ECO EMERGING

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EDITORIAL

ECONOMIC RESEARCH

BNP PARIBAS

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TURKISH TROUBLES

For emerging economies, the balance prospects/risks has been deteriorating since end-2021. For 2022, a bigger than expected growth slowdown is very likely, sometimes with social instability as already seen in Kazakhstan. Over the last three months, Turkey has experienced a mini financial crisis again. Monetary and exchange rate policy is betting on exports and investment to support growth and rebuild the major economic balances over the medium term, albeit at the price of short-term financial instability. This is a daring gamble that could force the authorities to introduce genuine foreign exchange controls instead of the incentive measures they have implemented so far.

Threats to growth in emerging economies increased at the end of 2021 with the economic slowdown and the real estate sector crisis in China, the widespread acceleration in inflation over commodity price effects and the extension of monetary policy tightening, non-resident investment outflows from domestic bond markets (China excepted), geopolitical tensions, and the emergence of new waves of Covid-19 infection with the Omicron variant. In 2022, therefore, economic growth will very likely slow more than expected. There are also risks of social unrest such as was seen recently in Kazakhstan.

Over the last three months, Turkey has been on the spotlight. Since mid-November, the lira has depreciated by 28% against the euro-dollar basket, yields on domestic government bonds have increased from 18.5% to 24% and the 5-year CDS premium has widened from 440 to 560 basis points.

TURKEY: SURPRISES AND TREMORS

Turkey has caused surprise and concern in equal measure. Surprise because economic growth proved to be very resilient in 2021, including during the financial shock at the end of the year, with the Markit PMI and MUSIAD indexes remaining above 50 through to December. The current account deficit is unlikely to have been more than 2% of GDP in 2021, despite the increase in oil prices, and the budget deficit was probably only 2.5%, despite above-inflation increases in primary spending over the second part of the year.

Turkey has raised concerns because inflation appears to be spiralling out of control. Between October and December it jumped from 21.3% to 36.1%, a bigger increase than would have been expected from the usual statistical relation between the exchange rate and prices. Although the central bank (the TCMB) has limited its interventions, forex reserves have fallen by USD 17 billion since mid-November and deposit dollarization accelerated through to the end of the year.

The series of emergency measures adopted by the authorities to stop the renewed decline in forex reserves have also raised questions on how severe was the situation. The measures have been notably aimed at i) protecting savings of households and companies whilst encouraging them to increase their lira-denominated assets; ii) attracting foreign investment[1]. Other measures can even be considered as 'soft' foreign exchange controls (requirement for companies to repatriate and convert 25% of their revenue in USD, euro or sterling, increased monitoring by the TCMB of sizeable purchases of foreign currency by companies), although President Erdogan has ruled out strict capital controls.

Since the last week of December, pressures on the exchange rate, interest rates and the TCMB's forex reserves have eased somehow. By mid-January, forex reserves were estimated at USD 109 billion, including around USD 70 billion in foreign currency. TCMB's weekly monitoring suggests that the dollarization trend has even been reversed (after correction for exchange rate effects, foreign currency deposits of individuals and companies fell by nearly USD 5 billion). Also in mid-January, the Ministry of Finance indicated that some USD 9.7 billion were covered by the indexation mechanism. Meanwhile, non-resident positions in the offshore swap market were estimated at just USD 2 billion on 9 January, from USD7 billion in mid-November and USD 21 billion at the start of 2021.

However, this very recent de-dollarization is far from assured, as the indexation mechanism has mainly attracted TRL deposits and more marginally those in dollars. Most importantly, official forex reserves look low in net terms (i.e. after deducting foreign currency placed by banks in reserve with the TCMB), at just USD 15 billion[2]. On 9 January, the value of equities & government securities in TRL held by non-residents was still USD 22 billion, from USD 28 billion in mid-November.

TURKEY: FOREIGN EXCHANGE RATE & DOMESTIC BOND YIELDS

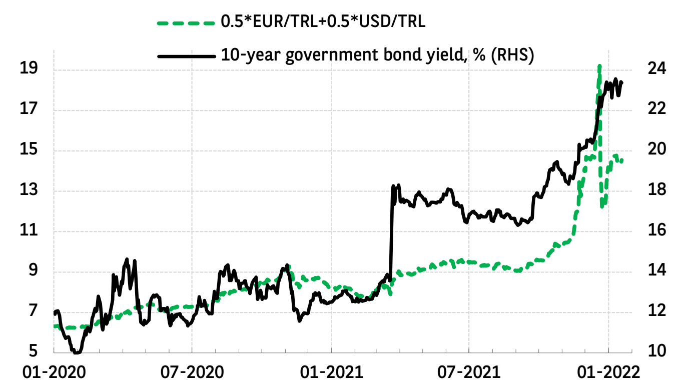

CHART 1 SOURCE: MACROBOND, BNP PARIBAS

1 Introduction of a indexation mechanism of deposits and investment funds of individuals and companies indexing deposits and investment funds to the USD/TRL rate, introduction of a forward exchange rate instrument for exporters and importers (with compensation for any TRL losses by the TCMMB), temporary removal of the withholding tax on TRL-denominated government bond income, making Turkish nationality available to non-residents who undertake to invest in real estate or a TRL-denominated financial investment and to retain this investment for at least 3 years

2 Indeed they were significantly negative if no account is taken of currency swaps between banks and the central bank, which are a liability for the latter. However, unless the banks have an urgent need for dollar liquidity, this foreign currency can be used by the central bank.

THE RISKS OF THE NEW ECONOMIC POLICY

This financial instability is a by-product of the authorities' strategy, which is to support growth through exports, thanks to a weak currency, and stimulate investment through a deliberate relaxation of monetary policy to support domestic lending (the TCMB's main policy rate has been cut from 19% in September to 14%, leading to significantly negative real interest rates). By boosting competitiveness, authorities expect to foster the current account balance and to stabilize the exchange rate, indirectly reducing inflation. In the meantime, liquidity support from Gulf States would be a possible option to foster forex reserves.

However, this strategy carries a number of risks. As inflation accelerates, household confidence has historically fallen, despite measures adopted to offset the loss of purchasing power (such as the exceptional 50% increase in the minimum wage on 1 January, which will be likely followed by a further increase in the second half).

True, the impact of currency depreciation on the current account is significant: between 0.5 and 1 point of GDP of improvement in the underlying current account balance (i.e. excluding energy and gold) for a depreciation of the real exchange rate of 10%. But any gains would be largely offset by the increased price for net energy imports (5% of GDP in 2021) and net imports of gold, which act as a hedge against inflation. Above all, maintaining gains in currency competitiveness in real terms will require recurrent TRL depreciations.

BALANCE SHEET IMPACT OF THE DEPRECIATION

Currency depreciation also affects the balance sheets of banks and corporates

The direct exchange rate risk for banks is limited, as they have to balance their on-balance sheet debtor position with an off-balance sheet creditor position, mainly through currency swaps. Moreover, the counterparties to these swaps have changed; since the end of 2019, non-residents have withdrawn (from the offshore market) and the central bank has filled the gap. As a result, banks' off-balance sheet positions are deemed to be more stable. Moreover, foreign currency bank deposits from residents and non-residents (USD 261 billion at the beginning of January) are 37% covered by foreign currencies in blocked accounts and the value of currency swaps with the TCMB (USD 96 billion in total).

However, the foreign-currency exposure of corporates is substantially negative (of about USD 166 billion in October 2021). The debt ratios of exporting companies (i.e. external debt including import financing loans to revenue from exports of goods and services) has trended upwards over the past decade and now stands at 93%. This is a matter of concern even if there are some risk mitigating factors (at least in the ST); corporates' short-term foreign currency position is positive (USD 63 billion) thanks in particular to the high level of deposit dollarization (66%). The rollover rate of medium and long-term loans was still above 100% up to November. Lastly, domestic debt denominated in foreign currency has been stable at around 20% of GDP since 2015.

The government's exposure to currency risk is also very high, with foreign-currency debt accounting for two-thirds of its total debt. Fortunately, total government debt remains modest at 40% of GDP.

TURKEY: CENTRAL BANK INTERNATIONAL RESERVES (USD BN)

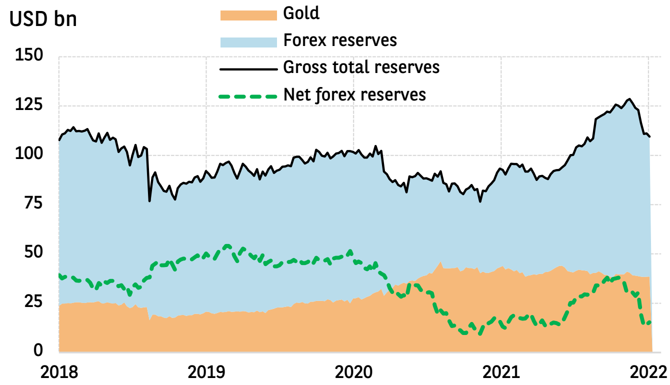

CHART 2

SOURCE: TCMB, BNP PARIBAS

In summary, the Turkish authorities' strategy is based largely on winning export market shares as the main engine of growth (as a matter of fact, exports of goods increased by 30% in dollar terms in 2021, around twice the average growth for the main countries of Central Europe).

But this strategy will also need corporates to invest and households to maintain consumption levels. Strongly negative real interest rates and indexation measures are expected to help them. But President Erdogan is also appealing to the population's sense of economic patriotism. In economic terms, this strategy is an uncertain bet on an adjustment through flows (mainly exports), whilst the analysis of stocks (forex reserves, foreign-currency debt of corporates and the government, bank deposit dollarization) highlights potential risks. The fear is that this adjustment may lead to a temporary recession or genuine foreign exchange controls and thus be more a constraint than a choice.

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CHINA

SHAKEN BY THE REAL ESTATE CRISIS AND THE OMICRON VARIANT

Economic indicators for the fourth quarter of 2021 confirm that China's economic growth has been heavily constrained by the crisis in the real estate and construction sectors, the authorities' zero-Covid strategy and the persisting weakness of household consumption. Export activity remains buoyant. However, it could start flagging in the very short term due to weaker momentum in global demand and the Omicron wave's repercussions on factory production and the transportation of goods. The Chinese authorities are gradually easing their monetary and fiscal policies to support economic activity. At the same time, they are expected to continue cleaning up the property market, reducing financial risk and tightening regulation.

THE EXPORT SECTOR: A SOLID GROWTH DRIVER

China's economic growth slowed considerably in the second half of 2021. After a very sharp rebound following the Covid-19 shock, economic growth fell from 7.9% year-on-year in Q2 2021 to 4.9% in Q3 and 4% in Q4. China's National Bureau of Statistics (NBS) estimates that in seasonally adjusted terms, real GDP growth was 1.3% quarter-on-quarter in Q2, 0.7% in Q3 and 1.6% in Q4. The acceleration in the fourth quarter appears to have been mainly driven by the improvement in the manufacturing sector after the difficulties of the summer.

In fact, since mid-2021, manufacturing activity has suffered from supply-side constraints arising from supply-chain disruptions (including shortages of microchips affecting the automotive sector and congestion in ports) and most importantly from power cuts hitting factories in September and early October. The authorities responded rapidly, asking coal mines to increase production and authorising power companies to raise their selling prices to consumers to as much as 20% above the regulated tariff. Industrial growth then recovered gradually after slowing in Q3, accelerating from 3.1% y/y in September to 4.3% in December (chart 1).

In 2021 as a whole, the manufacturing sector posted growth of 9.8%. It has been driven to a large extent by exports, which have remained very solid. According to General Administration of Customs data, exports were up 22.9% y/y in USD terms in Q4 and up 29.7% in the year as a whole (vs. 4% in 2020). Meanwhile, total import growth reached 30% in 2021 (after falling 0.4% in 2020), driven by higher commodity prices. China's trade surplus hit a record USD 689 billion, 30% more than in 2020.

In the immediate future, exports are likely to suffer as the latest wave of Covid-19 affects the production and transportation of goods, and as global demand growth may become less buoyant. In fact, growth in the manufacturing sector could slow again in Q1 2022 due to disruption affecting factories in a large number of regions as a result of lockdown measures introduced to slow the new epidemic wave.

In 2022, assuming that production of goods continues to normalize in the rest of the world and supply-chain pressures ease, China is likely to see its market share fall slightly after the large gains seen in the last two years. China accounted for 15% of total world goods exports in 2020 and the first nine months of 2021, vs. 13.3% in 2019.

THE PROPERTY CRISIS CONTINUES AND SPREADS THROUGHOUT THE ECONOMY

The services sector posted growth of 8.2% in 2021, but again the headline figure masks a sharp slowdown in the second half of the year: activity growth in the services sector decelerated from 10.9% y/y in June 2021 to 3% in December (chart 1). Firstly, activity has been held back by the regulatory tightening implemented in many sectors that Beijing regards as sensitive, such as digital service platforms, video games and tutoring.

Moreover, services in many regions have been affected by the successive waves of Covid-19 and travel restrictions. In the last few weeks, the spread of the Omicron variant has resulted in drastic restrictions as the authorities have maintained their zero-tolerance approach to the pandemic.

