater without the good performance of the services sector, where the surplus increased by 0.5 GDP points (to 3.9% of GDP).

Pressures on external accounts are likely to remain strong at least in the first part of 2023, mainly because of the decline in exports to Europe and the United States. Therefore, over 2022/2023 as a whole, the current account deficit should reach 3.5% of GDP, compared with only 1.2% last year. In addition, capital inflows will not be sufficient to cover this, increasing the downward pressures on foreign exchange reserves and on the rupee.

Although pressures on the currency eased in October and November 2022, they remain strong, as evidenced by the downward movements since the beginning of December. Over the calendar year 2022 as a whole, the rupee depreciated by 10.3% against the dollar. This movement could have been larger without the currency sales by the central bank. The latter's room for manoeuvre remains comfortable, but it has reduced significantly with the contraction in foreign exchange reserves (-USD 70bn over one year). At the end of December, foreign exchange reserves covered the country's short-term financing needs by a factor of 1.4.

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Article completed on 3 January 2023

MALAYSIA

NORMALISATION AFTER THE STRONG REBOUND IN 2022

Malaysia's economy held up well in 2022. Economic growth may have exceeded 8% and public finances strengthened thanks to the sharp rise in oil revenues. Furthermore, although external accounts weakened due to capital outflows and increased imports, the current account balance remained in surplus and the ringgit depreciated moderately against the dollar over the year as a whole. The outlook for 2023 is less favourable. Economic growth is expected to decelerate given the monetary tightening and the global economic slowdown. Public finance risks are still contained even though debt remains above pre-crisis levels. The new government should present its 2023 budget in parliament at the end of February. Its budgetary strategy should be in line with that of the previous government. The main question is whether the goods and services tax should be reintroduced or not.

SIGNIFICANT SLOWDOWN IN GROWTH IN 2023

Over the first three quarters of 2022, real GDP growth reached 9.3%, supported by the dynamism of domestic demand and a positive contribution from net exports in the third quarter.

Economic activity was particularly dynamic in the construction and services sector. The increase in subsidies on energy and food prices helped limit the impact of rising international prices on household purchasing power. In addition, the return of tourists, the upturn in the labour market and the increase in minimum wages boosted domestic demand. Although the number of tourists remains 37% lower than pre-COVID-19, it has multiplied by more than 3.2 since the borders reopened in April 2022.

Similarly, although still more fragile than before the crisis, the labour market has strengthened significantly over the past twelve months. Employment rose by 3.6% in the third quarter of 2022 and the unemployment rate fell to 3.7% in October, 0.7pp less than at the same time last year. The labour participation rate continued to rise, reaching 69.7% in October. Wage increases continued, particularly in the services sector (+8.7% in Q3-2022), the main job creation sector.

Economic growth probably slowed significantly in the fourth quarter of 2022. Since September 2022, economic activity indicators have showed a slowdown in retail sales and industrial production. Business confidence deteriorated significantly in conjunction with rising production costs. In addition, exports gradually declined after reaching a high point in August and this movement is not expected to reverse in the first quarter of 2023 due to the resurgence of the COVID epidemic in China. Nevertheless, despite the slowdown in activity in the fourth quarter, economic growth may have exceeded 8% over 2022 as a whole.

Growth forecasts for 2023 are much less favourable. They have been revised downwards by the World Bank and the Asian Development Bank since September. The Malaysian economy is much more exposed to the international environment than other Asian countries, and the risks of recession in Europe and the United States are high. Furthermore, domestic monetary tightening should weigh on domestic demand. Over the past twelve months, interest rates deflated by the core inflation (excluding fuel and food prices) have increased by 210 basis points.

Under these conditions, real GDP growth is unlikely to exceed 4-4.5% unless activity in China recovers more rapidly than expected.

CONSOLIDATION OF PUBLIC FINANCES

Public finances strengthened during 2022. Although still above the pre-crisis level, the federal government deficit and debt have decreased and are expected to stand at 5.3% and 62% of GDP respectively over the year as a whole. On the other hand, some structural weaknesses remain: the fiscal base remains relatively narrow (revenues should barely exceed 15% of GDP this year) and the proportion of rigid expenditure remains high (the cost of interest payments, retirement and emoluments accounts for 41% of total expenditure).

Over the first eleven months, the budget deficit fell by 28% compared to the same period last year (-0.7 GDP points) to 5.2% of GDP. This consolidation results from a sharp increase in government revenues (+29.5%) while the increase in expenditure was more modest (+11.1%)

FORECASTS

	2020	2021	2022e	2023e	2024e
Real GDP growth, %	-5.5	3.1	8.0	4.0	4.8
Inflation, CPI, year average, %	-1.2	2.5	3.4	3.0	2.0
General Gov. balance / GDP, %	-6.2	-6.4	-5.3	-5.2	-4.6
General Gov. debt / GDP, %	62.1	63.5	62.0	63.0	63.5
Current account balance / GDP, %	4.2	3.8	2.0	1.5	2.2
External debt / GDP, %	67.6	70.0	67.5	65.0	62.5
Forex reserves, USD bn	100	104	98	100	104
Forex reserves, in months of imports	6.2	5.7	4.9	5.0	5.4

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

MALAYSIA: PUBLIC FINANCES

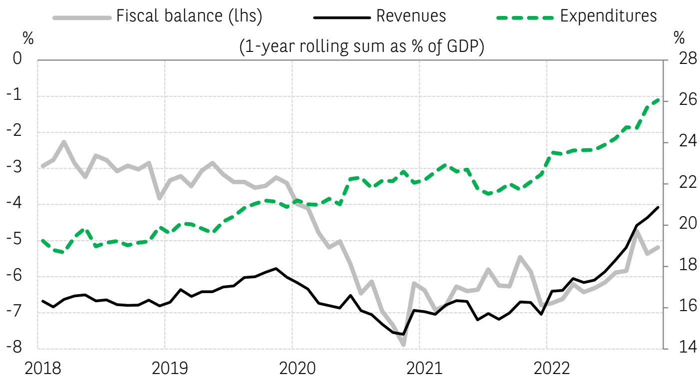

CHART 1

SOURCE: BNM, BNP PARIBAS

despite the significant increase in subsidies (multiplied by almost 1.6). This increase in revenue can be explained both by the strong recovery in economic activity and by the soaring oil prices. In fact, over the first three quarters of 2022, revenues from petroleum activities reached levels not seen since 2014 and accounted for 27.3% of total government receipts. Indeed, according to the latest forecasts from the Ministry of Finance, the dividends paid by Petronas alone should reach MYR50 billion (i.e. more than 17% of total revenues for the year) without taking into account direct taxes from companies in the oil sector (7% of total income) and indirect taxes on sales of oil products. The increase in budgetary revenues for 2022 will therefore only be temporary unless the new government decides to reintroduce the tax on goods and services, which was abolished in 2018. Such a project had been contemplated by the former government but was not voted on before the dissolution of parliament.

In terms of expenditure, over the first three quarters of 2022, the cost of interest payments compared to revenue, although still higher than the pre-crisis level, fell to 14% compared with over 16% in 2021.

The budget for 2023 is expected to be presented on 24 February by the new Prime Minister Anwar Ibrahim (also Minister of Finance). The budget initially presented in October by the former government provided for a reduction of the deficit from 5.8% of GDP in 2022 to 5.5% of GDP. Although the new government is expected to further consolidate its public finances, it has however announced that it does not wish to increase tax pressure and that it will continue its efforts to support growth. In particular, it wants to focus more on subsidies for the most disadvantaged households. In addition, capital expenditure should continue to rise in order to compensate for infrastructure failures, particularly in road and rail transport.

In Q3 2022, debt stood at 61.6% of GDP. Although it remains high, refinancing risks are contained. Debt is almost exclusively denominated in local currency (at 97.2%) and held mainly by domestic investors (77.6%).

TEMPORARY STRESS ON EXTERNAL LIQUIDITY DESPITE THE CURRENT ACCOUNT SURPLUS

Malaysia has a structural current account surplus. Although falling significantly during 2022, it remained in positive territory and should stay there in 2023.

In 2022, Malaysia benefited from the rise in the prices of exported commodities (palm oil, hydrocarbons). However, the increase in exports over the first three quarters of the year (+2.2 GDP points) was offset by the increase in imports (+4.2 GDP points), particularly in food products and durable consumer goods against a backdrop of a sharp acceleration in domestic demand. Thus, despite the increase in tourism revenues, the current account surplus decreased by 2.3 GDP points compared to the same period last year to just 1.6% of GDP. In the fourth quarter, the drop in imports caused by the economic slowdown and the turnaround in the price of commodities will compensate for the contraction in exports generated in particular by the sharp slowdown in activity in China. Over 2022 as a whole, the current account surplus should therefore stand at 2% of GDP compared with 3.8% in 2021.

In terms of the financial account, like other South Asian countries, Malaysia was not spared by capital outflows generated by the sharp rise in US policy rates. They reached the equivalent of 1.9% over the first three quarters of 2022.

MALAYSIA: TRADE

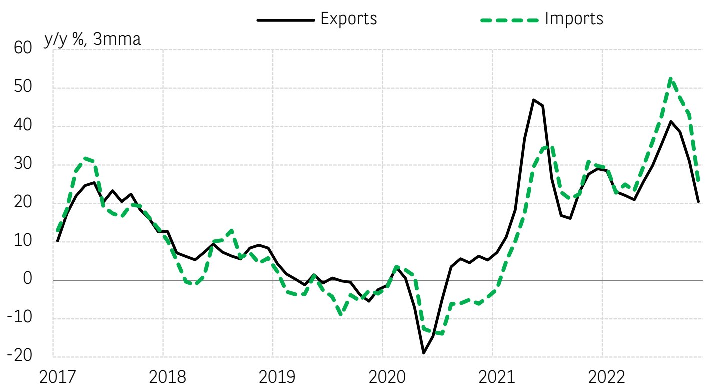

CHART 2 SOURCE: BNM, BNP PARIBAS

The proportion of equities held by foreign investors fell 0.7 points over the past twelve months to just 13.7% in December 2022. The same applies to bonds. On the domestic bond market, foreign investors only hold 12.7% of the bonds (-0.8pp in one year).

Against this backdrop, to contain the depreciation of the ringgit against the dollar, the central bank intervened on the exchange markets, thus generating a drop in foreign exchange reserves of USD10.4 billion between January and October 2022. Since November, downward pressures on external accounts have eased. The ringgit strengthened against the dollar to end the year down only 4.6% and foreign exchange reserves rose once again to USD98 billion at the end of November 2022, the equivalent of 4.9 months of goods and services imports.

The ratio of external debt to GDP remains high, but it fell to 67% of GDP in Q3 2022, despite the rise in the nominal value of debt. The share of external debt denominated in foreign currency remains high (67.8% of total debt) but the risks of revaluation caused by the depreciation of the ringgit remain moderate. In fact, according to the central bank, 67.6% of foreign currency debt is subject to strict currency hedging rules. Furthermore, 14.2% of external debt corresponds to intra-company debt and 11.1% to «commercial» debt naturally covered by export transactions abroad.

The downward trend in the prices of certain commodities (palm oil from the end of April and oil since June), as well as the resurgence of the COVID-19 epidemic in China and the expected recession in advanced countries, are all factors that will weigh on the country's exports in 2023. However, the current account balance is expected to remain in surplus due to the slowdown in imports.

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PHILIPPINES

LIMITED SLOWDOWN IN ECONOMIC GROWTH IN 2023

The government of the Philippines maintained health restrictions linked to the pandemic for longer than the average period in emerging countries, with some regions still under lockdown until April 2022. The rebound in activity is not yet finished, and the strength of consumer spending, still supported by remittances, should help to offset the effects of higher inflation and the slowdown in global growth. Economic growth is expected to slow in 2023, but should remain solid. However, the after-effects from the crisis and health measures are weighing on the medium-term outlook.

DYNAMIC RECOVERY IN 2022

Strong real GDP growth in 2022 (estimated at around 8%, after a decline of 9.5% in 2020 and growth of 5.7% in 2021) can in particular be explained by a recovery in post-Covid activity that was later than in other countries in the region. After a stricter and longer lockdown in the Philippines (some regions remained under lockdown until April 2022), the wave of "Omicron" infections in 2022 was less severe, particularly as the vaccination rate was much higher than initially anticipated.