FORECASTS

	2019	2020	2021e	2022e	2023e
Real GDP growth (%)	6.0	2.2	8.1	5.0	5.5
Inflation (CPI, year average, %)	2.9	2.5	0.9	2.1	2.5
Official budget balance / GDP (%)	-2.8	-3.7	-3.2	-3.0	-3.0
Central government debt / GDP (%)	17.0	20.6	21.0	22.6	23.9
Current account balance / GDP (%)	0.7	1.9	1.9	1.8	1.8
Total external debt / GDP (%)	14.5	16.3	15.7	15.5	15.5
Forex reserves (USD bn)	3 108	3 217	3 250	3 310	3 360
Forex reserves, in months of imports	14.9	16.3	13.1	12.3	11.7

e: ESTIMATE & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

SLOWDOWN

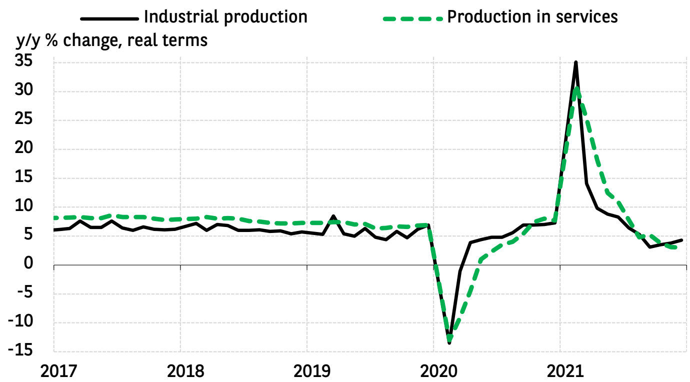

CHART 1 SOURCE: NBS, BNP PARIBAS

Lastly, the real estate crisis continued and spread to the rest of the economy in the second half of 2021. Developers have been subject to tighter macro-prudential rules and credit conditions since mid-2020, and this has caused a sharp correction in the real estate and construction sectors. Developers have experienced increasing cash-flow and funding problems. Real estate investment fell by 3%-5% y/y in September-November and by 14% y/y in December. Construction projects, new building starts and housing sales have collapsed since July (in December, they were down by 35% y/y, 31% and 16% respectively). The average house price has started to fall, and the decline is expected to continue in the near future (chart 2).

Private consumption has remained depressed. In real terms, retail sales rose by less than 2% y/y in August-October and by 0.5% in November. They were probably flat year-on-year in December. Inflation is not putting a great deal of pressure on household spending: consumer price inflation only accelerated slightly in 2021 and remained low. It even fell at the end of the year, reaching 1.5% y/y in December.

However, private consumption remains severely constrained by factors that are likely to remain in place in the short term: the authorities' strict zero-Covid strategy, weaker sales of home appliances and equipment due to the decline in house sales, negative wealth effects resulting from the correction in property prices, and consumer concerns about Covid risks and about further deterioration in the labour market. As a matter of fact, job losses at property and construction companies, and at some firms in the services sector (particularly SMEs and in the digital industry) constrained growth in household income in H2 2021.

The number of jobs created in urban areas hit a historically low level in Q4 2021 (they were 12% less than in Q4 2019). The unemployment rate calculated by the NBS from survey data was 5.1% in December, up from 4.9% in September and October (which was the lowest since the Covid-19 crisis began). The latest unemployment rate remains in line with the annual averages for 2018 and 2019, but its recent rise is symptomatic of the labour market's current weakness. In particular, youth unemployment remains high at 14.3% at the end of 2021 vs. 12.2% at the end of 2019.

FISCAL AND MONETARY POLICY EASING

The economic growth slowdown in H2 2021 was largely caused by the tightening of economic policy, the regulatory environment and prudential rules in the real estate sector. These measures form part of Beijing's medium-term strategy, which aims to make China's growth model more sustainable, less dependent on credit, greener and more inclusive, and to promote "common prosperity" under the government's control. As a result, the policies implemented in recent months have had multiple aims: to reduce corporate debt levels and reduce financial risk, to clean up the property market and moderate the cost of housing, to increase control both over activities related to social issues (such as education and wealth distribution) and over enterprises that collect data (especially in the digital industry), and to limit the expansion of digital groups that have overly dominant positions in their market.

The authorities are likely to maintain this course and their medium-term objectives in 2022, despite the short-term consequences on economic growth. However, they are gradually loosening their policy mix in order to mitigate these effects and support domestic demand. On the fiscal policy front, local government bond issuance has accelerated since October. Public investment in infrastructure projects may finally show signs of recovering, even though local governments are likely to

CRISIS IN THE PROPERTY AND CONSTRUCTION SECTORS

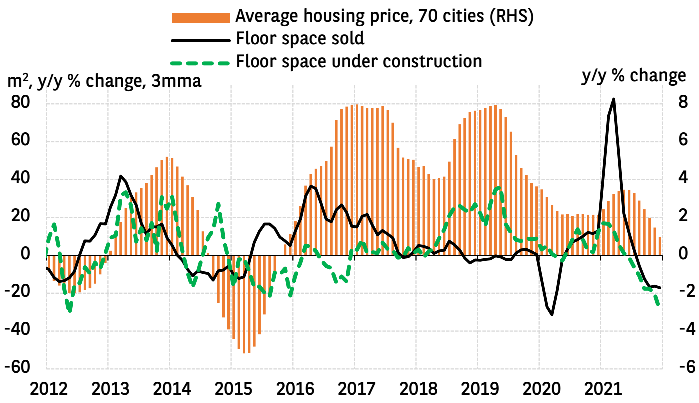

CHART 2 SOURCE: NBS, BNP PARIBAS

remain cautious.

In the real estate sector, the authorities have made adjustments to avoid a devastating collapse in the market, without changing the macro-prudential limits imposed on developers. Mortgage lending conditions and developers' access to certain types of short-term financing have been eased in recent weeks. Growth in real estate-related bank lending (loans to developers plus mortgages) already stabilised at 5.3% y/y in Q4 2021.

Most importantly, the central bank has gradually loosened monetary and credit conditions since December. It started with some targeted measures (including lending programmes for SMEs and agriculture and to support efforts to reduce carbon emissions). Then, on December 20th, it reduced the reserve requirement ratios (from 12% to 11.5% for the largest banks) and cut the one-year loan prime rate (by 5 basis points to 3.8%). On January 17th, the central bank announced a reduction in the medium-term lending facility (MLF) rate from 2.95% to 2.85% (vs. 3.25% at end-2019, just before the Covid-19 crisis struck), the first cut since April 2020. Growth in total credit to the economy, which had slowed between the end of 2020 and September 2021, recovered very slightly in Q4 (reaching 10.3% y/y in December). It is likely to accelerate gradually in the near term, especially since further interest rate cuts are expected.

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CONSTRAINED GROWTH IN THE SHORT AND MEDIUM TERM

Economic growth is still vulnerable to another epidemic wave as less than 50% of the population was fully vaccinated at the end of December 2021. Activity has already been losing momentum since December, and it could be curbed even further by the new epidemic wave that swept the country in January at a time when labour market conditions are still deteriorated. Inflation is another risk factor looming over the recovery. Not only does it reduce household purchasing power, but it could also convince the monetary authorities to raise policy rates. Under this scenario, enterprises that were already reticent to increase investment due to the prevailing climate of uncertainty would further postpone investment projects, even though their financial situation has improved significantly and banks are well positioned to increase credit supply. In the longer term, the halting of agricultural reform and the impact of the crisis on human development are factors that will crimp the country's growth potential.

A FRAGILE RECOVERY AT A TIME OF INFLATION AND A DETERIORATED LABOUR MARKET

In Q3 2021, real GDP rose above the pre-pandemic level of Q3 2019. Yet after rebounding strongly following the second pandemic wave, the recovery seems to have stalled in November. Demand for electricity, sales of tractors and automobiles, and basic industrial production have all slowed compared to September and October. This slowdown drove up the unemployment rate by 0.9 percentage points to 7.9% in December 2021.

Employment statistics are also alarming. Since the second wave of the pandemic ended, the employment rate has held relatively stable despite the growth rebound. In November, the employment rate was only 37.3%, or 2.5 percentage points below the pre-crisis level. Although the unemployment rate has fallen in recent months, the main job creations were in rural areas, where wages are lower than for urban jobs.

The first half of 2022 should be marked by another economic slowdown, especially in the services sector, since the pandemic is picking up again. The government has already announced new measures to limit the spread of the pandemic; at the end of December 2021, only 44% of the population had been fully vaccinated.

Inflation is the other risk factor threatening growth. Inflation accelerated again in October 2021 and rose to 5.6% in December. Although prices are not rising as fast as the monetary authorities' inflation target (4% +/- 2pp), the central bank could still raise its key rates over the course of 2022, in keeping with the tightening of US monetary policy. This risks further straining the recovery of private investment.

The IMF lowered its medium-term growth forecast from 7.3% to 6%. The pandemic is expected to have a lasting impact on capital accumulation (with the decline in private investment) as well as on the volume and quality of employment (more poverty and a lower level of education, with numerous labour market participants leaving the labour market). International institutions also fear that the banking and financial sectors are not in a position to support the recovery. Yet the banks' strong resilience to the crisis (including state-owned banks) is reassuring. The situation of certain non-banking financial companies (NBFC), in contrast, is more disturbing.

LARGE COMPANIES ARE HEALTHIER THAN BEFORE THE CRISIS

Despite the recession, Indian companies have consolidated their balance sheets. In 2020, they benefited from a sharp drop in wage costs. For listed companies, profits have surged to levels unseen since fiscal year 2015.

FORECASTS

	2019	2020	2021e	2022e	2023e
Real GDP growth(1) (%)	4.2	-7.2	8.9	8.7	6.0
Inflation (1) (CPI, year average, %)	4.8	6.1	5.4	5.7	5.0
General Gov. Balance(1) / GDP (%)	-7.3	-13.7	-10.6	-9.0	-8.5
General Gov. Debt(1)/ GDP (%)	73.7	84.2	83.9	81.9	81.8
Current account balance(1) / GDP (%)	-0.9	0.9	-1.8	-2.7	-1.3
External debt(1)/ GDP (%)	19.9	21.6	20.0	20.4	20.6
Forex reserves (USD bn)	457	580	633	670	695
Forex reserves, in months of imports	7.7	11.0	9.1	9.2	9.0

(1) Fiscal year from April 1st of year n to March 31st of year n+1
e: ESTIMATE & FORECASTS

TABLE 1

SOURCE: BNP PARIBAS ECONOMIC RESEARCH

INFLATION

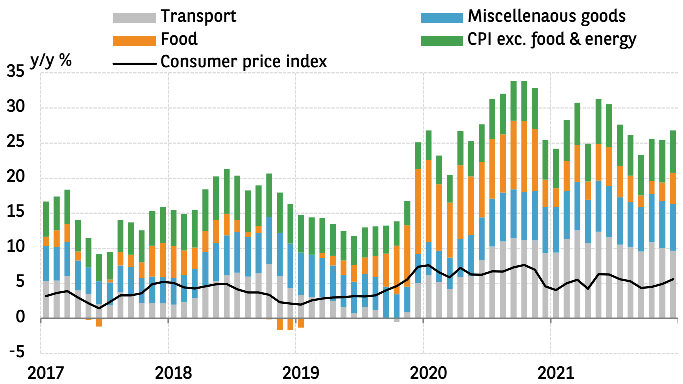

CHART 1

SOURCE: BNP PARIBAS

In a lacklustre economic environment marred by high uncertainty, companies stepped up debt reduction, a process underway since 2018. In Q2 2021, pre-tax profit was 5.3 times higher than the interest charge, the highest ratio since 2010. Yet despite favourable monetary conditions (the average interest rate on new loans declined by more than 120 basis points between end 2019 and end 2021), enterprises are reticent to invest. Production capacity utilisation rates are still below the long-term average.

BANKING SECTOR: CREDIT RISK SEEMS TO BE UNDER CONTROL

In its most recent financial stability report released in late December 2021, the Reserve Bank of India (RBI) confirmed that the banking sector continued to consolidate between March and September 2021. Although this analysis is still biased by government measures to support the most fragile households and enterprises, which were introduced in March 2020 and will run through March 2022, the banking sector should be in a position to face up to the expected increase in credit risk once economic agents no longer benefit from state-backed loans.

On the whole, asset quality, solvency and profitability of the banking sector (including the most fragile state-owned banks) have improved since 2018, and the Covid-19 crisis has not hampered the sector's consolidation.

The non-performing loan ratio for the banking sector as a whole declined to 6.9% in September 2021 from 8.5% in March 2020. Moreover, although asset quality of state-owned banks is much more fragile compared to private banks, it has been improving. Their average non-performing loan ratio declined from 11.3% in March 2020 to 8.8% in September 2021.

In the construction sector, loan quality is still mediocre, although it has improved slightly since March 2020. According to the central bank, 20% of loans to this sector are still considered non-performing. In industry and services, in contrast, the situation has consolidated, and in agriculture, it is still relatively stable. The quality of household loans has deteriorated: the non-performing loan ratio increased by 0.4 pp to 2.5% between March and September 2021. The most risky household loans are for automobiles and real estate. The impact on the banking sector as a whole, however, is still mild, because household loans account for only 10.5% of all bank loans outstanding.

According to the central bank's forecast, loan quality is expected to deteriorate between March and September 2022. The non-performing loan ratio could rise by 1.2 percentage points to 8.1% (+1.7 pp for state-owned banks). Meanwhile, non-performing loan provisions are still insufficient. In September 2021, the provision coverage ratio for risky assets was only 68.1% for the banking sector as a whole, and 66.5% for the state-owned banks.

Capital adequacy ratios improved between March and September 2021 thanks to the government's capital injections into the most fragile state-owned banks and capital increases by the private banks as well as by the more solid state-owned banks. For the banking sector as a whole, the Capital Adequacy Ratio (CAR) rose to 16.6% in September 2021 (vs. 16.3% in March 2021). Moreover, although the RBI expects the CAR to fall slightly to 15.4% by September 2022, all banks should be in a position to comply with the regulatory requirement of 9%, even in the event of an especially severe shock (last year they were not prepared to do so).

Lastly, bank profitability seems to have improved significantly, albeit from very low levels. In September 2021, banks reported a Return on Assets (ROA) and Return on Equity (ROE) of 0.8% and 9.2%, respectively. State-owned banks that failed to generate a profit in March 2020 were able to report an ROA and ROE of 0.5% and 7.7%, respectively, in September 2021.

Bank lending has rebounded since July. Loan growth has returned to levels not seen since mid-2019, even though it is still extremely low (+3.5% on average over the past three months for industrial loans). The recent rebound has been especially strong for loans to small and very small enterprises.

NON-PERFORMING LOANS IN THE BANKING SECTOR

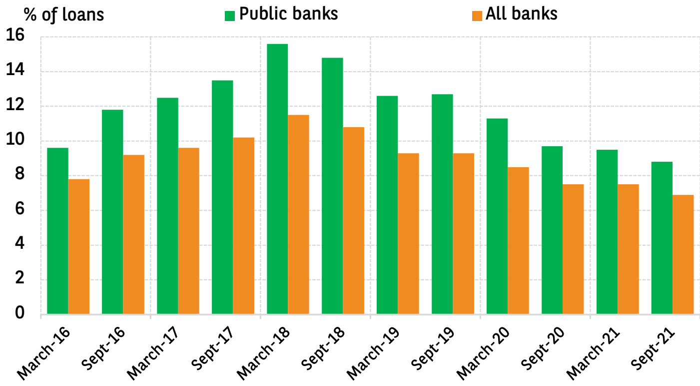

CHART 2 SOURCE: RBI

NON-BANKING FINANCIAL COMPANIES: WIDE DISPARITIES

Non-banking financial companies (NBFC) are still in a fragile financial situation. On the whole, their situation has improved slightly since March 2020, although there are still wide disparities between NBFCs.

According to the RBI, NBFCs produced loans equivalent to 12.6% of GDP in September 2021 (vs. 76.3% of GDP for bank loans). The quality of NBFC banking assets deteriorated slightly between March and September 2021, even though it is more solid than in March 2020. In September 2021, the non-performing loan ratio was 6.5% of total loans outstanding (+0.1 pp relative to March 2021). The non-performing loan ratio was 11.5% for farm loans, 11% for loans to services, and 7.9% for industry loans (40% of loans produced by NBFCs).

On the whole, their capital adequacy ratios are still comfortable. They averaged 26.3% in September 2021 (vs. 23.7% in March 2020). But of the 191 NBFCs analysed by the RBI, 10 NBFCs (whose assets accounted for 4.6% of total NBFC assets) did not comply with the regulatory requirement of 15% (in March 2021, only 7 NBFCs did not reach the regulatory target).

AGRICULTURAL REFORM IS ABANDONED

In fall 2020, Narendra Modi's government adopted several major reforms to stimulate medium-term growth. Among them was an agricultural reform programme. This reform aimed to increase productivity in a sector that employs a big share of the active population. Last November, however, faced with fierce opposition from farmers, the government finally decided to withdraw the reform. Abandoning the reform could enable Modi's party to win more seats in the regional elections to be held in Uttar Pradesh in the first part of 2022. Yet it raises doubts about the government's capacity to carry out vital reforms.

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VIETNAM

THE HEALTH SHOCK WAS MORE SEVERE IN 2021 THAN IN 2020

Vietnam weathered the 2020 health crisis without any major waves of infection, without a contraction in GDP and without a notable deterioration in its macroeconomic fundamentals. In 2021, the situation was much more complicated. In Q3, an upsurge in the number of Covid-19 cases and strict lockdown measures brought the economy to a standstill. The epidemic curve deteriorated further in Q4, but the economy picked up again thanks to the increase in vaccinations and the adjustment of the "zero Covid" strategy. In the manufacturing sector, production and exports rebounded, and growth prospects are still solid. In contrast, private consumption and activity in the services sector remain weak. The government still has some manoeuvring room to boost its fiscal support.

SEVERE ECONOMIC CONTRACTION IN Q3 2021

In 2020, the Covid-19 epidemic was very limited in scope in Vietnam, resulting in a very mild deterioration in its macroeconomic performance. In 2021, new waves of infection had much more severe consequences. The number of Covid-19 cases began rising in May and then soared in July and August, leading the authorities to introduce extremely strict lockdown restrictions and quarantine measures during the summer (chart 1). Economic activity collapsed across the board. Real GDP contracted by 6% year-on-year (y/y) in Q3 2021 (after increasing by 5.7% in H1 2021), the country's worst performance since the early 2000s.

The health situation is still fragile. After declining in September-October, the number of new cases has skyrocketed since November as lockdown restrictions have been eased. Although mobility indexes were still lower in December than at the beginning of the year, they have continued to improve slowly in recent weeks, despite another upturn in the epidemic curve. The authorities seem to be moving away from a strict "zero Covid" strategy, thanks notably to the rapid advancement of the vaccination campaign recently. By January 7th, 80% of the population had been partially or totally vaccinated, up from less than 5% at the end of June.

UNEVEN REBOUND IN Q4 2021

In this environment, manufacturing production and exports picked up again as of Q4 2021. Industrial output rebounded by 4.2% y/y in Q4 after contracting by 3.7% in Q3 (vs +10% in H1 2021). Export growth accelerated rapidly from 3.2% y/y in Q3 to 19.1% in Q4, driven by still strong global demand for telephones, computers and other electronic devices, as well as for lower value-added goods such as textiles and footwear.

In the services sector, in contrast, activity is still affected by the effects of the latest epidemic outbreaks. It is constrained by the prudence of consumers, remaining restrictions and the absence of foreign tourists (the direct contribution of tourism to growth was estimated at 6% of GDP in 2019). Retail sales volumes declined by another 9% y/y in Q4 after plunging by 32% in Q3. Activity continued to contract in the hotel, restaurant, transport and leisure services sectors in Q4 2021.

All in all, real GDP growth rebounded to 5.2% y/y in Q4 and reached an average of 2.6% in 2021. Assuming there are no more strict lockdowns, economic growth should continue to accelerate and is projected to exceed 7% in 2022, as it did in 2018 and 2019. Growth should be driven by the gradual recovery in domestic demand and the continued development of the export manufacturing sector. In fact, foreign direct investment (FDI) should continue to support the expansion and upmarket shift in Vietnamese exports.

FORECASTS

	2019	2020	2021e	2022e	2023e
Real GDP growth (%)	7.2	2.9	2.6	7.3	7.0
Inflation (CPI, year average, %)	3.8	3.2	1.8	2.9	3.5
Budget balance / GDP (%)	-3.3	-3.9	-4.7	-5.0	-4.6
General government debt / GDP (%)	43.6	46.3	49.0	49.5	49.4
Current account balance / GDP (%)	3.7	4.3	-0.8	2.9	2.7
External debt / GDP (%)	35.8	36.4	36.7	35.6	34.0
Forex reserves (USD bn)	78.3	94.8	107.0	110.0	115.0
Forex reserves, in months of imports	3.6	4.2	4.0	3.7	3.7

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

MAJOR COVID-19 WAVES SINCE LAST SUMMER

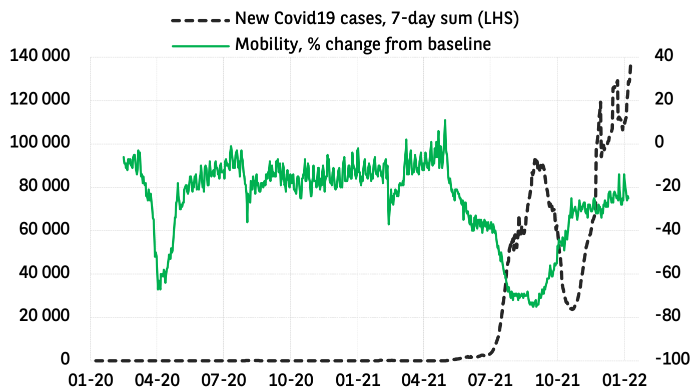

CHART 1 SOURCES: WHO, GOOGLE

TEMPORARY RETURN TO A CURRENT ACCOUNT DEFICIT

Vietnam's external accounts strengthened significantly in the years prior to the Covid-19 pandemic, thanks to large FDI inflows, steady growth in the export base and current account surpluses, increasing forex reserves, and the stabilisation of external debt ratios at moderate levels.

In 2020, these dynamics were not called into question (chart 2). The export sector was able to respond to growing global demand in the aftermath of the Covid-19 shock and increased its market share (Vietnam accounted for 1.6% of world exports in 2020, up from 1.4% in 2019). The current account surplus strengthened and exceeded 4% of GDP in 2020, thanks to an increase in the trade surplus, and despite the deterioration in the deficit of the balance of services (resulting from the fall in tourism activity). FDI inflows only dipped slightly. Forex reserves continued to rise and the external debt ratio held close to 36% of GDP.

In 2021, in contrast, the current account balance deteriorated sharply, and the full-year deficit is estimated at close to 1% of GDP. However, this current account deficit is not considered to be a major source of vulnerability.

First, it will be temporary. While the deficit in the balance of services continued to widen in 2021, the current account deficit mainly resulted from a major but transitory deterioration in the trade balance, which swung into a deficit in Q2 and Q3 2021. While import growth remained strong, export growth slowed as a result of the lockdown measures, supply-chain disruptions for intermediate goods and transport problems. Once the export engine started up again in October, both the trade and current account balances swung into surpluses again in Q4. This positive trend is expected to continue in the very short term, even though it may remain hampered by shortages still plaguing the region's industries.

Second, FDI is resilient. In 2021, net FDI inflows registered in the balance of payments continued to decline slightly, but held close to an estimated 4% of GDP. As a result, Vietnam managed to preserve a positive "basic balance" (current account + FDI), which means it did not have to resort to new debt to cover its external financing needs. The country also continued to accumulate forex reserves, which now exceed USD 100 bn and cover four months of imports. These dynamics also contributed to the dong's slight appreciation against the US dollar.

Vietnam is well positioned to continue to attract foreign investors and expand its export base in the short and medium term. We expect its current account surplus and its external liquidity and solvency position to consolidate in the future.

NEED FOR FISCAL SUPPORT

The authorities will need to strengthen fiscal support measures in the very short term. Domestic market-oriented activity is struggling to recover and the most vulnerable households and enterprises need assistance. The government has some manoeuvring room to ease its fiscal policy. The health crisis hit Vietnam after several years of public-account consolidation, and the stimulus plans launched since 2020 have been relatively small. The fiscal deficit is expected to increase to 4.7% of GDP in 2021 from 3.9% in 2020 and 3.3% in 2019 (based on IMF data). Government debt is still moderate, estimated at 49% of GDP at year-end 2021, compared to 43.6% in 2019. In 2022, assuming the fiscal deficit increases to 5% of GDP and the economy records a strong rebound, the public debt-to-GDP ratio should barely increase.

Moreover, the government has had no difficulty to cover its financing needs over the past two years, mainly on the local bond market (dong-denominated bonds now account for 60% of total government debt). The yield on 10-year government bonds (residual maturity) gradually declined to an average of 1.9% in Q4 2021, from 2.2% in Q4 2020 and 3.6% in Q4 2019.

THE CURRENT ACCOUNT BALANCE DETERIORATED IN 2021

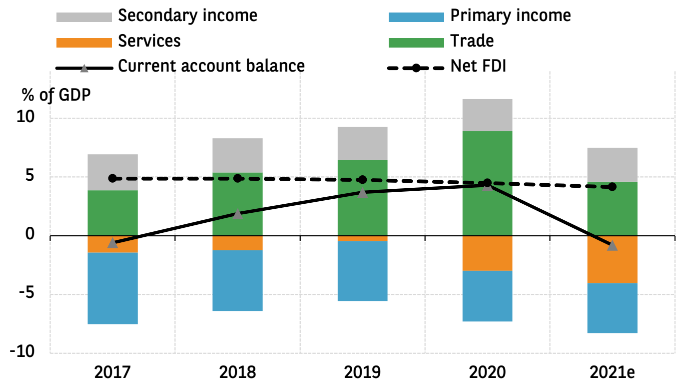

CHART 2

SOURCE: STATE BANK OF VIETNAM, BNP PARIBAS

In contrast, monetary policy will have less manoeuvring room in 2022. First, inflationary pressures are on the rise. Consumer price inflation slowed in 2020 before accelerating again in 2021, rising from 0.3% y/y in Q1 to an average of 2.7% for the period April-August. In Q4, inflation eased to 1.9%, but it is likely to pick up again in the short term, driven up by the recovery in domestic demand and by higher logistics and transport costs. Before reaching the central bank's 4% target, higher CPI inflation could lead to policy rate hikes by the end of 2022 (the key policy rate has been held at 4% since October 2020, down from 6% at year-end 2019).

Moreover, the economy's excessive debt burden is likely to push the central bank to be cautious. Monetary conditions have remained very accommodative since the beginning of the health crisis (given rate cuts, liquidity injections, the easing of macro-prudential rules, and loan rescheduling measures). Domestic credit growth accelerated from 10% y/y in mid-2020 to about 15% in mid-2021, before dipping a bit thereafter. It then levelled off at a persistently high rate of about 14% y/y in Q4. Consequently, total domestic credit represented 139% of GDP in 2021, up from 121% in 2019 (based on the new figures for annual nominal GDP, which was revised up by 25% by the Vietnamese statistics office). The authorities must act to slow down the increase in debt. At the same time, given the troubles some enterprises have encountered in the last two years, coupled with the fragility of some banks (which still lack sufficient capital ratios), an overly rapid tightening of monetary conditions is unlikely as it could result in a dangerous increase in credit risk.

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THAILAND

LIFE WITHOUT TOURISTS

Thailand's economic growth prospects over the short and medium term are limited. Private consumption and the tourist sector, the main engines of growth, will remain weak for some time. In tourism in particular, it is highly unlikely that the activity levels of 2019 will return before 2024. Moreover, the structural weaknesses of the economy (lack of investment and infrastructure) have been worsened by the pandemic and will hold back the recovery, particularly in exports. This said, although the country's external vulnerability has increased over the last two years, it remains moderate for the time being.

MODERATE ECONOMIC GROWTH IN 2021

After contracting by nearly 7% in 2020, Thailand's GDP bounced back only slightly in 2021. Economic growth was feeble in the first half (2.5% y/y) and was then held back in the second half by restrictions introduced to tackle a new wave of Covid-19 cases. Real GDP fell 0.3% y/y in the third quarter and we are expecting to see an additional fall in the fourth.

Given the faltering start to the vaccination campaign (a series of delays in ordering vaccines followed by problems in their supply and distribution), a very low percentage of the population had been vaccinated by the beginning of July when case numbers started to rise rapidly again (only 14% of the population had received their first dose, and less than 5% had received two doses). The restrictions introduced by the government were therefore very strict, hitting the services sector, private consumption and investment very hard despite new support measures from the authorities (most notably a sizeable increase in government investment). At the same time, the reopening of borders, which had been planned at least for the most popular tourist regions, was delayed until November.