During the first three quarters of 2022, consumer spending and private investment recorded very dynamic growth rates (almost 9% and 12% respectively, on average and year-on-year). Despite still relatively strict health restrictions in 2022 (schools were only reopened to students in September 2022), the services sector contributed significantly to growth in the first three quarters. The return of tourists made a notable contribution to the vitality of the sector. In total there were over 2 million arrivals recorded in 2022, or around 15 times the number recorded in 2021. However, the number of tourists remains well below the pre-Covid level (over 8 million arrivals in 2019). It may take several years to reach this level again. In Q3 2022, GDP was 10% lower than in the last quarter of 2019.

Moreover, the unemployment rate has fallen significantly in recent months, recording a historic low of 4.2% in November. That said, according to the Central Bank, the low unemployment rate is mainly due to an increase in informal work.

The outlook for the next two years remains relatively favourable. Economic growth is expected to be around 6% in 2023, before accelerating again in 2024 and reaching a level close to the growth potential estimated by the IMF (6.5%). Consumer spending should continue to be sustained, despite the persistent inflation. Transfers from foreign workers will continue to support private consumption. In current dollar terms, they rose by more than 3% in 2022. Expressed as a percentage of GDP, transfers have remained broadly stable at around 8% over the past three years.

At the same time, the slowdown in global growth will impact on the export sector, despite the "shock absorber" effect of the return of tourists. That said, the effect on growth is expected to be less pronounced than in other countries in the region, given the lower degree of openness of the economy.

PERSISTENCE OF INFLATION

Consumer price inflation has steadily accelerated since March 2022, reaching 8.1% year-on-year in December and averaging 5.8% in 2022. In its latest estimates, the Central Bank expects the inflation rate to remain high (close to 5% in 2023), due to strong domestic demand pressures (in the context of high commodity prices) and the continued high price of fertilisers. Since May, the Central Bank has steadily raised its interest rate (to 5.5% in December, a cumulative increase of 350 basis points). Monetary policy could tighten still further in the coming quarters. Rate differentials with the United States narrowed in recent months, causing outflows of capital and a depreciation of the exchange rate (the peso depreciated by around 15% against the USD over the first ten months of the year). The exchange rate reached PHP 59/USD at the beginning of October, despite interventions by the Central Bank (which however did reduce exchange rate volatility). The peso has stabilised around PHP 55/USD since the beginning of December.

Other interventions on the foreign exchange market are possible in the short term. The Governor of the Central Bank has stated on several occasions that the Central Bank is not aiming for a particular level on the exchange rate and remains focused on its mandate to maintain price stability. However, the Minister of Finance has stated that the government would «not allow the exchange rate to breach the PHP 60/USD level" and that around USD 10bn of forex reserves (which were estimated at USD 96bn in December) could be used for this purpose.

FORECASTS

	2020	2021	2022e	2023e	2024e
Real GDP growth (%)	-9.5	5.7	7.8	6.0	6.5
Inflation (CPI, year average, %)	2.4	3.9	5.8	4.8	3.5
Government balance / GDP (%)	-5.8	-4.6	-3.5	-3.2	-3.1
National government debt / GDP (%)	51.6	57.0	60.9	61.0	61.2
Current account balance / GDP (%)	3.2	-1.5	-5.0	-4.1	-3.4
External debt / GDP (%)	27.2	27.0	26.6	26.4	25.8
Forex reserves (USD bn)	110.0	108.8	94.1	88.7	83.9
Forex reserves, in months of imports	12.3	9.6	8.8	8.5	7.8

e: ESTIMATE & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

PHILIPPINES: REMITTANCES

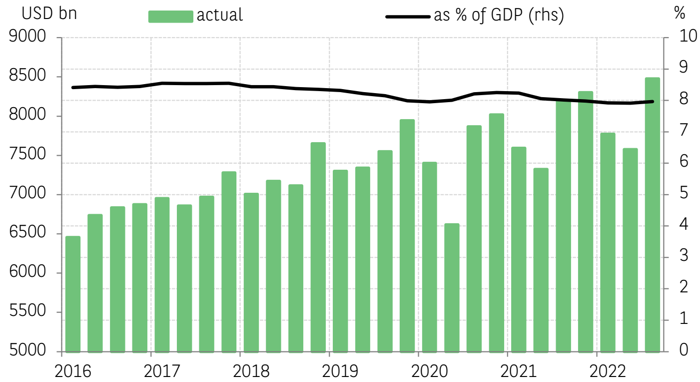

CHART 1 SOURCE: CENTRAL BANK, CEIC, BNP PARIBAS

The final decision, however, lies with the monetary policy council of the Central Bank, of which the Minister is a member.

FISCAL CONSOLIDATION CONTINUES

The government of the Philippines has taken advantage of the fiscal room for manoeuvre which it had in 2020 and 2021 to support the economy. The public deficit stood at 5.8% of GDP in 2020, and 4.6% in 2021, while on average it was less than 1% between 2015 and 2019. In the context of stronger growth, the public deficit reduced to 3.5% of GDP in 2022.

At the same time, government debt increased sharply, from 37% of GDP in 2019 to 60% of GDP at the end of 2022. That said, the risks surrounding a possible slippage in the public finances have not increased significantly. On the one hand, the structure of the debt remained favourable: despite the rapid increase in debt, the share of fiscal revenues allocated to interest payments remained moderate (at a little under 10% in Q3 2022, while on average it represented 8.5% in 2019), and maturities remained long. The proportion of debt denominated in foreign currency remains relatively high, at around 33%, but has been falling continuously for almost 15 years and the Philippines government has been able to obtain finance easily on the local market, at relatively low interest rates. All these elements illustrate the effectiveness of the macroeconomic policies implemented over the past decade, and the strength of the Philippine fundamentals despite the economic crisis.

Moreover, President Marcos Jr., who was elected last May, has confirmed his intention to continue the policy of consolidation announced by the previous government. Shortly after taking up his post, the new Minister of Finance announced a medium-term plan, structured around three main objectives: to reduce debt to below 60% of GDP by 2025, to get the deficit down below 3% of GDP by 2028 and to maintain a pace of growth in infrastructure spending above the rate of growth in GDP.

Several proposals to improve the collection of revenues have also been announced, such as the expansion of the tax base for property taxes, as well as the introduction of new taxes on digital consumption, or the consumption of single-use plastic bags. On the basis of the measures announced, public investment (apart from infrastructure expenditure) could decrease. That being said, the numerous public-private partnership projects initiated by the previous government, and continued by the current one, could partially replace public investment, and contribute more to the revenues than was expected.

All in all, in the context of a limited slowdown in economic growth, fiscal consolidation is expected to continue over the next two years, and the objectives announced by the government for reducing debt are likely to be maintained.

PHILIPPINES: FX RESERVES AND EXCHANGE RATE

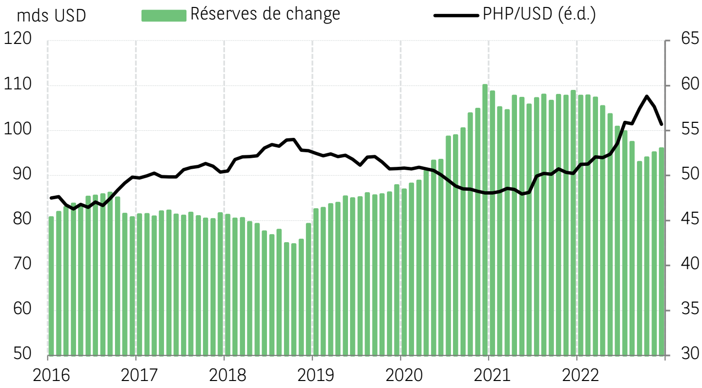

CHART 2

SOURCE: CENTRAL BANK, BNP PARIBAS

FRAGILITY RELATED TO THE PANDEMIC

Over the medium term, the forecasts for growth remain relatively high: according to the IMF, the GDP growth rate should be close to 6.5% over the next five years. However, the scale and the duration of the restrictions imposed in the country during the health crisis have caused many fragilities (increased poverty rate, increased use of undeclared work, reduction in the quality of education) which have partially erased the progress seen over the previous decade, and which are weighing on the potential for growth. Several avenues of reform have been announced by the new government, including a plan to encourage a return to school and to improve the level of education (Basic Education Development Plan 2030).

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Article completed on 12 January 2023

FINANCIAL VULNERABILITIES IN A CONTEXT OF SUSTAINED RECOVERY

Vietnam benefited from a solid recovery in its economic growth in 2022, supported by the dynamism of both the export sector and domestic demand. However, the country has also become increasingly vulnerable to the deterioration of the international environment. Exports fell in Q4 2022 and these difficulties are expected to persist in the short term. Inflation accelerated in 2022, the dong depreciated under the effect of US monetary tightening and capital outflows, and the Central Bank began to increase its policy rates. In addition, there was a confidence shock caused by reports of fraud in the local bond market. Against this backdrop, liquidity tensions emerged in the financial sector. They do not seem to be of any magnitude to generate systemic instability, but do highlight some fragility in the balance of payments and the financial sector. In the short term, domestic demand is expected to slow down. In the medium term, Vietnamese growth prospects remain good.

STRONG ECONOMIC GROWTH REBOUND IN 2022

In 2022, economic growth recovered vigorously to reach 8%, after two years marked by a significant slowdown linked to the health crisis. From Q4 2021, the authorities switched from a strict "zero Covid" policy to a "living with Covid" strategy, a change enabled by a strong acceleration of the vaccination campaign in previous months. The lifting of restrictions led to a rapid rise in the number of infections until March 2022, but without saturating healthcare infrastructure. Mobility indicators gradually improved, moving above their pre-Covid levels from spring 2022.

Economic activity has recovered at the same time since Q4 2021, driven firstly by production and exports of the manufacturing sector, then quickly also by the services sector and private consumption. Tourism activity also restarted due to the reopening of borders in March 2022. Finally, domestic demand has been encouraged by a new fiscal stimulus package (drop in the VAT rate from 10% to 8%, tax cuts for companies, public infrastructure investment programme) and the continuation of an accommodative monetary policy.

However, in recent months, the Vietnamese economy has increasingly felt the effects of the deterioration of the international environment following the war in Ukraine and US monetary tightening. On the one hand, external trade performance deteriorated sharply in Q4 2022 due to weakening global demand. Exports fell by 6% year-on-year, after an increase of 16% in Q3 and 18% in H1. The decline in sales to the United States (29% of Vietnamese exports) was particularly pronounced.

On the other hand, rising global commodity prices contributed to accelerating inflation. This has also been fuelled by the rebound in domestic demand and the labour market, as well as by the depreciation of the dong. Consumer price inflation thus increased from 1.9% y/y in Q4 2021 to 4.4% in Q4 2022, driven by the rise in food prices (+5.2% in Q4 2022 compared to +0.2% in Q4 2021) and energy prices, and by underlying inflation (+4.8% in Q4 2022 compared to +0.6% in Q4 2021). It has exceeded the official target of 4% y/y since October.

The Central Bank (State Bank of Vietnam, or SBV) began a monetary tightening cycle in September 2022. However, after two consecutive key rate hikes in September and October (the refinancing rate went from 4% to 6%), the SBV interrupted its action despite continued inflationary pressures. The authorities adjusted their priorities due to significant liquidity tensions in the financial sector.

DEPRECIATION OF THE DONG AND EROSION OF FOREX RESERVES

The rise in Vietnamese interest rates has added to other shocks. First of all, the US monetary tightening in 2022 and the strengthening of the dollar (up to its weakening in recent weeks) have led to capital outflows. These have been observed in deposits and loans transactions of the "other investments" item of the balance of payments, and above all in "errors and omissions" whose negative balance reached USD 23.5 billion over the first three quarters of 2022 compared with USD 8.8 billion over 2021 as a whole. Capital flight has come in particular from residents, whose confidence in the dong (VND) has been eroded by the rise in inflation and its loss of value against the USD, after several years of relative stability in the exchange rate.