Net exports also made a negative contribution to growth in the second half: imports (mainly of capital goods) continued to rise, whilst Thailand benefitted less than other countries in the region from the strength of global demand for electronic products. Supplychain disruptions, including the temporary closure of some factories (in Malaysia for example), the global shortage of semiconductors and the rising cost of transport also hit exports. Overall, we estimate that Thailand's real GDP grew by less than 1% in 2021.

RECOVERY UNDERMINED

Given the rapid increase in new Covid-19 infections since the beginning of January, the prospects of a strong economic recovery have been seriously compromised.

Although the government's vaccination target has nearly been met (some 68.5% of the population had received two vaccine doses by the end of December, against a target of 70%), a new set of restrictions was announced by the government on 6 January.

The country has returned to alert level 4 (of 5): working from home is strongly advised, many sites identified as 'presenting a high risk of transmission' could be closed, whilst those places that remain open are subject to strict rules and gatherings of more than 500 people are banned.

Apart from the 8 provinces most visited by tourists (called 'pilot zones'), all provinces have now returned to their 'orange zone' classification.

FORECASTS

	2019	2020	2021e	2022e	2023e
Real GDP growth (%)	3.7	-6.8	0.9	3.3	3.5
Inflation (CPI, year average, %)	1.3	-0.8	1.2	1.4	1.3
Gen. Gov. balance / GDP (%)	-2.3	-5.1	-7.2	-4.5	-2.8
Gen. Gov. debt / GDP (%)	41.1	49.4	58.8	62.2	61.5
Current account balance / GDP (%)	7.3	3.3	-3.4	0.8	1.9
External debt / GDP (%)	31.5	38.1	36.2	36.1	36.0
Forex reserves (USD bn)	224	258	246	233	221
Forex reserves, in months of imports	9.0	15.0	11.0	9.0	9.3

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

COVID NEW CASES & VACCINATION

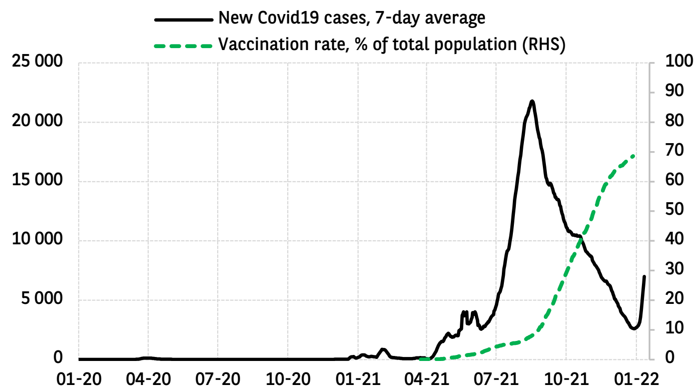

CHART 1

SOURCE: MINISTRY OF HEALTH

Against this background, and bearing in mind that even stricter measures cannot be ruled out in the short term (alert level 5 would allow the introduction of curfews and a ban on gatherings of more than 5 people), the authorities will need to continue to prop up the economy.

The 2023 budget, put before parliament in December 2021, already included a 'Covid-19' component, and the central bank left its policy rate unchanged at 0.5% (as it has been since May 2020) at its most recent meeting, given limited inflationary pressures (inflation was 2.2% y/y in December, giving an annual average of 1.2%). The central bank also believes that the negative output gap could persist until at least 2023.

These measures will probably not be enough to stimulate domestic demand, which is likely to remain sluggish in the first quarter, before recovering gradually. Similarly, exports could be hit by slower global demand in the early part of this year. Overall, real GDP growth is unlikely to be above 3.5% in 2022.

THE RETURN OF TOURISTS DELAYED AGAIN

Even in this relatively pessimistic scenario, the risks to growth in the short and medium term are on the downside. Structural weaknesses in the Thai economy (lack of investment, lack of infrastructure, very high level of political risk) will limit the scale of any recovery. Potential growth, which was put at over 3.5% before the Covid crisis, is now estimated at around 2%.

In the tourism sector (which in broad terms represents nearly 20% of Thailand's GDP), a return to the levels seen in 2019 looks likely to be delayed for a number of years, holding back growth and the current account surplus.

On the one hand, several countries in the region, including China (whose citizens made up nearly 30% of total tourists in 2019) are still operating very strict quarantine measures for travellers returning from abroad. On the other, by partially reopening its borders in November 2021, the government sought to encourage a gradual return of tourists. Fully vaccinated visitors from a list of 63 countries (which in 2019 accounted for more than 90% of total tourists) were able to enter Thailand without needing to quarantine.

These conditions were adjusted on 22 December 2021: even fully vaccinated visitors must now isolate for seven days in a government-certified hotel, and provide two negative PCR tests before moving around within Thailand (including the pilot zones).

The number of tourists will remain very low in the short term: the government estimates that around 45,000 and 90,000 arrivals were registered in the third and fourth quarters respectively, only one-third of the target the government had initially set. In 2019, the monthly average was nearly 3.3 million arrivals.

In its scenario established at the beginning of December 2021, the World Bank predicted a very gradual increase in tourist numbers, to a total of 7 million in 2022 (nearly all of them in the second half), followed by a stronger increase to 20 million in 2023, or around half of the 2019 total.

EXTERNAL VULNERABILITY REMAINS LIMITED

Thailand's external vulnerability has increased over the last two years, but remains relatively low. For the first time in more than ten years, the current account is likely to have been in deficit in 2021. The deficit was probably around 3.5% of GDP (compared to a surplus of 3.3% in 2020, when imports collapsed even more brutally than exports and tourist revenue). The current account surplus in 2019 was 7% of GDP, and averaged 8% between 2014 and 2018.

BALANCE OF PAYMENTS

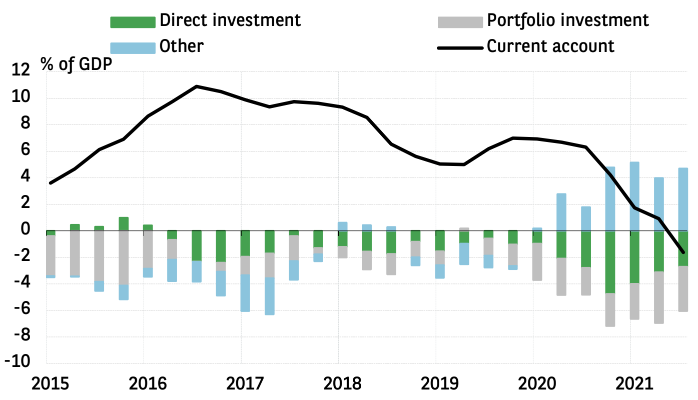

CHART 2

SOURCE: CENTRAL BANK

The short-term outlook is not positive: higher energy and transport prices, persistent pressure on value chains, the slowdown in exports and very low levels of revenue from tourism are unlikely to allow the current account surplus to be much more than 1% of GDP in 2022 and 2% in 2023.

The capital account also remained in deficit, with capital outflows (something seen for a number of years now, due to Thai investors' preference for direct and portfolio investments abroad rather than in Thailand) continuing over recent quarters.

This said, the very moderate level of external debt and very comfortable foreign reserves (USD 246 billion in December 2021), built up over a decade of current account surpluses, continue to protect Thailand from external shocks, most notably the effects of a tightening of US monetary policy.

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BRAZIL

A RECOVERY IN LOSS OF MOMENTUM

Despite the acceleration of the vaccination campaign, the anticipated rebound of growth in H2 2021 did not materialize. Instead, the economy fell into a recession in Q3 while available indicators for Q4 continued to show signs of weakness. Meanwhile, binding aspects of the spending cap have been called into question translating into an increased defiance of the market towards the sovereign. As the general election looms (October), economic prospects are expected to be very mild. Uncertainties regarding the evolution of the epidemic, the electoral cycle, the fiscal trajectory, the persistence of inflation and the tightening of monetary and financial conditions are all expected to act as potential brakes on the recovery.

RETREAT OF ECONOMIC ACTIVITY

Despite the acceleration of the vaccination campaign[1] the normalisation of activity in the service sector, and the retreat in unemployment, economic activity in Q3 recorded a decline for the second consecutive quarter, thereby plunging the Brazilian economy into a recession (-0.1% q/q in Q3 after -0.4% q/q in Q2). The decline in real GDP in Q3 has been driven by the fall in agricultural output (-8% q/q) due to i/ climate-related problems affecting the coffee, cotton, orange and sugar industries, but also due to ii/ the suspension of beef production following cases of mad cow disease. The progression of activity in both services and construction was not enough to offset the fall in production in the mining and manufacturing sectors.

The persistent pressures faced by the industrial sector (input shortages, high costs[2]) combined with weak data prints in the last few months of the year (fall in the Central Bank's advanced GDP proxy in October, drop in confidence indicators, slowdown in activity in services and the manufacturing sectors) raise fears that GDP in Q4 may have stagnated. The tightening of monetary policy (rise of 725 basis points in the SELIC rate between March and December 2021) in response to the acceleration of inflation (10.7% y/y in November, i.e. more than 8 points in one year) has concurrently led to a slowdown in real credit[3]. The stock market, which turned in June, continued its decline in the second half of the year, ultimately losing 11.9% of its value in 2021.

A GOOD RESILIENCE OF EXTERNAL ACCOUNTS

In 2021, the weakness of internal demand contrasted with the good performance of external accounts thanks to the improvement in the terms of trade and the weakness of the real effective exchange rate. The current account stabilised at a moderate level (1.9% of GDP over 12 months in November) thanks to a record trade surplus (USD 61 bn), driven by the solid performance of exports of iron ore, soybeans and crude oil)[4]. At the same time, portfolio investment flows from non-residents has returned into positive territory for the first time since the beginning of 2018 (cumulative USD 32.1 bn over 12 months in November), driven by the rise in interest rates and the increase in debt issuances in the local market. Meanwhile, external vulnerability did not deteriorate: external financing needs (current account and external debt amortization) remained in large part covered by net FDI flows, limiting the increase in external debt[5]. Official foreign exchange reserves consolidated at a high USD 362 bn.

FORECASTS

	2019	2020	2021e	2022e	2023e
Real GDP growth (%)	1.4	-3.9	4.5	0.3	2.0
Inflation (CPI, year average, %)	3.7	3.2	8.3	7.4	4.2
Fiscal balance / GDP (%)	-5.8	-13.2	-4.9	-8.0	-7.4
Gross public debt / GDP (%)	74	89	80	81	84
Current account balance / GDP (%)	-2.7	-0.5	-1.7	-2.1	-2.5
External debt / GDP (%)	37	45	42	44	44
Forex reserves (USD bn)	357	356	362	356	350
Forex reserves, in months of imports	16	19	16	15	15

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

CONFIDENCE INDICATORS

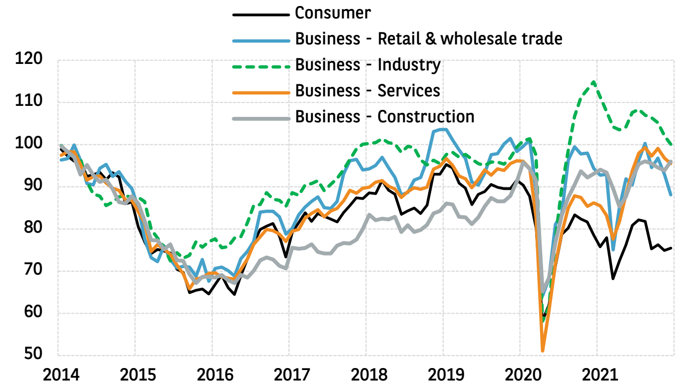

CHART 1

SOURCE: FGV, BNP PARIBAS

The BCB intervened in the FX spot market to the tune of USD 12 bn and expanded its portfolio of *cambial* swaps by nearly USD 25 bn to smooth out the volatility of the real[6] and meet the growing demand for FX hedging.

1 In early January: 78% had received a first vaccine dose, 67% were fully vaccinated and 10% had received a booster
2 The producer price index, IPA-IGP-M, although in retreat, remained at nearly 20% (y/y) in December
3 Nominal credit growth remained stable at around 15% over the year but slowed in real terms (4.9% y/y in November vs 11.3% in January)
4 For exports, the price effect dominated the volume effect (+28.3% vs. +3.5% respectively) and vice versa for imports (+14.2% vs. +21.8%)
5 The rollover rate on medium-long term external debt was 128% from January to November
6 The BRL lost 6.8% in 2021 against the dollar after falling 22.6% in 2020

The promulgation of a new law (which will enter into force in December 2022) authorising the opening of accounts in foreign currency in Brazil (and in real abroad) is expected to help enhance liquidity in the spot market and simplify capital movements abroad.

THE CREDIBILITY OF THE FISCAL RULE CALLED INTO QUESTION

Despite the improvement in the primary fiscal balance[7] and the decline in liquidity risk, the market has manifested increased concerns over the fiscal trajectory[8] as multiple developments over the past year contributed to weaken the spending cap[9] – the country's main fiscal anchor : i/ extension in March of emergency support up to 1.4% of GDP (not subject to the spending cap), ii/ change in November of the rule for calculating the spending cap[10], and iii/ suspension of parts of the payments due to honour *precatorios*[11] in order to accommodate an increase of BRL 89 billion (0.7% of GDP) in social spending in the 2022 budget (as part of the government's new social program, *Auxilio Brasil*). The markets are also worried about the rise in the cost of debt, the rise in the SELIC, inflation and long rates having led in 2021 to a rise of nearly 2 points of the implicit interest rate on the public debt. Added to this is the fear of a fall in tax revenues resulting from the anticipated economic slowdown in 2022. The institutional mechanisms governing fiscal policy should continue to fuel market concerns, with the current government making no secret of its desire to make the spending cap more flexible, if re-elected, while Lula would not be opposed to dropping it altogether.