FORECASTS

	2020	2021	2022e	2023e	2024e
Real GDP growth (%)	2.9	2.6	8.0	6.0	6.5
Inflation (CPI, year average, %)	3.2	1.8	3.2	3.8	3.5
Budget balance / GDP (%)	-2.9	-3.5	-4.6	-4.7	-4.4
General government debt / GDP (%)	41.7	39.7	40.4	41.6	41.7
Current account balance / GDP (%)	4.3	-1.8	-0.5	0.9	1.4
External debt / GDP (%)	36.5	37.2	35.0	34.8	33.6
Forex reserves (USD bn)	94.8	109.4	87.0	95.3	107.4
Forex reserves, in months of imports	4.2	3.9	2.8	2.8	2.8

e: ESTIMATE & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

VIETNAM: INFLATION AND INTEREST RATES

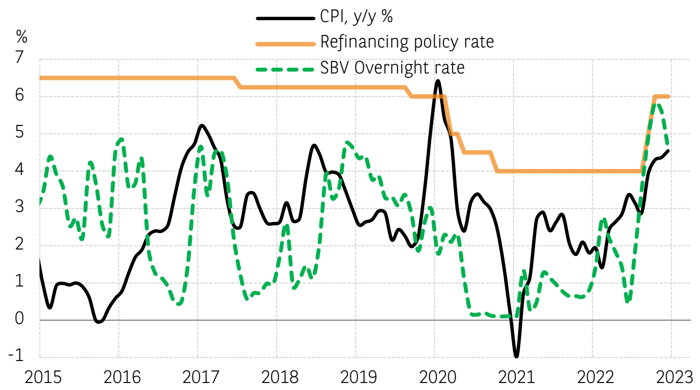

CHART 1 SOURCE: SBV, BNP PARIBAS

These dynamics were only partially offset by the improvement in the current account balance (which is estimated to have moved from a deficit in H1 to a surplus in H2). Net inflows of foreign direct investment (FDI) have recently weakened but remained strong (at almost USD 10 billion over the first three quarters of 2022) and largely above the slight current account deficit expected for 2022 as a whole.

SBV has increased its intervention in the foreign exchange market to defend the VND. Last October, it also widened the VND/USD trading band from ±3% to ±5% around the reference rate (the Vietnamese exchange rate regime is based on a managed float and crawling band system). In the end, the VND only depreciated by 8% against the USD (spot rate) over the first ten months of 2022, and strengthened in November-December (+5% against the USD). By contrast, forex reserves fell rapidly, from USD 109 billion at the end of 2021 to USD 86 billion at the end of October 2022, bringing an end to six years of improvement in the external liquidity position. Forex reserves once again covered less than 3 months of imports of goods and services in 2022 (compared with almost 4 months in 2021) and offer limited protection against new external shocks.

CRACKS IN THE FINANCIAL SECTOR

Vietnam's monetary policy tightening and capital outflows have led to a significant and sudden tightening of liquidity (as shown by the rise in interbank rates until last November). In addition, a confidence shock has been caused by the authorities' anti-corruption campaign, which in particular uncovered fraudulent practices by property developers on the local bond market. The arrests of company directors and the authorities' directives to stop financing developers culpable of fraud have led to a correction in the bond market as well as significant withdrawals of deposits from private banks connected to these developers. The stock market also suffered a correction (the Ho Chi Minh stock market index lost 17% in H2 2022, returning to its level at the end of 2019).

Given, on the one hand, the excessive debt of the Vietnamese economy and, on the other hand, the fragility of the banking sector as a whole (notably due to insufficient capitalisation ratios) and the smaller private banks in particular (which have less stable funding sources and a more risky loan portfolio than large banks), the recent events are raising concerns. Will corruption scandals increase? Can rising interest rates lead to a dangerous rise in default risks? Will the stress on the bond market and banking liquidity last and extend to other institutions? Are banks able to cope with such shocks? The answers to these questions are uncertain, all the more so since opacity remains high in the banking sector (for example, the official non-performing loan ratio was only 2% at the end of 2021, but most certainly underestimated).

There are, however, some positive points. Firstly, financing difficulties have so far been limited to a few small private banks, and the four major public banks have not experienced any particular stress on their liquidity. Secondly, tensions on the interbank market and on the dong have eased in recent weeks: the main effects of US monetary tightening seem to have passed, which has given Vietnamese authorities some leeway to improve financing conditions and try to restore confidence. At the beginning of December 2022, the SBV raised the ceiling on bank credit growth for 2022 (from 14% to 16%) – a quota banks can use to finance companies via the local bond market. This market is narrow and concentrated. Corporate bonds accounted for around 7% of GDP in 2021 (compared to domestic bank credit to the private sector, equivalent to 125% of GDP), which limits the potential systemic effects of a bond market crisis. Caution remains necessary, however, as property developers are among the largest bond issuers and are expected to continue to face difficulties in the short term.

VIETNAM: VND /USD EXCHANGE RATE

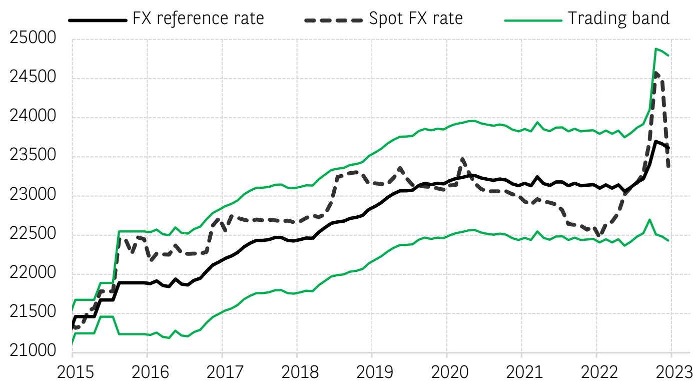

CHART 2

SOURCE: SBV, CEIC, BNP PARIBAS

MEDIUM-TERM ECONOMIC PROSPECTS REMAIN GOOD

Finally, Vietnam's macroeconomic fundamentals improved in the decade before the pandemic, making it more resilient to shocks. Strong GDP growth rates, strengthened external accounts and fiscal consolidation in particular were enabled by the rapid expansion of the export manufacturing sector, supported by FDI. These dynamics have been interrupted since 2020, but the deterioration of fiscal deficits and the current account balance has been limited. At the end of 2022, public debt and external debt ratios remained moderate, estimated at 40% and 35% of GDP respectively, i.e. levels close to those at the end of 2019. The government has faced rising interest rates in recent months, but covering external financing needs is not a problem, especially as Vietnam's basic balance (current balance + FDI) remains positive.

Finally, the medium-term economic growth outlook remains strong. Admittedly, economic growth will be penalised in the short term by the slowdown in both the export sector (slightly offset by the rebound in tourism) and domestic demand: due to lessening post-Covid catch-up effects, the rise in inflation, less favourable credit conditions and the expected deterioration of the labour market. In the medium term, Vietnam's manufacturing sector should continue to benefit from adjustments in Asian value chains and from substitution effects (particularly because firms should relocate part of their production outside China). The expected real GDP growth for the next five years remains above 6.5% per year on average.

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FRAGILE FINANCIAL STABILISATION

Türkiye has enjoyed a period of financial calm since mid-2022 with exchange rate stability relative to the first half of the year, lower risk premiums and bond yields. Growth stagnated in Q3 2022, but monthly inflation slowed and the economic indicators available for Q4 2022 continued to be positive. For 2023, a slowdown is inevitable given the weaker levels of activity expected from the country's main trading partners. But domestic demand could mitigate the external shock and the fall in oil prices should help to reduce the current account deficit. However, it is still too early to draw any conclusions about the success of economic policy combining fiscal support, monetary easing, and measures to channel the growth of credit and to encourage *liraization*.

Over the past six months financial conditions in Türkiye have eased significantly. Since October, the lira has been more stable against the dollar (USD) after depreciating by 25% over the first six months of 2022, a depreciation which slowed sharply over the summer (-7%). The official foreign exchange reserves were reconstituted, reaching USD 128bn at the end of December compared to USD 100bn at the end of June. The risk premium measured by 5-year CDS spreads fell from 900 basis points in mid-July to 500 basis points at the end of December. More striking still, the yields on 10-year government bonds fell by 25% from the beginning of April to 9.7% at the end of December despite the acceleration in inflation, which over the same period went from 60% to 64.3% year-on-year.

Is this easing just temporary or, on the contrary, does it indicate the success of the monetary and financial strategy combining monetary easing (since mid-August 2022, the central bank's main key rate has been reduced from 14% to 9%), an increase in the regulatory measures affecting banks (90 between December 2021 and December 2022) mainly to channel credit growth, and incentives for *liraization?*

It is still too early to answer this question. On the one hand, activity is holding up, the monthly rate of inflation is falling and the budget deficit is much lower than was generally anticipated. On the other hand, the current account deficit exceeds the warning level of 5% of GDP, due to the increase in the energy bill, and the external financing sources are fragile. However, the risk of further financial stress before the elections in June 2023 is low.

SUSTAINED GROWTH DESPITE INFLATION

Over the first nine months of 2022, and compared to the same period in 2021, real GDP growth stood at 5.9% in spite of a slight contraction in Q3 (-0.1% q/q). Consumer spending was the main driver with an increase of 21%, a record since the national accounts were created[1]. Compared to 2019, the increase was 40%. The usual indicators (car sales, industrial production and imports of consumer goods) showed more moderate increases but were just as exceptional in their extent[2] . However, real wage income (+13% compared to 2019) rose at a slower pace than consumption despite dynamic employment (+11% since 2019). Acceleration in inflation led to a loss in purchasing power until mid-2022. Nevertheless, household confidence has recovered since the summer thanks to a second increase in the minimum wage in July and the announcement last June of a sharp increase in the State budget, in particular current transfers in the run-up to the presidential and legislative elections in June 2023[3]. In particular, consumption was supported by credit.

FORECASTS

	2020	2021	2022e	2023e	2024e
Real GDP growth, %	1.8	11.4	5.0	2.8	3.5
Inflation, CPI, year average, %	12.1	19.6	72.3	39.4	33.4
Gen. Gov. balance / GDP, %	-3.5	-2.8	-1.9	-3.4	-2.6
Gen. Gov. debt / GDP, %	35.9	37.9	29.3	27.5	25.0
Current account balance / GDP, %	-5.0	-1.7	-5.9	-3.6	-3.6
External debt / GDP, %	60.1	54.0	56.6	53.3	47.3
Forex reserves, USD bn	49.0	72.5	83.0	85.0	90.0
Forex reserves, in months of imports	2.6	3.1	2.7	2.7	2.7

e: ESTIMATE & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

TÜRKIYE: BETTER FINANCIAL CONDITIONS

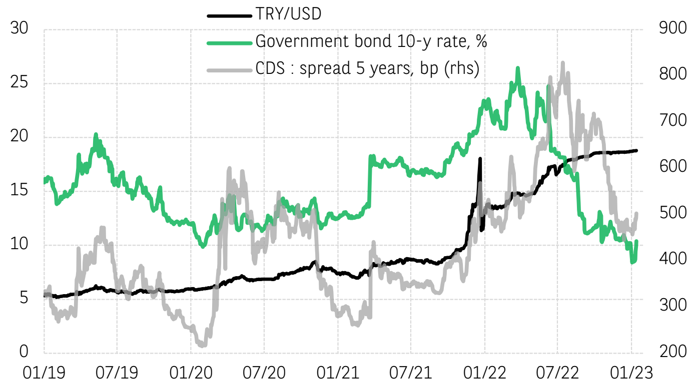

CHART 1 SOURCE: MACROBOND, REFINITIV, BNP PARIBAS

The increase in consumption over the past two years has gone well beyond just a catch-up effect: true, several factors (anticipated purchases of durable goods, negative real interest rates, dynamic labour market) can help to explain this, but the pace of growth appears difficult to extrapolate. Investment and net exports contributed much less to growth. Nonetheless, their composition contributes to macroeconomic stability and suggests an increase in potential GDP.

1 The previous records were in 1977 (19.6%) and 2021 (15.3%).
2 +12% for car sales (compared to 2019), +25% for industrial production of durable goods, +28% for non-durable goods, +39% for imports of consumer goods measured in dollars. However, the market for new cars for private individuals is a small market (550,000 per year on average over the last 5 years) and is volatile (following the significant upturn in 2020, sales fell by 8% in 2021 and again by 2.5% year-on-year January-November 2022).
3 The budget, which has been revised twice (in June and then in September as part of the medium-term fiscal programme), provides for an increase in current transfers of up to 10% of GDP in 2022 compared with 5% initially (and 8.5% in 2021).

Investment in machinery and equipment was very dynamic (+15.4% after 9.1% in 2021) unlike investment in construction (-12.4% after -6% in 2021). Imports were rather moderate (only 7.8% in 2022) given the strength of demand components, whose propensity to import is a priori the strongest (consumption, investments in machinery and equipment, exports[4]). Moreover, the increase in imports of capital goods exceeded that of consumer goods. At the same time, exports increased more vigorously than imports from the European Union (respectively 14% compared with 9.5% in 2022), Türkiye's main market (41% of its exports). There are more diversified geographically; the EU's share of total exports has decreased by 3 points since 2018 in favour of the United States and very recently Russia (+1.5 points each).