OUTLOOK FOR 2022: MULTIPLE BRAKES CONSTRAINING GROWTH

Growth prospects are projected to be very mild in 2022 (+0.3%) given a still very uncertain macroeconomic and political backdrop (the country has been under the threat of the Omicron[12] variant for a few weeks now and the general elections are looming in October). This projection reflects the many constraints weighing on domestic demand: despite the deployment of social aid as part of the government's new social program[13], private consumption is expected to be held back by the decline in the purchasing power of wages, the increase in household debt and the new rate hikes planned in 2022. Election rules will also limit the increase in government spending. The tightening of monetary policy and electoral uncertainties are meanwhile expected to weigh on investment. External demand will, at the same time, be held back by the slowdown in China, the United States and Europe (the country's main trading partners). The possibility of a drought (as in 2021), and inflation-related strikes represent downside risks that cannot rule out a recessionary scenario.[14]

Inflation should decelerate somewhat due to i/ the normalisation of electricity prices (with the reduction in the risk of rationing), ii/ monetary tightening[15], iii/ weak domestic demand.

CENTRAL GOVERNMENT BALANCE AND DEBT RATIO (12-MONTH ROLLING SUM)

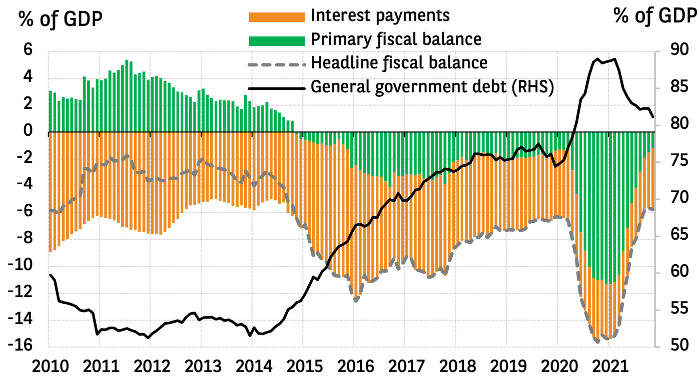

CHART 2 SOURCE: NATIONAL TREASURY, BCB, BNP PARIBAS

The 10% increase in the minimum wage in January could, however, maintain the rise in prices in the service sector. The food component of inflation should become an increasingly salient electoral issue due to its weight in households' budgets (approximately 25%).

Despite the overall expected slowdown, some sectors should fare better. Automotive production could increase by almost 10% according to the association of car manufacturers Anfavea (the lack of microprocessors resulted in approximately 300,000 vehicles not being produced in 2021). Certain services segments such as tourism, care and events should see a rebound with the increase in vaccination. The energy and infrastructure sectors should benefit from the several planned auctions destined to offer concessions across multiple areas (solar, wind, thermal projects as well as 12 ports, 7 highways, 4 airports and 1 railway for an estimated total amount of BRL 116 bn). This however will be contingent on foreign investors' appetite not being adversely affected by the general election.

The start of the election cycle means that some major proposals currently evaluated in Congress such as i/ the tax reform (designed to simplify taxation by unifying federal taxes and reduce the tax burden on companies) as well as ii/ the public administrative reform (aimed at improving the efficiency of public spending, containing the wage bill and easing hiring/firing rules in the public sector) will have a reduced chance of seeing the day of light. Political risks coupled with the anticipated rise in interest rates in some developed markets will, meanwhile, further fuel market volatility.

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7 The primary balance fell from a deficit of -9.9% of GDP at the end of 2020 to -1.1% of GDP in November 2021. At the same time, public debt fell from 88% of GDP to 81.1% of GDP.
8 The 5-year CDS and the EMBI+ increased by 60 and 66 basis points respectively over the year to stand at some 205 bps and 326 bps respectively at the end of December
9 The increase of primary spending is limited to the inflation of the previous year
10 Taking into account December inflation (+10.06%) rather than that of June (+8.35%)
11 Court-ordered mandates requiring the federal government to pay damages following lawsuits (disputes over pensions, wages, housing, disability or death benefits, expropriations, etc.)
12 60% of new infections in early January vs 40% for the Delta variant
13 *Auxilio Brasil* will expand coverage of low-income households to 17 million families (compared to 14.6 million for *Bolsa Familia*) reaching approximately 50 million Brazilians. The payment of at least BRL400 will be paid for each eligible family until December 2022.
14 The slight inversion of the yield curve (1-year yields are higher than 10-year yields) already signals market concerns over a potential recession.
15 A 100 bps rise in the SELIC drives the IPCA down 30 bps in one year according to BCB models

ARGENTINA

TIME IS RUNNING OUT

Looking beyond the strong recovery in 2021, the Argentine economy remains fragile. Production in primary and secondary sectors has returned to its pre-pandemic levels. However, the economy remains constrained by high though largely repressed inflation, which is hitting household consumption and services. Since December 2021, a new wave of Covid-19 infections has introduced additional uncertainty. The mid-term elections have weakened the government coalition, which is still negotiating with the IMF. Monetary policy is tightening and the normalisation of budget deficit financing will require a slowdown in expenditures, although a drastic consolidation is unlikely. However, time is running out. Despite the jump in prices for agricultural raw materials, the divergence between the market exchange rate and the official rate has widened. Moreover, the central bank's forex reserves have only just stabilised due to capital outflows, notably from residents. Above all, very large repayments fall due in March.

COALITION WEAKENED IN ITS NEGOTIATIONS WITH THE IMF

President Alberto Fernandez's *Frente de Todos* (FdT) centre-left coalition lost out in the partial mid-term legislative elections in November 2021. Its position in the Chamber of Deputies was weakened, with its seat count dropping from 120 to 118 (of 257 in total). More importantly, FdT lost its Senate majority, as it was left with only 34 of the 40 seats it previously held (out of 72). The Fernandez government was punished for dissent within the Peronist camp itself. It has been accused of excessively radical management of the pandemic (tainted with scandals), with long lockdown periods in the capital and surrounding region, as well as of an inability to control inflation.

The negotiations with the IMF are dragging on. They are designed to allow the country to reschedule its debt to the IMF under an Extended Fund Facility (EFF). The electoral setback can only strengthen the government's bid to limit the IMF's conditions. After technical meetings in early December 2021, the IMF team indicated that the fiscal consolidation needed to be gradual, sustainable and to allow investment in infrastructure and technology and targeted social spending. Therefore, there will not be drastic improvement in the fiscal position. The declaration also stressed the need for a multi-pronged strategy to control inflation. This must combine a reduction in the monetary financing of the budget deficit, an appropriate monetary policy with positive real interest rates and, in much vaguer terms, coordination between wages and prices. Inflation is responsible for fuelling financial instability, providing a structural brake on growth and exacerbating the poverty that affects 40% of the population.

A FRAGILE RECOVERY AND REPRESSED INFLATION

The economic recovery continued in H2 2021, but remains fragile. Real GDP jumped 4.1% q/q in Q3 vs. -0.9% in Q2, but then fell again in October (it still remains 2% above its pre-pandemic level). The recovery of the construction sector was strong and explains the sharp increase in investment, the most dynamic component of demand (13% higher than in 2019). However, industrial production has been weakening since July 2021, even though it is 8% higher than its pre-pandemic level (see chart). Most service sectors, with the exception of healthcare and education, have not returned to their end-2019 levels, still less the levels at the end of 2017 when the recession in the country began.

In Q3, household consumption was still 5% below its level in Q4 2019, with real wages falling by 6% over the period in the private sector and 9.5% in the public sector. Public consumption has partly offset the weakness of private consumption, particularly since mid-2021.

FORECASTS

	2019	2020	2021e	2022e	2023e
Real GDP growth (%)	-2.0	-9.9	8.0	1.5	2.0
Inflation (official, annual average, %)	53.5	42.0	48.4	59.3	43.0
Fiscal balance/ GDP (%)	-4.7	-8.9	-5.0	-4.5	-4.0
Public debt/ GDP (%)	90.1	104.3	85.4	80.1	78.2
Current account balance / GDP (%)	-0.8	0.9	1.3	0.8	0.5
External debt / GDP (%)	62.7	69.9	58.6	51.5	49.5
Forex reserves (USD bn)	44.8	39.4	39.6	43.3	47.8
Forex reserves, in months of imports	8.1	9.1	7.2	7.6	8.0

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

ACTIVITY INDICATORS

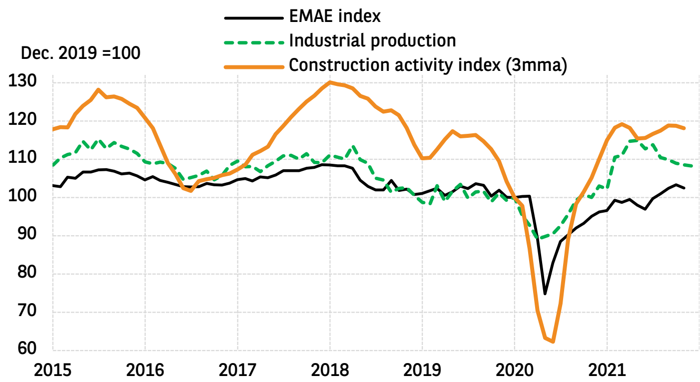

CHART 1

SOURCE: INDEC, ISAC

The latest wave of Covid-19 infections has introduced additional uncertainty in the recovery. Since mid-December the number of new cases has risen steeply as the Omicron variant has taken hold. Argentina is by far the worst hit country in Latin America, with more than 100,000 cases per day at mid-January, a rate of 2,500 per million people (against an average of 680 for the major Latin American countries).

This upsurge in the pandemic coincided with the mid-October removal of restrictions on foreign tourists for the summer season. For the time being, deaths remain very low and the number of people in intensive care is lower than in previous waves.

Even though activity fell again in Q4 2021, GDP will have posted a strong recovery over the whole year, given strong carry-over effects. In 2022, however, growth is likely to slow markedly due to: 1/ the expected acceleration of inflation and tightening of monetary policy (the BCRA has already raised its policy rate from 38% to 40%; 2/ the (temporary) shock from the expected devaluation of the official exchange rate, a necessary condition to reduce the increasing divergence between exchange rates[1] and for the gradual withdrawal of foreign exchange controls; and 3/ the normalisation of the financing of the budget deficit and a slowdown in current spending.

The monthly inflation rate fell by an average of around 4% between October 2020 and April 2021, and by 3.2% between May and December 2021. But this deceleration is temporary. Granted, the depreciation of the official exchange rate has been reduced to 1% per month since July, compared to 3% in H1 2021. But the gap between the market rate and the official rate is well above the 40% threshold at which the pass-through effect of the exchange rate on prices is amplified. Moreover, the slowdown in inflation has come at the cost of price controls (going as far as a temporary freeze between October 2021 and early January 2022), the already-broad scope of which is likely to be extended[2]. Repressed inflation is estimated at around 10 percentage points compared with 51% y/y for CPI inflation.

The expected catch-up of frozen prices and the adjustment of regulated prices have raised fears of a reacceleration in H2 2022, which could push the inflation rate to 60% y/y at mid-year or so. On top of this, there is the possible unfavourable effect of future monetary and exchange rate policies if their negative effects (devaluation of the official exchange rate, increase in the target rate of depreciation to allow the central bank to rebuild currency reserves) outweigh the positive effects (monetary tightening, closing of the gap between official and market exchange rates).

A MIXED PICTURE FOR PUBLIC FINANCES AND EXTERNAL ACCOUNTS

At first sight, the budget deficit was reduced markedly in 2021. It was only 3.1% of GDP (2.2% excluding interest payments) over the 12 months to November, compared to 8.5% and 6.5% respectively in 2020. However, the performance is less impressive when one takes account of the transfer of SDRs (1% of GDP) and exceptional revenue raised on the extraordinary tax on financial market gains (0.6% of GDP). Moreover, the interest paid by the central bank on its debt (Leliq and swaps), which in December represented around 100% of money supply (from 80% in 2020), is not included in the central government's budget. Even so, these payments represent the sterilisation cost of budget deficit monetary financing. These payments were the equivalent of 2.6% of GDP, as in 2020, despite the reduction in direct advances from the BCRA to the Treasury (from 7% of GDP in 2020 to 2.7% in 2021).

EXCHANGE RATES AND OFFICIAL FOREX RESERVES

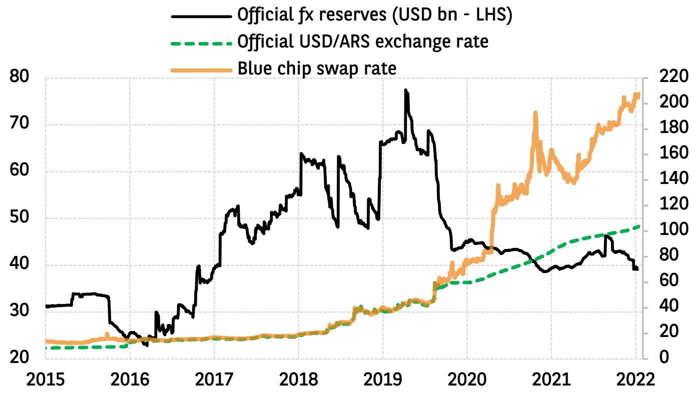

CHART 2

SOURCE: BCRA, BNP PARIBAS

In all, the budget deficit corrected for transfers from the central bank, but including sterilisation costs, was 6.4% of GDP, which gives a more accurate picture of the imbalance in the public finances. By the end of December, the 2022 budget had still not been adopted, having been rejected by the Senate. The government will need to revise it and get it passed quickly, as its adoption is a precondition for the IMF.

External liquidity remains low despite a trade surplus that has increased, and will probably exceed USD 15 billion in 2021 as a result of the very strong price increases for the main agricultural exports (+47% for soybeans, +38% for corn and +16% for wheat). The basic balance (current account balance + net direct investment) is likely to show a surplus of at least USD 10 billion. However, forex reserves, which increased to USD 46 billion after the acquisition of SDRs, have since fallen to USD 39 billion, below their end-2020 level. Net outflows of portfolio investment reached USD 5 billion over the first nine months of 2021, and net purchases of foreign currency by the non-financial private sector resumed in the second part of the year.

According to estimates from Global Source Partners, payments of interest and principal on external debt will reach around USD 25 billion in 2022 (USD 22 billion to the IMF) and USD29 billion in 2023 (USD 23 billion to the IMF). A rescheduling agreement is essential before the next major repayment date in March (when more than USD 5 billion are due to official creditors alone, consisting mainly of the IMF and the Paris Club).

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1 The market rate for the dollar against the ARS (the Blue Chip Swap Rate) is currently double the official rate. Since April it has risen much faster (4.5% per month on average compared to 1.3% for the official rate). It has moved in step with the ratio of money supply to currency reserves, which is a good proxy for exchange rates in countries experiencing very high rates of inflation.

2 On 15 October 2021, the government reached agreement with major retailers and manufacturers and/or their representatives to freeze prices on around 1,200 products until 7 January. Price controls already existed on more than 700 products under the *Precios Cuidados* programme. When the temporary freeze ends, the government hopes to negotiate an extension of the scope of *Precios Cuidados* to around 1,300 products. This would be a voluntary agreement to limit price rises to 2% per month or 6% per quarter.

CHILE

A FULL PROGRAMME

Gabriel Boric won the second-round presidential election in December. He will take up his post in mid-March and will face many challenges during his term. The new government will have to deal with a fragmented legislative assembly and high levels of popular expectation. Economic growth is likely to slow as exceptional support measures are gradually withdrawn. Although vaccination levels are high, activity could be weakened by new waves of infection and the accompanying restrictions. Lastly, consolidating public finances whilst fulfilling promises to reform education, healthcare and pensions would seem to be the biggest difficulty.

A TENSE ELECTION

On 19 December 2021, Gabriel Boric, the candidate of a very broad coalition of leftist parties, won the second round of the presidential election from J. Kast, the extreme right wing candidate. He took 56% of votes cast, with a turnout of 55%, a record high since mandatory voting was ended in 2012. In last November's first round, the turnout was 46%. The new government will come to power on 11 March.

The task ahead looks particularly challenging for the president-elect, and his difficulties will be amplified by changes in the global health situation. Although the population is well-vaccinated (with 80% having had two jabs and 60% having had a booster shot), the country remains exposed to new potential waves of infection (which would hit domestic demand, the tourist industry and exports).

Moreover, Chile's political and social stability has deteriorated significantly since the violent demonstrations in the autumn of 2019. Surprising for both their scale and their duration, these demonstrations covered a broad range of claims including frustration with growing inequality and opposition to the Pinera government's proposed reforms on access to the healthcare system and pensions.

The economic and health crisis has also increased the fragility of the healthcare and social protection systems, which face great difficulties despite the massive support provided by the authorities over the past two years. People's expectations have nevertheless been raised.

At the same time, the process of writing a new constitution (which should be completed by the end of 2022) and the ensuing debates, focused on the same topics of education, healthcare and so forth, amplifies the pressure on the new government, even before it takes office. The independence of the central bank and its mandate (a growth and/or employment target could be added to the inflation target, in line with the Fed's mandate) are also being debated.

UNFAVOURABLE CONDITIONS

The implementation of the new government's economic and social policy is already looking like a challenge. The make-up of the new Congress (elected at the end of November at the same time as the first presidential round) is not clearly helpful for Mr Boric's government: there is no majority in the Senate, and the left has only a two-seat advantage in the 155-member Chamber of Deputies.

Such a situation may certainly prevent the radical change in economic policy feared by some analysts (the stock market dropped more than 6% on the day after the election). But it could also prevent any substantial structural reforms, and much negotiation and doubtless compromise will be needed if the government is to push them through.

FORECASTS

	2019	2020	2021e	2022e	2023e
Real GDP growth (%)	1.1	-5.8	10.8	2.5	2.0
Inflation (CPI, year average, %)	2.8	3.0	4.4	4.9	4.5
Central Gov. balance / GDP (%)	-2.8	-6.2	-7.6	-3.9	-3.5
Public debt / GDP (%)	28.1	32.7	35.1	38.7	40.7
Current account balance / GDP (%)	-3.6	1.3	-3.2	-3.5	-3.5
External debt / GDP (%)	70.0	82.6	74.3	72.6	71.0
Forex reserves (USD bn)	40.6	39.2	53.8	53.4	52.8
Forex reserves, in months of imports	4.8	5.5	5.3	4.8	4.5

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

MONTHLY ACTIVITY INDICATORS

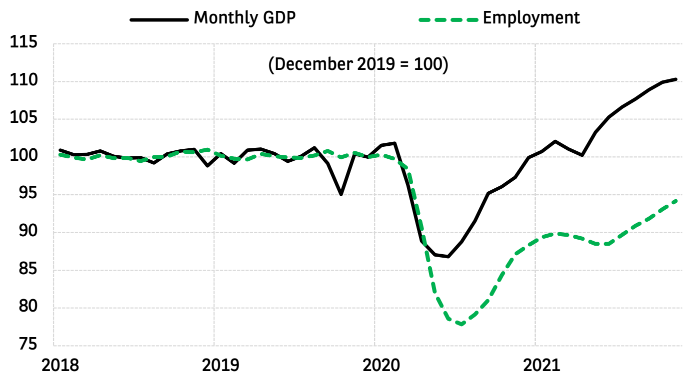

CHART 1

SOURCE: CENTRAL BANK

It is highly likely that the political and social climate will remain tense throughout the government's term, and that in the end changes will be much less radical than predicted.

Meanwhile, economic growth is likely to slow significantly. Real GDP probably grew by nearly 11% in 2021, thanks to the massive support from the authorities (as in 2020) and rising copper prices (in addition to comparison basis effects). However, the authorisation granted (on three occasions) to pension holders to draw against their retirement savings provided an artificial stimulus to consumption, and real GDP is likely to grow by 'only' 2.5% this year, with the gradual withdrawal of exceptional support measures and an uncertain international climate.

It is against this challenging background that the new government will begin its work in March. Details of its programme are not yet known, but the new president wants to find the 'right balance' between the need for reforms to improve social justice and the rebuilding of 'favourable conditions' for investment and growth, whilst remaining 'fiscally responsible'.

In other words, Mr Boric would appear to want to respond to the high levels of popular expectation and launch several large-scale reforms to achieve this. But he will also need to maintain the confidence of investors, the rating agencies and the IMF, something that has been undermined by the political crisis and the withdrawals of pensions savings with their medium and long-term economic and fiscal consequences.

It is worth remembering that Chile is one of the few countries to enjoy a flexible credit line with the IMF, providing a precious guarantee that helps boost market confidence in times of rising risk. Chile has had this credit line since May 2020.

PUBLIC FISCAL DEFICIT & DEBT

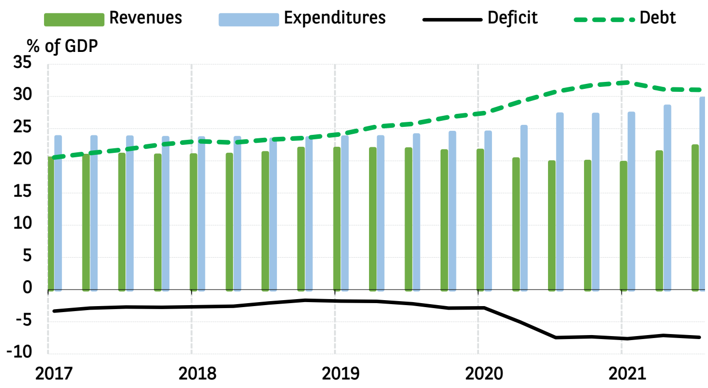

CHART 2 SOURCE: MINISTRY OF FINANCE

OVER-AMBITIOUS TARGETS?

The new government's many ambitions look hard to achieve and incompatible with fiscal constraints. As soon as the campaign had ended, Mr Boric announced that he wanted to increase public spending substantially, with the twin targets of improving the social safety net and beginning a deliberately 'aggressive' green transition, whilst also setting in motion a fiscal consolidation process.

But the president-elect has also committed to 'fiscally responsible' policies, with the initial aim of bringing the government deficit down from 7.6% of GDP in 2021 to less than 4% in 2022. He therefore plans to respect the target deficit of 3.9% of GDP which was set in the 2022 budget proposed by the outgoing government.

According to his announcements, fiscal deficit reduction should then continue throughout his term, returning it to levels similar to those before the crisis (between 2015 and 2019 the average government deficit was less than 2.5% of GDP). The aim is to stabilise the public debt ratio, which remains modest (35% of GDP at end-2021) but has been rising steadily for more than ten years, in order to keep it below 45% throughout his term.

Continuing fiscal consolidation whilst making significant (and lasting) increases in expenditure will thus require substantial and permanent increases in government revenue. The government's working hypothesis is that revenue can be increased by 5 points of GDP by the end of its term (revenue represented 21.5% of GDP on average between 2015 and 2019) through increases in business taxes, the introduction of a wealth tax and new 'green taxes', royalty charges for private mining companies and a significant reduction in tax evasion and exemptions. However, it seems fairly unlikely that the government will be able to pass the necessary measures and reforms to achieve the increases in either spending or revenue.

Mr Boric has also recently stressed that each lasting increase in spending must be preceded by an increase in revenue. In 2014, Michelle Bachelet proposed a fiscal reform which was projected to increase revenue by 3 points of GDP over her term. By 2018 revenue had risen by 1.4 points relative to 2014.

Concerning the pension system, one of the most keenly anticipated areas of reform, the new government could (on the basis of its campaign proposals) seek to reform the existing system totally but gradually. Three main phases are planned. First, improving and strengthening the 'solidarity pillar' by creating a universal minimum pension (with a value more than 30% above the current minimum pension, which is not universal at present). The resulting increase in spending (estimated at the equivalent of 2.5% of GDP) should be offset by additional revenue generated from fiscal reform.

Secondly, employer contributions will be gradually increased (from 10% of wages currently to 16% by the end of the government's term). Finally, a new public pension fund will be created that will gradually replace existing private pensions.

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RUSSIA

INFLATION AND GEOPOLITICAL RISKS WILL CONSTRAIN GROWTH

After showing rather strong resilience to the pandemic and the collapse of international oil prices in 2020, the Russian economy rebounded strongly in 2021. Yet two major risks are currently threatening growth: inflation and a tightening of international sanctions. These sanctions could even add to the inflationary risk. Nonetheless, the government has the financial capacity to support the economy, with solid public finances and low refinancing risks. Moreover, even if international sanctions were tightened to the point that foreign investors were denied access to Russia's secondary debt market, the government would still be able to finance itself on the domestic market.

INFLATION WILL HAMPER ECONOMIC GROWTH IN 2022

In the first three quarters of 2021, economic activity rebounded 4.6% compared with the same period in 2020. A very strong acceleration in domestic demand, especially household consumption, fuelled the recovery, while the contribution of net exports to growth remained negative due to a sharp upturn in imports. The big increase in domestic demand put major pressures on production capacity, and the capacity utilisation rate rose to more than 85% in Q3, an all-time high. This environment led companies to step up investment, especially in IT and services activities (banking, wholesale and retail). With the resurgence of the pandemic, activity seems to have slowed slightly in Q4 2021 but remained robust. In November, the unemployment rate hit a low of only 4.2%. Labour market pressures were particularly strong, generating higher wage pressure. In full-year 2021, economic growth may have reached 4.5%.

In 2022, growth prospects are not as favourable as in 2021, although they will still surpass the country's potential. Growth will automatically slow due to an unfavourable base effect. Although the Russian economy should benefit from high oil prices and production increases as part of its OPEC agreement, growth will be hampered by stubbornly high inflation, at least in the first quarter. In December, inflation rose to 8.4% year-on-year (y/y), while core inflation, excluding energy and food prices, rose to 8.9% y/y. These are the highest inflation rates since 2014-2015.

In the short term, inflationary risk will remain high in Russia for two reasons: 1) labour market pressures will persist, and 2) geopolitical risks will remain high, straining the rouble. In the monetary policy committee's latest report of December 2021, the Central Bank of Russia (CBR) estimated that inflation could drop back to its 4% target by the end of the year. Even so, the CBR could opt to raise its policy rates again as of the next monetary policy meeting in February, after raising them substantially in 2021, by a total of 425 basis points. Monetary tightening will weigh on corporate investment strategies. In Q3 2021, 24.4% of loans to small and mid-sized enterprises (SME) and 42.7% of loans to major corporates were variable-rate instruments.

FORECASTS

	2019	2020	2021e	2022e	2023e
Real GDP growth (%)	2.0	-3.0	4.5	3.0	1.8
Inflation (CPI, year average, %)	4.5	3.4	6.7	6.3	4.1
Central Gov. balance / GDP (%)	1.9	-4.0	0.2	1.1	0.5
Public debt / GDP (%)	13.8	19.3	18.0	16.2	15.0
Current account balance / GDP (%)	3.8	2.3	6.0	5.0	3.2
External debt / GDP (%)	28.5	31.6	30.8	29.2	29.0
Forex reserves (USD bn)	425	445	462	485	499
Forex reserves, in months of imports	15.1	17.6	17.5	16.5	16.2

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

ACTIVITY INDICATORS

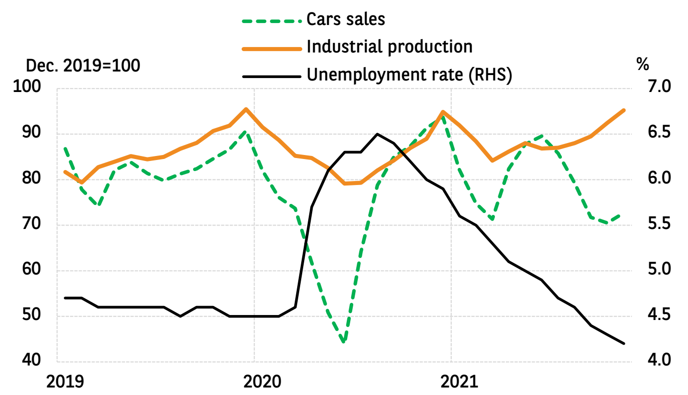

CHART 1

SOURCE: ROSSTAT, BNP PARIBAS

PUBLIC FINANCES: STILL SOLID

In full-year 2021, the fiscal balance for all public administrations should have recorded a slight surplus, after reporting a deficit of 4% of GDP in 2020.