NO RISK OF RECESSION IN 2023

In October, the economic indicators improved once again and in the last quarter, exports grew by +6% compared to Q3 despite the loss in growth momentum in the Eurozone. Activity could therefore have bounced back in Q4. However, according to the central bank's surveys in the manufacturing sector, the opinion of companies on production and order books continued to be more pessimistic until November 2022 and companies considered that their stock levels were too high.

For 2023, the expected slowdown or recession in the main trading partners (Germany is the country's largest external market) is likely to eventually hinder exports. However, domestic demand could mitigate the external shock.

The wages catch-up should continue (a further 30% increase in the minimum wage in July) and, with the stabilisation of the lira, inflation should continue to slow (core inflation fell from 8% per month end of 2021-beginning of 2022 to 4% between February and August, then 2% between September and November 2022). In addition, households will benefit from the rise in current transfers, which should be focused on the first half of 2023[5] . It is unlikely that they will draw on their savings as much as in 2022, but a further drop in the savings rate is still a possibility as Turkish households are not over-indebted.

Productive investment should continue to be supportive of growth. The opinion of manufacturers about their investment plans remained quite positive until last November. The gross operating surplus[6] has recovered strongly in real terms since mid-2020 and, unlike consumer credit, corporate loans appear to have played only a secondary role in the recovery of investment in equipment.

In total, despite an external environment that is much less buoyant than in 2021 and 2022, the Turkish economy would not only escape recession in 2023, but growth could surprise on the upside once again.

EXTERNAL DEFICITS, A LIMITING FACTOR FOR FISCAL SUPPORT

The budget implementation for 2022 shows a central government deficit of only 1.2% of GDP in January-November with a primary surplus of 0.9%, and therefore a net interest burden which remains moderate at 2.1%. The government benefits from artificially low negative real interest rates by requiring banks to hold Treasury securities for reserve requirements, not only on deposits but also on loans[7].

The fiscal room for manoeuvre is significant and the government will use it. External imbalances, however, are a limiting factor for fiscal support.

At USD 43.5bn over a twelve-month rolling period to October, the current account deficit reached 6% of GDP. This results from the increase in the energy balance deficit (8% of GDP compared to 5% in 2021 and only 0.5% in 2020) and the growth differential with the rest of the world. According to the central bank, when adjusted for the growth gap and terms of trade, the current account has been in surplus since Q4 2021.

In 2023, the current account deficit should reduce with the fall in oil prices. The government forecast of 2.5% of GDP, which until now was considered very optimistic, has become more realistic because, at the current price level (80 dollars per barrel for Brent), the energy bill should reduce by around 2 points of GDP. However, it is unlikely that, excluding energy, the current account will improve by an additional 1.5 points of GDP because inflation has reduced the exchange rate-based gains in competitiveness.

In 2022, the current account deficit was covered up to 30% by the "errors and omissions" component. The latter includes some (probably underestimated) tourist revenues, as well as unrecorded flows from Russia (unlike the EU, Türkiye does not impose an embargo and serves as a bridge for Russia's foreign trade). For 2023, errors and omissions should normalise. However, they could be offset by a reduction in portfolio investment outflows if the elections do not result in a conflicted situation (in the event of political coexistence, for example), generating further outflows of capital.

Liraization has become the main objective of the authorities[8]. The incentive scheme for individuals and companies to convert their foreign exchange deposits into lira[9] has been a success, with the share of foreign exchange deposits held by companies and individuals combined having fallen from 63% at the end of 2021 to 46% at the end of 2022. The cost of this scheme for the State amounted to almost USD 5bn in 2022, or 0.7% of GDP, which remains moderate. However, with the fall in key rates and the stabilisation of the exchange rate, exits from the arrangement took place last December and caused further tensions on the lira.

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4 The headline elasticity has decreased by 30% since 2019 compared to 2009-2019.
5 Current transfers effected between January and November 2022 only reached 82% of the expected annual budget.
6 Measured, as a first approximation, by nominal GDP – compensation of employees – taxes net of subsidies on production.
7 The scale of the anticipated disinflation is not enough to explain the drop in nominal rates: in December, only 7% of the professionals surveyed by the central bank forecast a rate of inflation of less than 25% by the end of 2023, and only 5% a rate of less than 10% by the end of 2024.
8 In the title of the official central bank document detailing the monetary policy strategy, the term «liraization» appears explicitly.
9 The so called fx-protected deposit scheme was put in place at the end of 2021 and extended until the end of 2023.

HUNGARY

MONETARY AND FISCAL POLICY RECALIBRATION

Economic activity weakened in the third quarter. The outlook remains gloomy in the short term. Last September, the central bank ended its monetary tightening cycle in the face of downside risks to growth. This policy is currently not very consistent with the trajectory of inflation. Meanwhile, fiscal policy was tightened in the second half of the year due to the marked deterioration in budget deficit. The EU's freezing of funds in 2022, depriving the Hungarian authorities of a source of income, has probably weighed on their decision. While this recalibration limits support for growth, it strengthens the credibility of Hungary's fiscal policy.

In the third quarter, GDP fell by 0.4% compared to the previous quarter after a relatively solid performance in the first half of the year (+1.6% and +0.8% in the first and second quarters respectively). However, unlike neighbouring countries, business confidence has not deteriorated in recent months despite supply constraints and rising commodity prices. Despite higher inflation and a more restrictive monetary policy, consumer and investment growth remained positive. Domestic demand contracted in Q3 mainly due to a strong negative contribution from stocks.

Industrial activity held up quite well, also supported by exports. However, energy-intensive industries are severely affected by higher energy bills. Other sectors, such as the plastics industry and transport, are also losing momentum.

SLOWDOWN IN THE COMING MONTHS

Consumption may weaken in the short term for a number of reasons. Firstly, households saw their purchasing power fall (real wages fell by 7% between April and September). The labour market has become less dynamic with a slightly higher unemployment rate. It stood at 4.1% in November compared to 3.1% in June 2022. Furthermore, the effects of the government's supportive measures to households in the first half of the year will ebb out. Finally, the abolition of the price cap on fuel, firstly for affluent households, then extended to all households last December, will weigh on their budgets. Retail sales are already running out of steam, rising at an annual rate of 2.6% in October-November compared to 4.0% in September.

Other growth drivers are expected to weaken. The expected slowdown of the global economy this year, the energy shock and uncertainties related to the war in Ukraine will likely lead to the postponement of investment projects. Demand from Hungary's main trading partners, including Germany, will likely be weaker. In total, we expect a slightly negative growth in 2023.

LESS RESTRICTIVE MONETARY POLICY

Last year, monetary tightening was pronounced in Hungary. The central bank raised its key rate by 1010 basis points cumulatively in 2022. By way of comparison, the increase was more moderate in other countries in the region, i.e. +450 bp in Poland, +550 bp in Romania and +470 bp in the Czech Republic. Last September, however, the Hungarian monetary authorities ended the cycle of key rate hikes due to downward risks to growth. Other tools, such as deposit rates and lending rates, were favoured for the conduct of monetary policy. Faced with downward pressures on the Hungarian forint last October, the overnight deposit rate was raised to 18%. Similarly, the lending rate was increased to 25%.

The move towards a less restrictive policy could delay the fight against inflation in 2023. Hungary is one of the most affected countries by inflationary pressures in the region. At 23.1% year-on-year in November 2022, inflation will remain high in the short term due to (i) the removal of the ceiling on certain pump prices in December; (ii) the effects of last year's severe forint depreciation; and (iii) significant wage pressures. The dampened rise in energy prices in the last two months (with a 3.1 points contribution to headline inflation in November) could thus accelerate again in the coming months. The same applies to food and alcoholic/non-alcoholic beverage prices, which contributed significantly to inflation (10.9 points in 2022).

FORECASTS

	2020	2021	2022e	2023e	2024e
Real GDP growth, %	-4.7	7.1	5.2	-1.4	2.9
Inflation, CPI, year average, %	3.3	5.2	14.5	20.0	7.2
Gen. Gov. balance / GDP (%)	-7.5	-7.1	-5.6	-4.1	-3.3
Gen. Gov. debt / GDP (%)	77.6	74.4	69.3	62.6	60.0
Current account balance / GDP, %	-1.0	-4.2	-6.8	-2.7	-2.1
External debt / GDP, %	80.9	84.6	78.0	71.7	68.0
Forex reserves, EUR bn	33.7	38.4	38.7	37.2	37.9
Forex reserves, in months of imports	4.0	3.8	3.5	3.6	3.9

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

HUNGARY: CURRENT ACCOUNT AND CAPITAL FLOWS

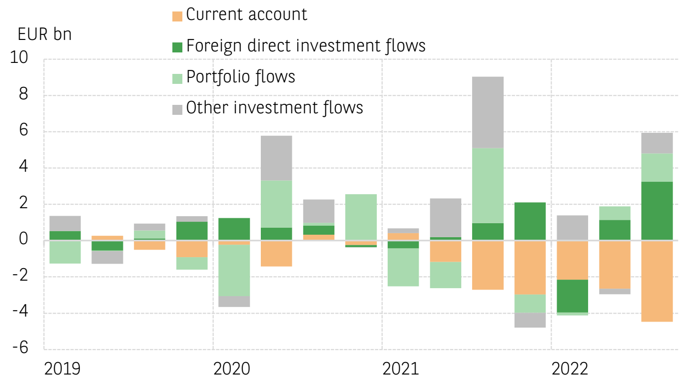

CHART 1

SOURCE: CENTRAL BANK, BNP PARIBAS

LAST-MINUTE AGREEMENT ON EU FUNDS

In 2022, the EU blocked funds related to the recovery plan (EUR 5.8 billion) and cohesion funds under the EU budget over the period 2021-2027 (EUR 21 billion). Finally, a last-minute agreement was reached between the Hungarian authorities and the EU at the end of December. However, the disbursement of funds will not be immediate as it is conditional on the adoption and implementation of many reforms. For example, the EU imposed 27 "super-milestones" regarding legal, audit and anti-corruption reforms before the funds could be paid.

The freezing of EU funds was a serious challenge in the face of the deterioration in public and external accounts. The authorities responded by tightening their fiscal policy. This move strengthens the credibility of budgetary policy, although the scope for supporting growth is limited. As for external accounts, concerns related to the financing the current account deficit. Last year, in the absence of EU funds, the gap was funded in part by debt and foreign direct investment flows.

FISCAL CONSOLIDATION REMAINS IN PLACE

Regarding public finance, last April's generous measures significantly widened the deficit, which reached 4.6% of GDP in June 2022. This was close to the official target of 4.9% for the whole year. In response, the government cut spending, specifically investment, in the second half of 2022, against a backdrop where EU funds were frozen. The introduction of a temporary windfall profit tax has generated additional revenue and the reforms on energy subsidies that came into force on 1st August have led to savings.

Fiscal consolidation efforts are expected to continue in 2023. The government aims to bring the deficit to 3.9% of GDP, although this target seems optimistic.

Financing the deficit is not a major problem, but the cost will be higher as 5-year and 10-year interest rates have risen sharply and EU funds are not yet available. The increase in the cost of debt remains manageable insofar as interest expenses relative to revenue is very low: 5.7% in 2021.

Public debt could hover close to 60% of GDP over the next two years. Its profile has improved in recent years with a sharp drop in the share of foreign currency denominated debt (21% of the total in 2021 compared to the peak of 51% in 2011).

EXTERNAL ACCOUNT DETERIORATION IS MANAGEABLE

The current account slipped back into the red in 2019 after several years of surpluses. This deterioration can be explained by a widening of the trade deficit. In 2022, the energy shock and the rise in food prices increased the estimated current account deficit to -6.8% of GDP in 2022 after -4.2% in 2021.

HUNGARY: INFLATION AND POLICY RATE

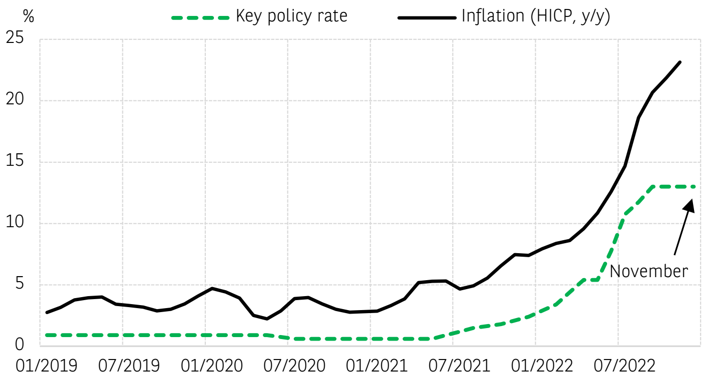

CHART 2 SOURCE: CENTRAL BANK, EUROSTAT, BNP PARIBAS

The deficit was only partially funded by the stable component of capital flows, notably through foreign direct investment (FDI). Over the first nine months, they reached EUR 2.6 billion, thus covering 23% of the expected deficit in 2022. Despite this, foreign exchange reserves continued to improve, reaching EUR 38.7 billion at the end of December. FDI, generally resilient in past crises, is expected to hold up this year. Furthermore, the current account deficit may ease in 2023 due to the relative easing of energy and food prices on global commodity markets. However, the date of payment of EU funds remains a factor of uncertainty.

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BULGARIA

THE AUTHORITIES AIM TO ADOPT THE EURO IN 2024

GDP growth was resilient in the first three quarters of 2022 but is expected to slow down significantly in 2023. Inflation will be a key feature to monitor as price stability is one of the economic convergence criteria for Bulgaria's future entry into the Eurozone in 2024. Another point of concern is that the political scene continues to be subject to uncertainty given the many changes in the government over the past 20 months. Investment has suffered as a result of this situation. However, the commitment of the authorities towards reforms does not appear to have been affected.

In the third quarter, GDP growth remained positive, despite multiple shocks caused by the war in Ukraine. Economic activity rose by 0.6% quarter-on-quarter (3.3% year-on-year) after 0.8% and 0.4% in the previous quarters. While consumer spending and net exports contributed positively to growth, investment and changes to stock levels fell. Consumer spending held up quite well in the first three quarters of 2022, despite the sharp rise in consumer prices. This resilience is explained by salary growth and fiscal measures in favour of households (and companies) in the face of rising prices in the energy sector. Investment has been affected by prevailing domestic political uncertainties, with 4 elections in the last 20 months.

Economic growth will be relatively solid in 2022 with a carry-over of 3.7% at the end of the third quarter. Conversely, the outlook is significantly dimmed for 2023. External demand will be weaker due to the expected slowdown in the Eurozone, Bulgaria's main trading partner. Similarly, domestic demand, and in particular consumption,may slow down.

ECONOMIC INDICATORS ARE SOFTENING

Economic indicators are showing signs of weakening. Household confidence has been declining for several months and retail sales growth slowed to 0.5% year-on-year in October after 1.8% and 2.0% in the two previous months. The automotive sector has recorded a sharp drop in vehicle sales in recent months (-10.1% year-on-year in October, -10.8% in September).

Furthermore, the cost of mortgage loans has increased with the rise in interest rates, in a context where almost all mortgage loans are contracted on a variable rate basis. This will have an impact on household budgets. On the positive side, the labour market still remains dynamic, with an unemployment rate that has been improving for several months. It stood at 4% in October compared to 4.6% in January 2022.

Industrial activity has weakened since September. Furthermore, the country is not immune from a scenario of energy rationing , which would affect industrial activity.

However, there are some reassuring elements. Gas only represents a marginal share of the energy mix. Conversely, oil and coal make up 39%. Storage of gas was at 94% of its capacity at the end of November. Bulgaria has stopped importing gas from Russia since April 2022, but has found other sources of supply. Azerbaijan is expected to supply part of Bulgaria's annual consumption. In addition, a new gas pipeline between Bulgaria and Greece has become operational since October 2022. With regard to oil, the country has obtained an exemption from the European Union, allowing it to continue importing Russian oil until the end of 2024.

FORECASTS

	2020	2021	2022e	2023e	2024e
Real GDP growth (%)	-4.0	7.1	3.6	0.8	2.9
Inflation (HICP, year average, %)	1.2	2.8	13.5	8.3	3.9
Gen. Gov. balance / GDP (%)	-3.8	-3.9	-3.7	-4.9	-3.1
Gen. Gov. debt / GDP (%)	24.5	23.9	24.1	26.1	26.7
Current account balance / GDP (%)	0.0	-0.5	-0.7	-1.0	0.5
External debt / GDP (%)	63.8	58.4	49.9	46.3	44.3
Forex reserves (EUR bn)	31	31	33	35	37
Forex reserves, in months of imports	12.1	9.6	8.5	7.9	8.3

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

BULGARIA: INDUSTRIAL PRODUCTION AND RETAIL SALES

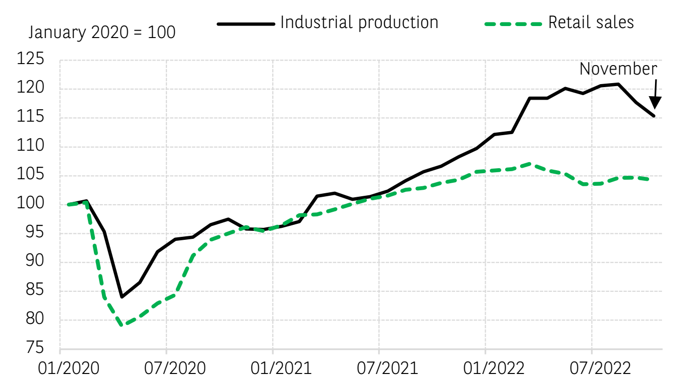

CHART 1

SOURCE: EUROSTAT, BNP PARIBAS

CONVERGENCE CRITERIA FOR ADOPTION OF THE EURO IN 2024

As the Bulgarian government is aiming to adopt the euro on 1st January 2024, 2023 will be a decisive year. Indeed, the convergence report from the European Commission and the European Central Bank, due in June, will decide whether or not the 4 economic convergence criteria have been met.

These criteria relate to price stability, the sustainability of public finances, exchange rate stability and long-term interest rates. When the previous convergence report was published in June 2022, Bulgaria fulfilled all of the conditions except price stability.

This year, the criteria relating to exchange rate stability and long-term interest rates should not pose major problems. By contrast, inflation and public accounts do raise questions. The budget deficit is expected to deteriorate further in 2023. Inflation will be an important element to monitor this year. According to the rules on convergence, the average inflation rate over one year should not exceed that of the three best-performing Member States by more than 1.5 points.

By way of comparison, Croatia joined the Eurozone on 1st January 2023 and met all of the convergence criteria last year. In the penultimate convergence report published in 2020, Croatia did not meet the exchange rate criterion.

HIGH INFLATIONARY PRESSURES

The inflation rate has accelerated since the end of 2021, reaching a peak of 15.6% year-on-year last September. Subsequently it has fallen back, to 14.8% in October and 14.3% in November. The slight drop in inflation can be explained by the lower contribution from the "energy" component in November. On the other hand, the "food" component continues to drive inflation upwards. Core inflation rose by 10.3% and contributed 6 points to headline inflation . In the coming months, the contribution from the «energy» and «food» components will probably be smaller given the relative easing of energy and food prices on the international markets. Nonetheless, core inflation is likely to remain high due to wage pressures. In 2022, salaries were higher, with an increase of 10% in the third quarter year-on-year after 7.2% and 8.6% in previous quarters.

Amid the rise in prices, the Central Bank's room for manoeuvre has been limited. The implementation of monetary policy is linked with that of the European Central Bank. Bulgaria has adopted the European exchange rate mechanism since July 2020 with a view to future membership in the Eurozone. This means that the Bulgarian lev is anchored to the euro.

As a result, the extent of monetary tightening has been much less in Bulgaria than in other countries in the region. The key rate was raised by 142 basis points cumulatively in 2022, compared to 1010 basis points in Hungary and 450 basis points in Poland.

Within the Eurozone, France, Spain and Finland are currently experiencing relatively lower rates of inflation than other Member States. These three countries would probably serve as a benchmark for assessing convergence in terms of price stability.

THE DETERIORATION IN PUBLIC ACCOUNTS REMAINS MANAGEABLE

The Covid-19 pandemic shock has tipped public accounts into the red. After several years of budget surpluses, the public deficit reached 3.8% of GDP in 2020 and 3.9% in 2021. The deficit will remain high in the short term, reflecting the government's support measures for dealing with the price shock in the energy and food sectors. They are estimated at 5.3% of GDP in 2022, according to the Bruegel Institute.

This situation does not present major concerns for the sustainability of the public debt. The public debt ratio compared to Bulgaria's GDP (at 23.9%) is in fact the lowest in the region after Estonia, and is unlikely

BULGARIA: INFLATION

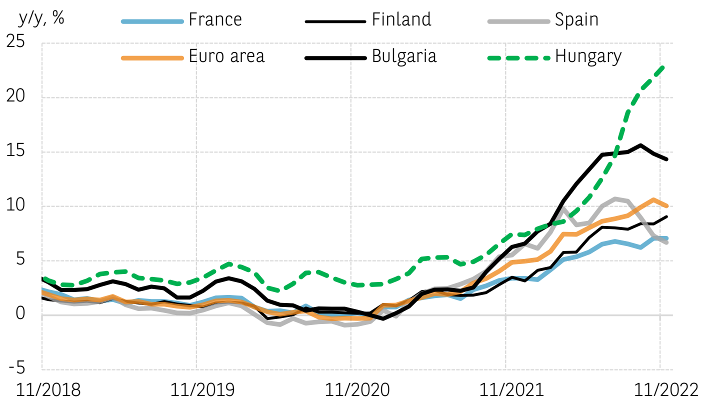

CHART 2 SOURCE: EUROSTAT, BNP PARIBAS

to exceed 30% of GDP over the next 3 years. The public accounts have been well managed in recent years, the credibility of the currency board within the framework of the European mechanism requiring a strengthening of public finances.

The government will most likely remain committed to the fiscal consolidation process in the short term. Debt servicing remains affordable despite the recent rise in government bond rates. In 2021, the interest charge on the debt remained low, representing 1.3% of government revenues. Other factors also tend to reassure. In particular, European funds under the resilience plan, amounting to 6.3bn euros, should contribute to financing the budget.

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AMONGST TOP OECD ECONOMIC PERFORMERS

Israeli economic performance was particularly strong in 2022 and remained above OECD average. Growth was very buoyant thanks to the dynamism of consumption and investment, while the fiscal year should end with a surplus. Although relatively moderate, inflation accelerated during 2022 and forced the Central Bank to tighten significantly its monetary policy. Against this backdrop, which is not favourable to consumption and investment, activity should slow this year. The continued depreciation of the shekel was an additional inflationary factor. The fall in the exchange rate against the USD reflects the general strengthening of the dollar, but also Israeli investors' management of their assets in dollars. External accounts remain solid, thanks to strong competitiveness in some key sectors. The short-term outlook for public finance is more uncertain. The recent formation of a new government is delaying the adoption of a new budget, which will limit its positive impact on economic activity.

MODERATE ECONOMIC SLOWDOWN EXPECTED FOR 2023

Economic activity remained very strong in 2022. The consequences of the international energy crisis were very limited given the country's gas self-sufficiency. More generally, Israeli leadership in some high-tech sectors mitigates vulnerability to changes in the international economy.

In the third quarter of 2022, real GDP grew by 5.8% year-on-year, confirming Israel's status of being one of the most dynamic economies in OECD countries (2.5% on average for OECD countries). Over the first three quarters of the year, growth reached 7.8%, mainly supported by household consumption and investment (in production and real estate). After a continuous reduction since 2021, the unemployment rate has risen slightly since June 2022 but remains very low (3.9% in November). Given the acceleration of inflationary pressures, the trend in real wages has been negative since October 2021. At the same time, consumer credit is not very dynamic in real terms, rising 1.5% year-on-year in June 2022. On the other hand, housing loans to households (around 75% of total lending) grew strongly (+14% year-on-year in real terms during the first quarter). Residential real estate investment has therefore experienced two-digit growth over the past 2 years (+18% over Q1-Q3 2022 compared to the same period in 2021 after +15% over the year in 2021); it accounted for around 30% of total investment in 2022. Growth in exports of goods and services also remained sustained (+13% on average over the last four quarters), but the net contribution of external trade should be negative in 2022. For 2022 as a whole, the Central Bank of Israel expects growth of 6.3%.

The outlook for the next two years is less positive. Given the expected slowdown in global activity (the IMF forecasts growth of only 0.7% in the European Union, Israel's main trading partner, and barely 1% for the United States), exports of goods and services should slow down (+2% in 2023 according to the central bank). Furthermore, the tightening of monetary conditions will contribute to the slowdown in domestic activity, in particular household consumption and real estate investment. Nevertheless, the increase in public spending announced by the new government should be a supportive factor, provided that the new budget is approved within a reasonable time frame and the government coalition remains stable. Against this backdrop, the Central Bank forecasts a drop in growth to 2.8% in 2023, before a moderate recovery to 3.5% in 2024, linked in particular to the recovery of the global economy.