The consolidation of public finances can be attributed to a very strong increase in fiscal revenues, which rose more than 24% in the first 11 months of the year compared with 2019. Public finances mainly benefited from the big increase in oil prices and production: revenues from oil and gas-related activities accounted for more than 80% of federal government revenue, up from only 40% in 2019. Fiscal revenues also benefited from the dynamic momentum of household consumption and the increase in corporate profits. As to spending, the government reduced its expenditures by nearly 5% compared to the same period in 2020, although they were still much higher than pre-Covid-19 levels.

The consolidation of public finances is expected to continue in 2022 and 2023. Over the next two years, the government is forecasting *surpluses* of 1% and 0.2% of GDP, respectively. In 2024, it is calling for a deficit of only 0.3% of GDP, which should be financed by bond issues in the domestic market.

Excluding a decline in oil prices, the main short-term risk is a stronger-than-expected increase in inflation, since 42% of the Russian population is highly dependent on government subsidies. According to the rating agency Moody's, every 1 percentage point increase in inflation could result in an increase in public spending of 0.2% of GDP.

In case of a shock, however, the government has comfortable fiscal manoeuvring room to support the economy. In 2021, solid public finances and the dynamic momentum of nominal GDP growth should help reduce the public debt to only 18% of GDP (vs. 19.3% of GDP in 2020).

Moreover, the asset value of the National Wealth Fund is very comfortable. The government can use the fund not only to finance its development projects, but also to face up to any oil price shocks, as was the case in 2020. At 1 December 2021, the fund was valued at USD 185 bn, the equivalent of 12% of GDP. In 2022, the fund's value should increase by more than USD 41 bn (2.5% of GDP). This amount corresponds to the central bank's FX purchases on behalf of the finance ministry in 2021, in compliance with the fiscal rule that stipulates that the government must save any surplus oil revenues once oil prices exceed USD 40 a barrel.

Another risk that cannot be neglected is a tightening of international sanctions. They would not only drive up the cost of financing for the government, but also would force it to finance itself solely on the domestic market. Yet the government's financing needs are small over a 3-year horizon. For the period 2022-2024, bonds reaching maturity are equivalent to only 2.8% of GDP, and most are comprised of domestic bonds (Eurobonds maturing in 2022 and 2023 amount to USD 5 bn, or 0.3% of GDP). The share of debt held by non-resident investors is also small (less than 14% of total debt). There are sufficient domestic savings to face up to any new sanctions that would restrict non-resident investors from purchasing public debt in the secondary market. At end-November 2021, non-residents held 20.5% of domestic bonds. The government and the CBR are also seeking to reduce their dollar dependency. The finance ministry issued more euro-denominated Eurobonds, and the CBR reduced the share of foreign reserves held in dollars (to only 16.4% in Q2 2021, down from 22.2% a year earlier).

BANKING SECTOR: STRONG RESILIENCE TO THE CRISIS

*T*he banking sector showed strong resilience to the Covid-19 crisis. Profitability rose, capital adequacy ratios remained satisfactory and the quality of assets, though fragile, improved slightly.

Bank profits rose by more than 20% in the first 11 months of 2021 compared with the same period in 2019. In Q3 2021, the return on assets (ROA) and the return on equity (ROE) were 2.2% and 21.5%, respectively, compared with the pre-crisis levels of 1.6% and 18.6%. This strong performance was mainly due to the decline in excessive provisions.

After enjoying greater flexibility during the Covid-19 crisis, banks have had to report all of their non-performing loans as of 1 July 2021. Even so, it was still possible to restructure loans held by the most vulnerable households and SMEs. At the end of September 2021, the CBR estimated that since March 2020, loan restructuring had involved 15.2% of loans to large companies, 14.4% of loans to SMEs and 4.2% of household loans.

INFLATION

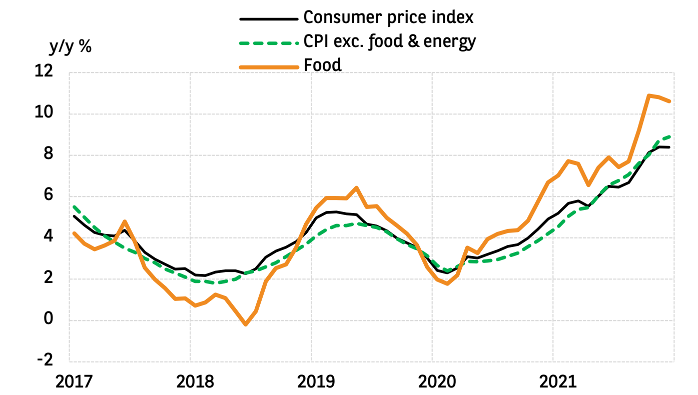

CHART 2

SOURCE: CBR, BNP PARIBAS

The CBR also estimates that between 20% and 30% of these restructured loans could default.

Yet the latest figures reported by banks are encouraging. Asset quality has not deteriorated thanks to support measures adopted by the government and the central bank. At the end of November 2021, risky assets accounted for 16.8% of total loans outstanding, which is 0.8 pp below the pre-pandemic level. According to IMF estimates, the share of non-performing loans declined from 10% at year-end 2019 to 7.5% in Q3 2021.

All in all, the capital adequacy ratios are acceptable. CAR averaged 12.4% in Q3 2021, which is higher than the regulatory requirement of 9%.

The degree of dollarization also declined slightly. The share of deposits and bank loans denominated in foreign currencies amounted to 23.5% and 15.4%, respectively, in October 2021.

The slight improvement in the quality of bank assets can be attributed in part to the consolidation of corporate balance sheets.

At year-end 2021, corporate debt was still contained (41.4% of GDP in November 2021) and the EBITDA-to-interest coverage ratio was 6.8x.

In contrast, the financial situation of households continued to deteriorate in keeping with the increase in their debt burden (+4pp since the outbreak of the crisis, despite the authorities' attempts to curb household lending). Though still limited, household debt came to 20.9% of GDP in November 2021. In Q2 2021, the CBR estimated that loan repayments would account for 10.2% of disposable income on average, which is unprecedentedly high. Although most household loans are comprised of mortgage loans, the risks are higher for unsecured loans, whose value per borrower has increased *according to the CBR.*

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UKRAINE

CAPPED GROWTH

The Ukrainian economy has suffered an accumulation of external and domestic shocks: the pandemic (vaccination rates are still low), the ongoing geopolitical risk, and domestic political tensions. Adding to these factors, inflation has accelerated over the past year. However, the Covid-19 crisis has been much better absorbed than was the case for the crises of 2008 and 2014. The current account balance has recovered and foreign currency reserves have increased, thanks in particular to higher commodity prices (cereals and metals). International support (mainly from the IMF and European Union) provided the required complement, allowing fiscal support to the economy. However, the country remains exposed to a sudden stop of capital flows. As a result, Ukraine still remains dependent on financing from international financial institutions.

BRAKES ON THE RECOVERY

Ukrainian economic growth was disappointing throughout 2021, with an unexpected recession in the first half followed by a relatively modest recovery. However, the country has come through the Covid-19 episode without a financial crisis, in contrast to 2008 and 2014. One notable difference lies in the increase in prices for commodity exports (which fell in 2008 and 2014); this made a substantial contribution to improving the current account, despite the drop in agricultural production seen in 2020 and the first half of 2021. Alongside the support of international financial institutions (mainly the IMF and EU), this helped protect foreign currency reserves, stabilise the exchange rate and, ultimately, ensure the country's solvency.

However, the private capital inflows have dried up. The fickleness of this flows affects the financing of growth and continues to limit its potential. The local economic situation has been difficult. Manufacturing production has not returned to its pre-Covid level and was still 6% below it in November 2021. The acceleration in inflation (with energy prices rising, particularly as the result of higher taxes) since the end of 2020 has hit household spending. Fortunately, production and exports of agricultural products probably bounced back in the second half of 2021, thanks to a good cereal harvest.

The health risk remains substantial, following several waves of infection, of which the most recent (in the autumn of 2021) was also the biggest both in the number of cases (25,000 per day at the peak) and of deaths (700 per day at the peak). Vaccination levels remain low, with only one-third of the population covered, which has resulted in severe restrictions being maintained.

Lastly, political risk remains significant and takes two forms: the difficulty in implementing reforms, notably to the judiciary (which is a condition of international aid), and the conflict with Russia (tensions in March 2021 and again since the end of the year). The continuation of these risks has resulted in the freezing of investment, despite a law introduced in early 2021 designed to encourage foreign investment.

FORECASTS

	2019	2020	2021e	2022e	2023e
Real GDP growth (%)	3.2	-4.0	2.0	2.8	2.8
Inflation (CPI, year average, %)	7.9	2.7	9.3	9.0	6.2
Gen. Gov. balance / GDP (%)	-2.0	-6.0	-4.5	-4.0	-3.0
Gen. Gov. debt / GDP (%)	50.5	60.8	62.0	63.0	63.0
Current account balance / GDP (%)	-2.8	4.0	-0.8	-2.5	-3.0
External debt / GDP (%)	79.1	84.0	80.0	76.0	74.0
Forex reserves (USD bn)	25.3	29.1	30.9	27.5	26.5
Forex reserves, in months of imports	4.0	5.6	5.0	4.3	4.1

e: ESTIMATE & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

GDP: CONSTANT PRICES SEASONALLY ADJUSTED

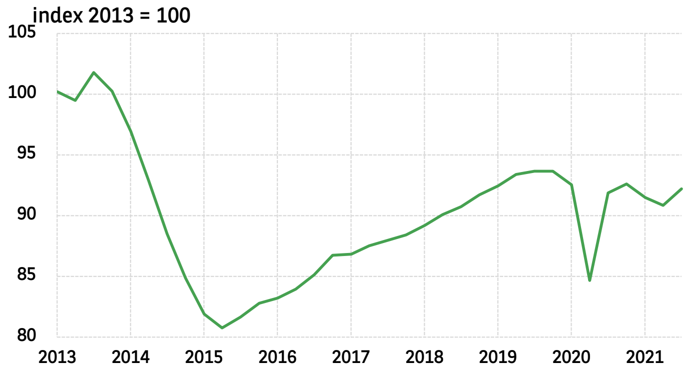

CHART 1 SOURCE: REFINITIV, BNP PARIBAS

SUPPORT FROM ECONOMIC POLICY IS CONSTRAINED

Initially, the policy mix helped support the Ukrainian economy. International financing supported this by funding the budget directly rather than payment being made to the central bank as in a traditional programme. A stable exchange rate and low inflation at the time the pandemic hit allowed the central bank to cut its policy rate. The shock of the pandemic was therefore cushioned and the recession in 2020 was fairly modest.

However, fiscal support remained more modest than in other emerging economies, with a primary government deficit (i.e. before interest costs) of 3.1% of GDP in 2020 and 1.2% of GDP in 2021 (compared to an average for emerging economies of 7.5% and 4.7% respectively). This gap can be explained by Ukraine's more limited leeway. The country had a payment default in 2014 and debt service costs increased to 3.3% of GDP in 2021.

In particular, monetary support proved temporary. The acceleration in inflation (from 2.6% in October 2020 to 6.1% three months later and 10.9% a year later) led the central bank to act at the beginning of 2021 (more than 6 months before those in other emerging economies did so). Overall, the policy rate was increased by 300 basis points, to 9%, by the end of 2021. Ukraine's exposure to inflationary risk is structural; monthly inflation figures have been above 10% half of the time since 2014. Imperfections in the transmission channels of monetary policy reduce the level of control the central bank has over these trends.

Moreover, international support has run up against persistent deficiencies in governance. The World Bank's government effectiveness indicator is amongst the lowest amongst emerging economies. This suggests that government reforms do not always feed through into facts on the ground (notably due to problems of implementation and rule of law).

The judicial reform that the government introduced was intended precisely to reduce the risk that funds invested or loaned (whether by banks or by international funders) are not misused. The high level of non-performing loans (30.1% of loans by volume at the end of 2021) demonstrates the extent of this risk.

However, internal political conflict, notably between the country's president and the constitutional court, have disrupted the adoption of these reforms. These are the symptoms of the existence of special interest groups that are delaying necessary structural changes.

The many limits on the support that economic policy could provide explain why the recovery in activity in 2021 was disappointing.

LIMITED SAFETY NETS IN THE EVENT OF AN EXTERNAL LIQUIDITY SHOCK

In a largely dollarised economy such as Ukraine, the interruption of foreign currency inflows needs to be closely monitored. A shortage, whether as the result of a shock to steel exports or to capital flows, would affect the day-to-day functioning of the economy. Repeated shortages hit growth and improvements in standards of living. In the shorter term, the risk is clearly that currency reserves could become insufficient to cover net currency outflows.

Currency reserves have increased over the past few years. The current account went from a deficit of USD 4.2 billion in 2019 to a surplus of USD 6.2 billion in 2020 and a modest deficit of USD 1.5 billion in 2021. Part of the improvement appears to be structural, with an increase in migrant remittances. Another element, linked to sales of commodities, looks more vulnerable to a downturn. Volume effects could become more positive in the short term on the back of a good cereal harvest and strong demand for metals. However, the price effect has largely been wiped out by increases in the price of imported hydrocarbons since the summer of 2021.

International financing has made a significant contribution to the increase in currency reserves. However, this effect is reversible to the extent that the loans received will need to be repaid. Ukraine's net reserves (i.e. with future repayments deducted) are much smaller than the gross figure. This highlights the importance of continued support from international institutions in the absence of a durable alternative source of financing (notably FDI).