... DESPITE THE EASING OF INFLATION

Inflationary pressures increased in 2022, but remained well below the average of other OECD countries. Both domestic factors (increase in property prices) and external factors (price of fuel and food and the depreciation of the shekel) are driving the price increase. This reached 5.3% year-on-year in November.

In 2023, inflationary pressures should ease against a backdrop of expected lower oil prices on international markets and rising domestic interest rates. Inflation in tradable goods prices has already started to decrease since last July's high, due in particular to the drop in hydrocarbon prices.

FORECASTS

	2020	2021	2022e	2023e	2024e
Real GDP growth (%)	-1.9	9.9	6.3	2.8	3.5
Inflation (CPI, year average, %)	-0.6	3.1	4.4	3.0	2.0
Cent. Gov. balance / GDP (%)	-11.4	-4.5	0.3	-2.5	-2.0
Cent. Gov. debt / GDP (%)	73	69	61	60	58
Current account balance / GDP (%)	5.6	4.4	3.7	3.8	4.5
External debt / GDP (%)	32	33	30	31	32
Forex reserves (USD bn)	173	213	196	225	240
Forex reserves, in months of imports	22	21	16	17	19

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

ISRAEL: CONTRIBUTION TO REAL GDP GROWTH

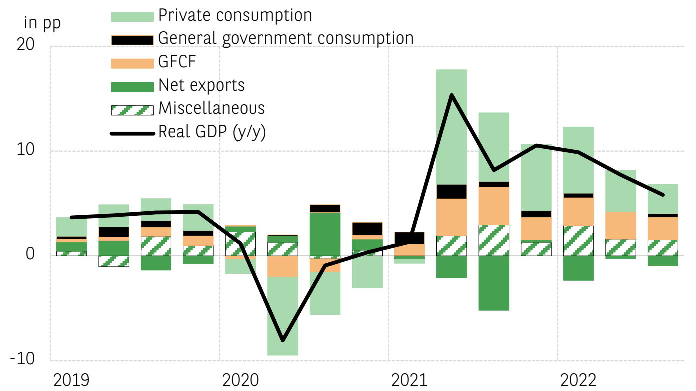

CHART 1

SOURCE: CENTRAL BUREAU OF STATISTICS, BNP PARIBAS

By contrast, inflation in non-tradable goods (essentially domestic services) continues to rise, mainly due to tensions on the property market. According to the Central Bank, residential property prices rose 20% year-on-year in November 2022. Nevertheless, even if the rise in property prices is expected to continue, the rise in interest rates could dampen its extent.

MONETARY POLICY TIGHTENING

In 2022, inflation overshot the central bank's target zone (1%-3%). Against this backdrop, the latter increased its main interest rate by 365 bp from March 2022 to reach 3.75%, which is its highest level since 2008. Further monetary tightening is possible until at least the first quarter of 2023, but should remain limited given the expected fall of inflationary pressures and the uncertainties weighing on the growth outlook. Furthermore, the Central Bank still has the means to intervene on the foreign exchange market if there is excessive depreciation of the shekel. If necessary, the Central Bank's means of intervention are significant since its foreign exchange reserves amount to around USD 200 billion, i.e. 15 months of imports of goods and services.

In 2022, the shekel depreciated 12.5% year-on-year against the USD and 5.6% against the euro, fuelling inflationary pressures. As budgetary and external performance was solid, and beyond the dollar appreciation against all major currencies in 2022, it was mainly international asset market developments that favoured the depreciation of the shekel. In fact, Israeli institutional investors' exposure to the US equity market obliges them, in the event of falling markets, to provide margin to cover their losses and to maintain target equity exposure by buying assets denominated in foreign currencies. In 2022 the 20% drop in the S&P500 index therefore mechanically translated into dollar purchases.

SOLID EXTERNAL ACCOUNTS

In a challenging international environment in 2022, Israeli external accounts remained strong. Over the first eleven months of 2022, the trade deficit widened by 6%, mainly due to the rise in the oil bill. Nevertheless, in 2022, the current account is expected to be in surplus thanks to the continued rise in exports of services (mainly in the high-tech sector), which have become one of the main sources of current revenue for several years (around 40% of total current-account revenue). The current account surplus should reach 4% of GDP in 2022.

In 2023, despite the expected decline in commodity prices, the current account surplus should fall to around 3% of GDP due to the main trading partners' slowdown. But in the medium term, the current surplus should widen. The development of new gas capacity of production and renewable sources of energy (7.7% of the energy mix in 2021 and a target of 30% in 2030) will maintain relative energy independence, and therefore limit the consequences of possible new disruption in the global energy market. Furthermore, exports of high-tech goods and services will remain a structural advantage.

Regarding capital flows, the competitiveness of the Israeli economy attracts a significant volume of foreign investment, mainly in high-tech sectors. Net foreign direct investment reached 3.5% of GDP on average between 2017 and 2021. It should remain at around 2.5% of GDP in 2022 and 2023. Portfolio investment flows were also significant over the course of 2022 (USD 11.5 billion over Q3 2022). The balance of payments fundamentals therefore remain strong and are still a factor supporting the shekel in the medium term.

ISRAEL: SHEKEL EXCHANGE RATE

CHART 2 SOURCE: CENTRAL BANK, BNP PARIBAS

BUDGET DEFICIT CONTAINED IN 2023

The government's budget is in surplus over the first eleven months of 2022 and although December is traditionally a month of significant increase in spending, the fiscal surplus should reach 0.3% of GDP over the year as a whole. These good performances can be explained by the increase in direct taxes and the drop in pandemic-linked expenditure. Government debt is expected to fall to around 61% of GDP in 2022.

Given the recent formation of the government coalition (end of December 2022), the 2023 budget has not yet been voted on and an approval is not expected before the second quarter at the earliest, which prevents the current government from engaging in new spending. Although the expected economic slowdown will result in a limited increase in budgetary revenue, the situation is favourable to a moderation in the fiscal deficit. In 2023, it should amount to around 2.5% of GDP, and the government debt ratio should continue to reduce (60% of GDP expected) thanks to nominal GDP growth.

Nevertheless, the political constraint on budgetary spending could amplify the economic slowdown by depriving growth of a needed engine.

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BRAZIL

NEW PRIORITIES

Luiz Inacio Lula da Silva started his third term as President of Brazil amidst a tense socio-political climate and more benign economic environment. Despite the many obstacles lying ahead of him, Lula bolsters ambitious social and environmental objectives. Their realisation will rely, amongst other, on an increase in public spending and a more interventionist credit policy. In the absence of a credible redefinition of the fiscal framework, market participants and the Central Bank fear that the use of these policies will come at the expense of greater macroeconomic imbalances.

A TENSE HANDOVER OF POWER

The handover of power between Jair Bolsonaro and Lula da Silva at the head of the Presidency of Brazil was – in many respects – historic : absence of Jair Bolsonaro at the inauguration (a first for an outgoing head of state), storming of Congress, the Supreme Court and the Presidential Palace by pro-Bolsonaro rioters a week only after the inauguration. In the last few months, the latter have contested the legitimacy of the presidential election and have been calling on the army to take power. Lula's first measures in office did not help to appease them (signing of decrees affecting gun ownership and mining laws in indigenous and protected areas of the rainforest; revocation of ordinances affecting abortion; creation of new supervisory bodies to fight disinformation).

PUBLIC POLICIES: GRAND MANEUVERING IN THE WORKS ?

Unlike his predecessor, Lula wants to put the state back at the centre of the growth equation with the aim of reducing poverty and accelerating the transition to a more sustainable growth model. Ten million Brazilians have fallen into poverty since the pandemic and around 33 million (15% of the population) are currently in a state of food insecurity in a country which is the world's third largest food producer and the world's leading exporter of meat. To act quickly against poverty (in particular tackle hunger) Lula intends to lean on transfers. To that end, he will rely on i/ his flagship conditional cash-transfer programme – *Bolsa familia*, ii/ increase the minimum wage (above inflation), iii/ relaunch programmes to allow better access to housing and iv/ deploy an action programme against hunger. This part of his agenda will initially be financed by debt and then by a tax reform. The latter will also be aimed at tackling a complex and regressive taxation system (strongly based on consumption rather than income). However, this reform is unlikely to get approved prior to the revision of the country's fiscal rules, which Lula wants to make more flexible in order to allow the government to spend more freely on the poor and the energy transition. Public banks will also be more heavily leaned on to provide subsidized credit. Petrobras, the country's largest energy company, could also suffer a change in its pricing policy at the pump. The company – whose refining capacity will also be expanded under Lula – could see its prices become more decorrelated from international prices to better protect the most vulnerables in the event of shocks.

However, Lula will not be able to act sustainably against poverty and inequality with anaemic growth. He therefore intends to complement his policy of transfers and subsidies with public policies destined to stimulate investment and productivity – two important determinants of potential growth. The latter has been muzzled in recent years by stagnating productivity, the slowdown in the growth rate of the working population (a consequence of the country's demographic transition) and the erosion of investment (a consequence, in part, of fiscal adjustments since 2016). Lula would like to reactivate public investment in infrastructure in collaboration with the States. He is expected to continue to rely in part on concession contracts but projects to expand the use of public-private partnerships (PPP) and encourage more Environmental, Social and Governance (ESG) considerations in projects. The development bank, BNDES, will play a key role in the government's plans. It will be mobilized, in particular, to i/ finance green infrastructure (wind farms, solar power plants) ii/ support investment by SMEs and start-ups and iii/ help reinvigorate the country's industrial policy (industrial production has shrunk by 1/5th in 10 years.) Internationally, by taking a stronger position on the environment, Lula hopes to activate i/ financial levers (bolster official contributions to the Amazon protection fund ; capture international investors' appetite for ESG

FORECASTS

	2020	2021	2022e	2023e	2024e
Real GDP growth, %	-3,3	5,0	3,0	0,5	1,2
Inflation, CPI, year average, %	3,2	8,3	9,4	4,8	4,8
Fiscal balance / GDP, %	-13,3	-4,3	-5,3	-8,7	-6,6
Gross public debt / GDP, %	88	82	78	83	85
Current account balance / GDP, %	-1,9	-2,8	-3,0	-2,3	-2,0
External debt / GDP, %	44	42	39	40	43
Forex reserves, USD bn	356	362	324	335	340
Forex reserves, in months of imports	19	15	13	14	13

e: ESTIMATE & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

BRAZIL: AVERAGE COST OF THE FEDERAL DEBT (%, OVER PAST 12 MONTHS)

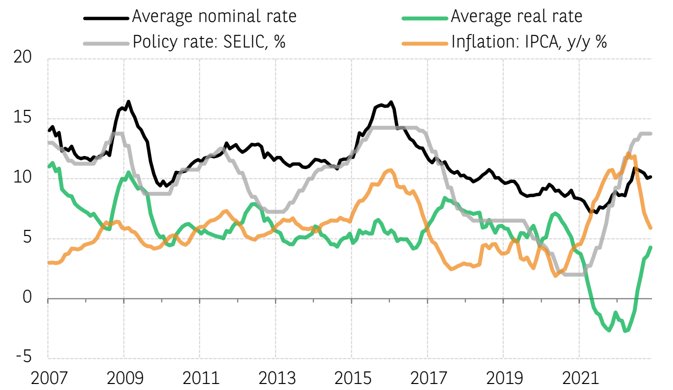

CHART 1 SOURCE: NATIONAL TREASURY, BNP PARIBAS

investments in a country where ¾ of the energy mix comes from renewable energies) as well as ii/ commercial levers (resumption of the free trade agreement between the EU and Mercosur – suspended since 2019 due to the country's low commitment to environmental protection). Greater trade openness would enable technology transfers that would ultimately lead to significant productivity gains for the country.

WILL LULA HAVE THE MEANS TO ACHIEVE HIS AMBITIONS?

Lula has an ambitious programme. But the fragility of the political and macroeconomic situation calls into question his ability to carry out his project. Firstly, the conditions under which he will exercise power won't be favourable to him : i/ high rejection rate in society, ii/ reinforced opposition in Congress and at the state level, iii/ more diluted power of his party, the PT, within the governing coalition and iv/ stronger opposition from conservative segments of civil society which are better organised and highly active. As such, it will be difficult to backtrack on the pension reform (2019), the labour market reform (2016) and the privatisation of Electrobras (2022), which members of his party contest. Recent experience in Latin America (Chile, Colombia, Argentina, etc.) also shows that it is increasingly difficult to govern in the region. Political cycles and "honeymoon" periods are becoming shorter with a very low rate of government renewal and a rapid erosion in popularity for newly elected presidents (except Mexico and El Salvador). This situation tends to constrain the influence that Presidents have on the legislature, potentially hindering the progress of reforms.

Secondly, his fiscal leeway will be very limited. Lula is starting his term in office in the midst a benign economic environment. Growth has been slowing down for several months and this trend is expected to continue this year. This environment will weigh on public revenues, further accentuating an already elevated interest burden (22% of revenues, 5.6% of GDP) and whose weight in real terms has increased sharply since the summer of 2022 (on the back of significant disinflation). The government is also facing considerable refinancing needs due to significant short-term debt (23% of the debt matures over the next 12 months). Furthermore, while the price of certain commodities should remain favourable in the short term, public finances will not be able to count on a prolonged boom in the price of commodities (as in 2003-2010) to finance social programmes – all the more so as a larger part of the oil windfall will be gradually passed on to the States. The Federal State, whose spending structure is very rigid, is also more indebted than during Lula's previous mandate (+25 points of GDP in 10 years). Nor will it be able to count on exceptional revenues from privatisations, since Lula is opposed to the sale of public assets. In addition to the constraint arising from the country's fiscal rules[1] , the economy's weak growth potential (estimated at some 1.5-2%) could also limit public action. An economy fuelled by public spending that operates persistently above its growth potential (positive output gap) would very quickly generate imbalances and feed inflation –a situation most prejudicial to the poorest segments of society.

ONE FOOT ON THE GAS AND THE OTHER ON THE BRAKE?

Despite the many obstacles that lie ahead to govern effectively, Lula is still expected to gain ground on many issues (a scenario which worries market participants, in particular locally). The allocation of 8 of his 37 ministerial portfolios to centre and centre-right parties (+6 to centre-left parties) has already enabled him to execute a large amendment to the budget (some BRL 145 bn, or 1.7% of GDP) to finance social spending in 2023. Lula also extended for two months the reduction in oil taxes, a measure at the origin of the rapid disinflation over H2-2022 (the IPCA reached 5.78% in December compared to 11.9% in June). Market participants are worried that prolonged fiscal easing and the roll-out of subsidized loans by public banks will keep inflation and interest rates at high levels (the SELIC has been at 13.75% since August). The minutes from the Central Bank in December also point to these concerns. The risk is that the economy finds itself caught between an expansionary fiscal policy and a restrictive monetary policy, fuelling a vicious cycle between inflation and interest rates at the expense of growth and debt dynamics. Despite these concerns, Brazil remains attractive from the perspective of international investors, especially when compared to other major emerging markets (e.g. Türkiye, China, Russia, Argentina and South Africa). In addition to its positive real yields, and the absence of foreign exchange controls, its now more positive stance on the environment, multilateralism, and the defence of democratic institutions have become new factors of appeal. Its low current account deficit, large foreign exchange reserves, the independence of its Central Bank and the absence of systemic fragilities across the banking and real estate sectors are also important assets.

BRAZIL: RATE OF CHANGE OF CAPITAL STOCK ACCUMULATION

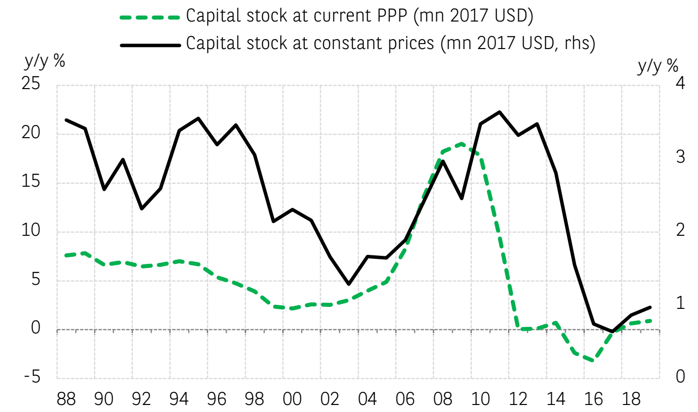

CHART 2 SOURCE: PENN WORLD TABLES, BNP PARIBAS

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1 The country has put in place a "spending cap" (2016) to prevent primary spending from growing faster than inflation. The "Golden Rule" (1988) prohibits the state from contracting debt to cover current expenses. The "Fiscal Responsibility Act" (1999), which applies at all levels of government, prohibits new expenditures from becoming permanent if financed by revenues, which are temporary in nature. The "Electoral Budget Law" prohibits new expenditures or tax exemptions in an electoral year. While these rules have been largely circumvented in recent years due to the pandemic and the war in the Ukraine, they will (even if amended) represent an additional constraint on public action. A prolonged disregard for the fiscal framework would meanwhile generate significant market reaction.

CHILE

REFORMS AGAINST A BACKDROP OF RECESSION

Chile is unlikely to escape a recession in 2023. The slowdown in global demand will weigh on exports, while domestic demand continues to be eroded by high inflation and interest rates due to restrictive monetary policy. The investment outlook remains closely linked to the political climate in the country, and in particular to the implementation of the two principal reforms announced by the government: the new constitutional process (which is expected to continue throughout 2023), and the implementation of pensions reform.

RECESSION IN 2023

After weak growth in 2022, the economy is likely to contract in 2023 (GDP already fell by 1.2% q/q in Q3 2022). Inflation has slowed but remains high, at 12.8% year-on-year in December 2022. As a result, monetary policy will continue to be restrictive. The Central Bank (CB) has steadily raised its interest rate over the course of 2022 to 11.25% (a cumulative rise of 725 basis points since January) and inflation expectations remain well above the inflation target (3%), over both 12 months and 24 months. Although the CB announced the end of its rate increase cycle in October, further hikes in the key rate cannot be ruled out.

A sharp slowdown in consumer spending is therefore expected. Despite the support measures announced recently by the government (to help the most vulnerable households compensate for the effects of inflation), household purchasing power is likely to continue to be eroded in the coming quarters. Investment is also expected to slow, despite the number of government support measures (facilitating access to financing for Chilean investors, tax incentives for foreign investors, increase in the number of public-private partnership projects). Any recovery in investment will be limited by the tightening of monetary policy and will be conditional on changes in the political climate and the progress of the various structural reform measures announced by the government. The slowdown in global growth will weigh on the export sector, which in particular is being impacted by the fall in global demand.

The next two years will be characterised mainly by the reforms launched since Gabriel Boric took up his post a little under a year ago: the project for a new constitution and the reform of the pension system (which are a direct response to the violent demonstrations in the autumn of 2019, and more broadly to the deterioration in the political and social climate seen in the country over several decades). Implementing these reforms is proving to be particularly difficult, with the government having to deal with a reduced majority in the Congress and very high popular expectations. Furthermore, the economic and health crisis has further weakened the healthcare and social protection systems, which have been in great difficulty despite massive budgetary support over the last two years.

FORECASTS

	2020	2021	2022e	2023e	2024e
Real GDP growth (%)	-6.1	11.9	2.4	-2.0	1.5
Inflation (CPI, year average, %)	3.0	4.5	12.8	6.5	3.5
Central Gov. balance / GDP (%)	-7.3	-7.7	0.5	-3.1	-2.9
Public debt / GDP (%)	32.5	36.3	37.9	38.8	38.6
Current account balance / GDP (%)	-1.7	-6.4	-6.2	-4.5	-3.8
External debt / GDP (%)	82.6	75.4	76.8	76.3	72.2
Forex reserves (USD bn)	39.2	51.3	39.4	38.5	42.9
Forex reserves, in months of imports	5.5	5.3	4.8	5.3	4.9

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

CHILE: MONTHLY ACTIVITY INDEX

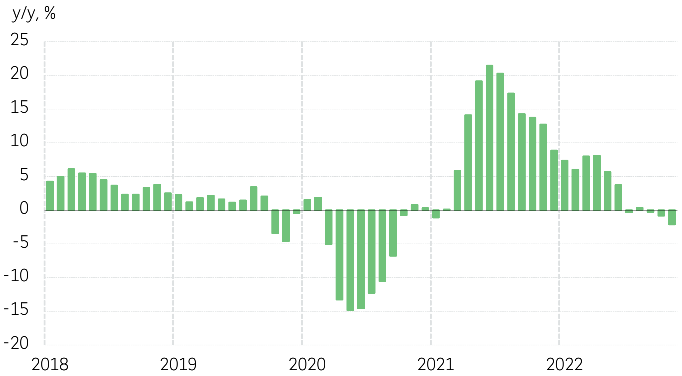

CHART 1

SOURCE: CENTRAL BANK

CONSTITUTIONAL REFORM: ANOTHER ATTEMPT

The first draft of constitutional reform was widely rejected, by 60% of voters, in the referendum held on 4 September. Since then, the process of developing a new constitution has continued. A very large majority of the population continues to favour a new constitution, and as a minimum expects amendments to the current constitution. The original draft did not propose any significant reforms of the Chilean economic model such as questioning the independence of the Central Bank or property or labour rights. However, as well as guaranteeing better access for the population to a range of social rights (housing, education, access to healthcare), the draft highlighted numerous commitments relating to the environment, women's rights and indigenous peoples (including a justice system which would have been specific to them). These latter proposals were overwhelmingly rejected by the population and the opposition parties.

After several months of debate, and a ministerial reshuffle, the President presented the new constitutional process at the start of December. As with the first draft, a constitutional Council will be elected in May. However this one will only have 50 members, compared with 155 for the previous one.

The method of voting has also been changed, potentially leaving less room for the smaller parties and the indigenous parties (there will be no quotas this time). In addition, the new council will be supported by two other bodies: a committee of 24 experts will be appointed by the Congress[1] and an "eligibility committee" of 14 lawyers (all appointed by the Senate), responsible for validating the technical points of the project.

Following a pre-draft presented at the end of January, which will serve as a basis for work, the draft must be drawn up by the end of October 2023, before being submitted for popular approval by a new vote scheduled for mid-December. It is almost certain that the new proposal will be more moderate than the first one, particularly on societal issues. However, it is highly likely that the proposals regarding social rights, and more generally a greater State presence in the economy, will be retained. Public spending is expected to increase significantly in the coming years in order to meet the demand for improved public services.

PENSION REFORM: STRENGTHENING THE SOLIDARITY ELEMENT

Reform of the pension system is part of a framework similar to that of constitutional reform. The desire to reform the Chilean pension system has been at the heart of public debates for more than 15 years. The main demands, and the essential points for reform, are an improvement in the replacement rate (i.e. the percentage of in-work earnings received by an employee when they draw their pension) and the coverage (many Chileans are excluded either completely or partially from the current system), as well as the

lack of transparent management of private pension funds. Apart from the addition of a solidarity element added in 2008 (allowing the most disadvantaged workers to access a minimum pension), and some marginal modifications, the pension system had actually remained unchanged since the ultra-liberal reform in the early 80s. The pay-as-you-go pension system had then been replaced by a compulsory pension fund system with individual defined contributions, managed by the pension fund administration companies (Administradoras de Fondos de Pensiones (Chilean Pension Fund Administrators), AFPs[2]).

The reform presented by the government at the end of November 2022 proposes several structural changes. Firstly, contributions will no longer be solely employee-based, since their contribution remains essentially unchanged (rising from 10% to 10.5% of salary) and an employer contribution of 6% of salary is introduced (allowing a stronger solidarity element to be financed, in addition to the improvement in the individual replacement rate).

CHILE: INFLATION AND KEY POLICY RATE

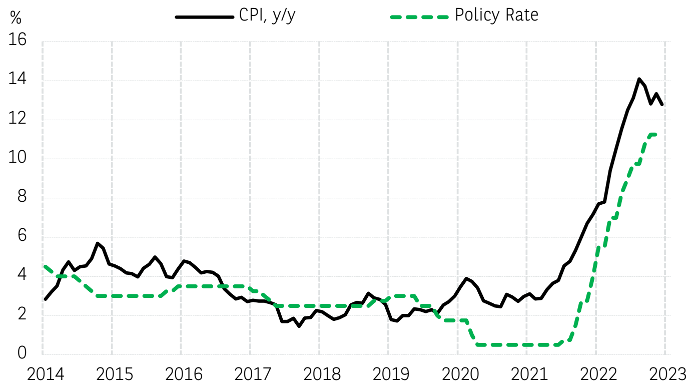

CHART 2 SOURCE: CENTRAL BANK

Secondly, going forward the role of the AFPs will be limited to fund management, with administrative management (collection, etc.) being left to a new public authority. Finally, the market for AFPs should be opened up to competition.

For the moment it is difficult to assess the fiscal consequences of these two major reforms. That said, while the public finances have deteriorated over the past two years (public debt represented almost 38% of GDP at the end of 2022, after 28% at the end of 2019), slippage in the fiscal deficit is relatively unlikely. President Boric seems determined to deliver his dual commitment of increasing public spending in order to improve social justice, while remaining "fiscally responsible". For the time being it appears that the government remains committed to its main objective (maintaining debt at a level below 45% of GDP by the end of the mandate).

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1 As a reminder, there was no-one with a majority in the Senate, and the left-wing coalition only has an advantage of two seats (out of 155) in the Senate. The two additional councils should therefore make it possible to further limit proposals deemed too radical in the first draft constitution.
2 Under this system, the pension received by each retired person only represented, in annuities calculated on the basis of an average life expectancy, their personal savings alone, the result of compulsory contributions paid solely by the employee.

MOROCCO

A NEW STRESS TEST IN 2023

The Moroccan economy will continue to experience significant external and budgetary imbalances despite the drop in global commodity prices. However, the country's macroeconomic stability is not under threat. Forex reserves are comfortable and the structure of public debt is favourable. Moreover, the economy should benefit from a rebound in agricultural production after a historic fall in 2022. However, the authorities still have a complex task to accomplish in an international climate that remains very unstable. Indeed, they must maintain a prudent economic policy, but they also might need to shore up economic activity once again. A pronounced growth slowdown in GDP excluding agriculture is expected.

After a strong upturn in growth in 2021, Morocco was affected by a combination of shocks in 2022 that reinforced each other, namely: 1/ a historic fall in cereal production caused by severe drought; 2/ a sharp rise in the prices of commodities of which the country is a major importer (wheat, oil). The overall picture is mixed, but several factors have enabled Morocco's economy to hold up well: its strong fundamentals, a strong rebound in tourism activity, and the healthy performance of exports and financial transfers from its diaspora. The year 2023 is set to be just as perilous. There are numerous sources of risk, including the continued volatility of global commodity prices and the threat of a recession in Europe, which is by far Morocco's largest partner (Europe accounts for 62% of foreign direct investment and more than 70% of exports, financial transfers from Moroccans living abroad and tourism revenue). The country's macroeconomic stability is not under threat, but the authorities' room for manoeuvre is diminishing.

EXTERNAL ACCOUNTS: STRONG BUT MANAGEABLE PRESSURES

With imports up by more than 40% year-on-year over the first 11 months of 2022, there is strong pressure on external accounts which looks unlikely to ease in the short term. IEnergy products (up 111%) and food products (up 49%) account for half of the sharp rise in imports. Despite a recent lull, global prices of the main commodities imported by Morocco will undoubtedly remain high. In terms of exports, the momentum generated by the boom in sales of phosphates and derivatives (up 55%) should also fade away. A contraction is even expected for 2023 as phosphate prices normalized after the peak reached in mid-2022.

Nevertheless, risks to external stability appear limited. Despite a record trade deficit in 2022, the current account deficit remains contained. It is estimated at 4.4% of GDP, which is 2 points higher than in 2021 but 3-5 points lower than the prevailing level in 2010 and the years that followed, when Brent prices also exceeded USD 100 (Figure 1). Several factors should continue to support Morocco's external position, starting with the sustained development of the automotive sector, whose exports grew by 35% year-on-year over the first 11 months of 2022 in an already challenging environment. Since this industry took off in 2013-2014, exports have never been higher. These levels can be explained by market share gains Morocco is making, especially in Europe. Given the expansion projects underway, a sudden reversal of this dynamic linked to a demand shock seems unlikely, but a slowdown in automotive exports is nevertheless to be anticipated in 2023.

Remittances from the Moroccan diaspora are in the process of crossing the symbolic threshold of 100 billion dirham (MAD), and revenues from tourism are now 12% higher than in 2019 after more than doubling in 2022. Although a drop cannot be ruled out depending on the scale of the crisis in Europe, these two major sources of currency should remain at high levels.

FORECASTS

	2020	2021	2022e	2023e	2024e
Real GDP growth, %	-7.2	7.9	1.2	3.0	3,0
Inflation, CPI, year average, %	0.6	1.4	6.3	3.9	2,0
Central Gov. balance / GDP, %	-7.1	-5.9	-5.3	-5.1	-4,5
Central Gov. debt / GDP, %	72.2	68.9	69.9	70.0	70,6
Current account balance / GDP, %	-1.4	-2.3	-4.4	-3.9	-3,4
External debt / GDP, %	53.9	45.5	48.0	47.6	44,2
Forex reserves, USD bn	34.7	34.3	30.7	31.2	32,4
Forex reserves, in months of imports	9.0	6.9	5.1	5.7	5,9

TABLE 1 e: ESTIMATE & FORECASTS SOURCE: BNP PARIBAS ECONOMIC RESEARCH

MOROCCO: EXTERNAL ACCOUNTS

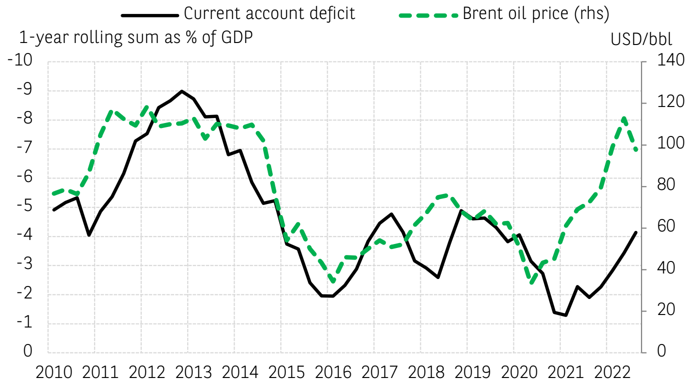

CHART 1 SOURCE: OFFICE DES CHANGES, BAM, HCP, BNP PARIBAS

At 3.9% of GDP in 2023, the current account deficit would remain high, but should be covered without difficulty. The Moroccan economy continues to attract significant capital flows, mainly in the form of foreign direct investment (approximately 2% of GDP), of which more than a third is now directed towards the development of industry. External debt is also moderate, standing at less than 50% of GDP, of which almost two thirds have been contracted by the government and a handful of large public companies on long maturities. Furthermore, the country benefits from good relations with donors. In particular, negotiations are apparently underway with the IMF with a view to obtaining a new flexible credit line by March. This type of financing has the dual advantage of being flexible and granted without conditions.

Finally, forex reserves are comfortable. They still cover five months of imports of goods and services and more than twice the amount of short-term external debt. Forex exchange reserves fell by more than USD 4 billion in 2022, mainly due to the appreciation of the US dollar against the euro, and therefore also the MAD. This adverse exchange rate effect should be less marked in 2023. Furthermore, the MAD remains within the fluctuation bands and aligned with the fundamentals of the economy. Central bank intervention in the foreign exchange market similar to that of 2020 therefore does not seem a current possibility, although the authorities have stated that they would not hesitate to take this step.

FISCAL TRAJECTORY WILL BE MORE DIFFICULT TO MAINTAIN

Although the impact of the crisis on public finances is significant, it has been fairly well managed so far. Even though energy and food subsidies have slipped back by almost 2 GDP points, the government should be able to meet its target of reducing the budget deficit to 5.3% of GDP in 2022 without altering its public investment programme (capital expenditure increased by 24% during the first 11 months of the year). Yet central government debt, which was estimated at 70% of GDP at the end of 2022, remains 10 points above its level at the end of 2019. Its structure is favourable (75% of the debt is held by local investors in local currency). Despite rising domestic yields and a shortening of the maturity of Treasury bill issues in 2022, financing conditions remain favourable overall, allowing interest payments to be kept to below 10% of budgetary resources. Furthermore, the authorities decided not to call on international financial markets in 2022 to cover the payment in Eurobond of USD 1.5 billion. It is possible that there will be a return to the international bond markets this year.

Nevertheless, the high level of debt calls for continued fiscal consolidation efforts. However, some doubts can be raised about the authorities' ability to achieve this. The 2023 Finance Act factors in a budget deficit of 4.5% of GDP (4.9% excluding revenue from privatisations), to be gradually reduced to 3.5% by 2025. But the authorities' strategy relies on controlling increases in public spending, as well as on sustained public investment at around 6% of GDP, which will be difficult to achieve in the short term. In particular, the government is counting on a fall in subsidy costs of 1.2% of GDP in 2023, but these will depend above all on movements in global prices for gas and grain products. Furthermore, the country's healthy public finances in 2022 can largely be explained by the very strong performance of budgetary resources (up 18%), but this will be difficult to reproduce in 2023 given the current economic slowdown and the expected contraction of transfers from OCP (the state phosphates company) to the government after an exceptional year (0.5% of GDP in 2022). Moreover, the very optimistic growth assumption used in the 2023 budget (4%) suggests a slight slippage from the target announced. Unlike in 2022, it may be that spending reallocations cannot be avoided. And this would further weaken already poor growth dynamics.

GDP GROWTH: A TWO-SPEED RECOVERY

Growth stalled in 2022, falling to 1.3% year-on-year over the first nine months of the year. This was essentially the result of a contraction of more than 15% in primary sector added value. A return to normal cereal production is expected to support an upturn in growth to 3% in 2023. However, unfavourable weather conditions returned at the beginning of this year, and are undermining this outlook. Aside from agriculture, the economy is also facing strong headwinds.

MOROCCO: CONTRIBUTION TO INFLATION AND KEY POLICY RATE

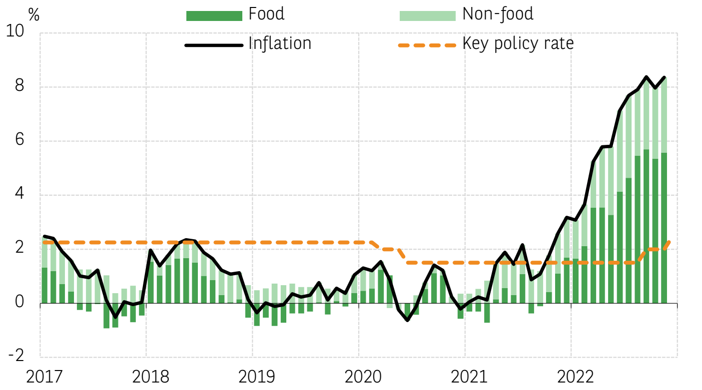

CHART 2

SOURCE: BAM, HCP, BNP PARIBAS

After a recovery to 4.3% year-on-year in Q2, GDP growth excluding agriculture once again slowed to 3.6% in Q3 despite a very good performance by the tourism sector. Several factors point to a continuing deterioration of economic conditions, starting with the record low level of household confidence caused by difficult labour market conditions (unemployment is still above its pre-pandemic level, at 11.4% in Q3 2022) and the strong inflationary pressures. Inflation has begun to show signs of stabilising but it remains above 8%, chiefly driven by a rise in food prices of more than 14% (Figure 2). In addition, sources of inflation are becoming more internal. Excluding food, inflation has now reached 4.5%, compared to 2.3% at the beginning of 2022. Further monetary tightening is therefore expected. Despite two interest rate rises in September and December by 50 basis points, the central bank's key policy rate remains low, at 2.5%. The cautious attitude of Morocco's monetary authorities reflects a growth-inflation dilemma which could become more acute this year in the event of another rise in the prices of imported commodities. In any event, the monetary environment will be more restrictive in 2023. Given the external context, which is also less buoyant, growth in real GDP excluding agriculture is now only expected to reach 2.5% – the worst performance since 2009 excluding the Covid-19 crisis.

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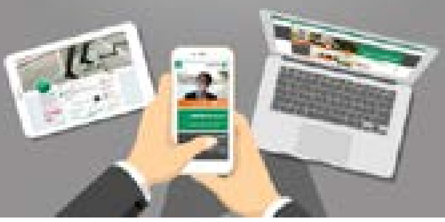

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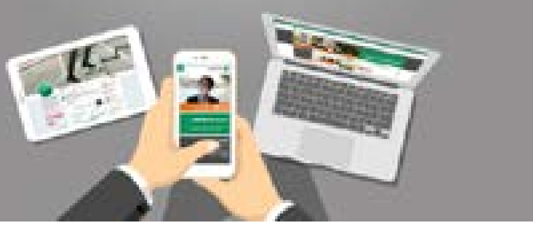

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