FOREIGN RESERVES IN % OF A METRIC

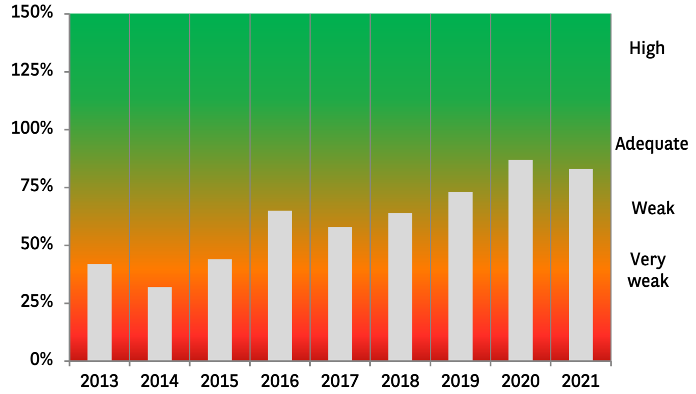

CHART 2 SOURCE: BNP PARIBAS

To assess whether or not foreign currency reserves are adequate, it is useful to quantify the threats to reserves, here summarised as follows[1]: an abrupt drop in exports (as the potential percentage reduction), potential capital outflows (as a percentage of gross liabilities to non-residents), and a sudden conversion of resident UAH assets into USD (as a percentage of M2 money supply). The first two of these percentage measures are assessed on the basis of the 2014 shock, with the conversion of M2 estimated at 5% (the standard figure used for a currency with a floating exchange rate). Adding these figures gives a metric representing the risks that currency reserves might need to cover. However, reserves remain below this figure, despite their marked increase since the 2014 crisis. External vulnerability remains high in the event of an internal or external shock, such as those seen in 2008 and then in 2014. The support of international financial institutions is essential in dealing with this liquidity risk.

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1 A method similar to that used by the IMF, Assessing Reserve Adequacy, Policy Paper (2011).

ISRAEL

FAVOURABLE OUTLOOK

The Israeli economy goes into 2022 in a favourable position. After a strong recovery in 2021, growth is likely to receive continued support from household consumption and exports. Although inflation is rising, it remains under control, which should allow the continuation of an accommodative monetary policy. Macroeconomic fundamentals remain very favourable for the shekel, although monetary tightening in the US and a possible correction in US equity markets could slow its rise. The vulnerability of public finances to an increase in interest rates remains limited, due to the essentially domestic financing of the budget deficit and the low risk of any substantial monetary tightening in the short term.

A STRONG ECONOMIC RECOVERY

The Israeli economy has held up well in the face of the pandemic. Real GDP contraction in 2020 (-2.2%) was one of the smallest in the OECD and there was a strong recovery in 2021. Real GDP growth reached an estimated 6.7% over the year as a whole. Private consumption and investment were the two main engines of the recovery. The effectiveness of the vaccine campaign (at least over the first three quarters of the year) allowed restrictions on mobility to be lifted. Household purchasing power has been sustained by moderate inflation and the reduction in unemployment over the course of the year. The unemployment rate (on its broad definition, which includes those deprived of work, even on a temporary basis, due to the pandemic) was 6.3% at the end of 2021, down from 13.2% a year earlier, whilst the employment rate has almost returned to its pre-pandemic level. Strong growth in investment (+14% y/y in Q3 2021, from +16% in Q2) was driven both by investment in residential real estate and productive investment in industry. Conversely, although exports, particularly of hi-tech services, remain an important source of support (+13% y/y over the first three quarters), the recovery in domestic demand has boosted imports (+20% y/y over the first three quarters), thus implying a negative contribution of net foreign trade to growth.

In the short term, economic activity is likely to remain strong, with growth projected at 5% in 2022. However, the resurgence of Covid-19 with the omicron variant could threaten this forecast. The variant is spreading in Israel, lagging Europe somewhat, but the government has so far opted in favour of mobility, by keeping restrictions as light as possible. However, infections are rising rapidly and some indicators argue for caution. Mobility indicators have once more been moving downwards since the beginning of the year and are well below their levels at the end of 2019. According to the Bank of Israel, credit card purchases have been losing steam since the end of 2021. Household consumption's capacity to continue to support growth could thus diminish, at least in the short term. Moreover, government support measures to households and corporates are gradually being scaled back. On the supply side, many sectors are suffering from difficulties in recruitment, particularly in services, whilst industry and construction are experiencing supply disruptions for materials and certain capital goods.

Medium-term growth prospects are favourable, thanks particularly to the competitiveness of certain sectors, most notably hi-tech. The limited economic recession seen in 2020 relative to other OECD members highlights the solidity of the Israeli economy. This said, a number of structural weaknesses remain and could hold back potential growth. Growing inequality remains a major weakness, fuelled by continued increases in property prices. There was a strong rebound in residential real estate prices over the course of 2021: they rose 10.3% y/y in October 2021, their biggest jump since mid-2011. Meanwhile, the OECD has highlighted the low level of labour productivity, which is 35% below that of the best performing OECD members. This is notably due to the marked dichotomy between hi-tech sectors and the more traditional economy, which has a domestic focus.

FORECASTS

	2019	2020	2021e	2022e	2023e
Real GDP growth (%)	3.4	-2.2	6.7	5.0	3.5
Inflation (CPI, year average, %)	0.8	-0.6	1.5	1.7	1.5
Cent. Gov. balance / GDP (%)	-3.6	-11.4	-4.5	-3.6	-3.4
Cent. Gov. debt / GDP (%)	60	73	68	67	67
Current account balance / GDP (%)	3.4	4.9	4.3	4.2	4.0
External debt / GDP (%)	26	33	31	30	30
Forex reserves (USD bn)	126	173	210	230	240
Forex reserves, in months of imports	14	22	23	23	21

e: ESTIMATE & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

REAL GDP GROWTH (CONTRIBUTIONS)

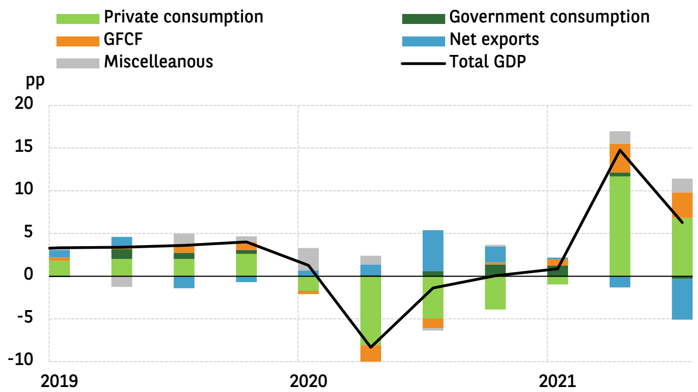

CHART 1 SOURCE: BNP PARIBAS

INFLATION IS UNDER CONTROL

Consumer price inflation accelerated during 2021, but remained well below the average for OECD countries. It was 2.4% y/y in November 2021, against an average of 5.8% for OECD members. Underlying inflation reached 2.5%, confirming the moderate inflationary pressures. Spending on housing (including energy) and transport have been the main contributors to the increase in inflation, whilst the continued appreciation in the shekel has helped keep it in check. More structurally, progress towards energy self-sufficiency, made possible by the exploitation of national gas reserves, has reduced vulnerability to rises in international energy prices. For 2021 as a whole, inflation is likely to have averaged 1.5%. In 2022 it is likely to rise a little to 1.7%, with the introduction of certain taxes, a smaller rise in the shekel and persistent pressure on international supply chains. Wage inflation remains under relatively good control for the time being, but some sectors (construction and the IT and communications industry) have seen increases in average wages of more than 13% since the end of 2019.

MONETARY POLICY REMAINS ACCOMMODATING

According to the conclusions of the most recent monetary policy committee (3 January 2022), the policy stance will remain accommodating. First, because of the continued uncertainty over the economic recovery; secondly, inflation forecasts remain within the Bank of Israel's target range of 1% to 3%. The policy interest rate has been stable at 0.1% since mid-2020. Although a tightening is possible in 2022, it is likely to be limited. Meanwhile, pandemic-related liquidity support measures have been reduced significantly since mid-2021. Repo arrangements backed by bonds had been cut to a residual amount by the end of 2021 (NIS 0.1 billion). Purchases of government bonds increased through to December 2021, reaching NIS 85 billion (5.6% of GDP), the target level set by the BoI when the programme was introduced in 2020.

As far as the exchange rate policy is concerned, the central bank has not so far announced a precise amount for foreign currency purchases in 2022 (USD 30 billion in 2021). The BoI's foreign currency reserves are at record highs (USD 209 billion in November 2021), equivalent to nearly two years of imports of goods and services. Having reached a twenty-year high against the dollar in November last year, the shekel has been more volatile since then, with no clear trend. On the one hand, macroeconomic fundamentals (current account surpluses and strong inflows of foreign direct investment) continue to be powerful sources of support for the shekel. Despite strong import growth in 2021, the current account surplus remained substantial (estimated at 4.3% of GDP) thanks in particular to the strength of exports of services. It is likely to remain above 4% of GDP in 2022. In addition, funds raised by hi-tech companies in 2021 (73% came from non-residents) again set a new record of USD 26 billion (40% higher than 2019 and 2020 combined). On the other hand, financial factors could slow the shekel's rise in 2022. In the short term, the shekel's appreciation will depend on the pace of monetary policy tightening by the Fed (which looks likely to be out of sync with any move by the BoI) and the performance of US equity markets, which affect the performance and thus the foreign currency positions of Israeli investment funds.

USD/ILS EXCHANGE RATE

CHART 2 SOURCE: BANK OF ISRAEL

FISCAL CONSOLIDATION

The budget deficit was reduced significantly in 2021, taking it to 4.5% of GDP from the record level of 11.4% seen in 2020. This was due both to a reduction in Covid-related expenditure (a reduction of 0.9% of GDP), allowing more or less stable total fiscal spending (up 0.6% y/y) and, more significantly, a sizeable increase in revenue (30%), particularly from property taxes and VAT. Debt service costs increased rapidly (+36%), but remained below 7% of total fiscal revenue.

The new government elected in June 2021 adopted the budget for 2021 and 2022 in November 2021. The 2022 budget does not include any significant reforms but puts an emphasis on spending relating to human capital (notably in order to improve access to labour markets for marginalised segments of the population) and infrastructure (particularly transport). The budget deficit is set to continue to shrink in 2022 and 2023 (to 3.6% and 3.4% of GDP respectively according to government estimates) but will not return to its pre-crisis levels (an average of 2.3% of GDP between 2015 and 2019).

From a peak of 73% of GDP in 2020, government debt is estimated at 68% of GDP in 2021. It is likely to stabilise at around 67% of GDP in 2022 and 2023. Despite this relatively high level of debt, sensitivity to an increase in interest rates is limited in the short term. As the government's debt is mainly held by domestic investors (84% of the total), local financial conditions are its main determinants. The BoI's programme of quantitative easing has held ten-year rates at fairly low levels. Meanwhile, with more than 45% of domestic bond debt being indexed to inflation, the modest level of inflationary pressures in the short term reduces the risk of a sharp rise in the government's debt service costs.

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GHANA

UNDER PRESSURE

In Ghana, the warning signs are multiplying. Although economic growth has been fairly resilient, public finances have deteriorated sharply at a time of surging inflation. This is unsettling investors and threatening economic prospects. The central bank has already reacted by raising its key policy rate. But the authorities must reassure that they are capable of reducing the fiscal deficit. For the moment, they have failed to do so. Yet severe financial constraints and a dangerously high debt burden could force them to make adjustments.

The economy has entered a zone of high turbulence that risks undermining growth prospects, which had been fairly upbeat until recently. In addition to potential sanitary risks (only 7% of the population has been fully vaccinated), Ghana must now face up to the severe mistrust of investors. Unlike most of its regional peers, Ghana's sovereign spreads have widened abruptly, increasing 430 basis points (bp) to above 1,100 bp since October (chart 1). Such a high risk premium makes accessing the international financial markets prohibitively expensive, and the country is currently shut out of them. The cedi has also come under pressure in recent months, ending the year 2021 down 6% on the US dollar, one of the worst performances of the African currencies. Moreover, the upturn in financial tensions is occurring in the midst of an inflationary surge. In November, inflation hit 12.2%, the highest rate in more than four years. In response, the central bank raised its key rate by 100 bp to 14.5%. More key rate increases could follow in 2022. Yet the tightening of monetary policy is unlikely to have more than a limited impact on macroeconomic stability, unless it is accompanied by tangible progress on fiscal consolidation. That promises to be a major challenge.

FRAGILE CONSOLIDATION OF PUBLIC FINANCES

With a total fiscal deficit still estimated at more than 12% of GDP (due to the impact of the pandemic) and debt amounting to 80% of GDP in 2021, the fiscal consolidation programme presented in November was expected. Yet despite its ambitious targets, it proved to be unconvincing. The government intends to reduce the deficit to 7.4% of GDP in 2022 and 5.5% in 2023 before bringing it below the 5% threshold as of 2024. The primary balance should swing into positive territory as of 2022, after a deficit of more than 5% of GDP in 2021. Yet there are numerous doubts about how these targets will be met.

Revenues are supposed to increase by 43% in 2022, which is three times faster than nominal GDP growth. This assumes that new taxes will be introduced and tax collection will improve substantially. Yet with fiscal resources (excluding donor funds) levelling off at 14-15% of GDP for the past decade, Ghana has one of the narrowest tax bases in sub-Saharan Africa. In addition, the main budget measure (a 1.75% tax on digital transactions, which is supposed to generate 35% of the additional revenues anticipated by the government) has not been voted on yet, due to profound disagreements with the opposition party, which has the same number of parliamentary seats as the presidential party. Even if the measure is passed, however, it remains uncertain how much revenue it will actually generate.

The 2022 budget is also expansionary, with a planned 25% increase in spending to 27% of GDP, 8 points more than the pre-pandemic level of 2019. The planned slowdown in spending as of 2023 will thus begin from historically high levels. Moreover, fiscal slippage cannot be excluded given the acceleration of inflation, especially for public-service wages, which already absorb 40% of fiscal resources. Contingent liabilities will also remain a risk, although they have tended to decline since banking sector restructuring was completed (it had a cost of about 8 points of GDP between 2017 and 2021). However, shortages in the energy sector could also generate extra costs for the government of up to 2 points of GDP per year.

FORECASTS

	2019	2020	2021e	2022e	2023e
Real GDP growth (%)	6.5	0.4	5.2	4.7	4.5
Inflation (CPI, year average, %)	8.6	9.9	10.0	9.0	8.8
Gen. Gov. balance / GDP (%)	-5.6	-13.8	-12.6	-9.4	-8.0
Gen. Gov. debt / GDP (%)	61.1	76.4	80.3	83.5	84.1
Current account balance / GDP (%)	-2.7	-3.1	-3.7	-3.5	-3.4
External debt / GDP (%)	38.9	45.5	47.0	46.9	47.5
Forex reserves (USD bn)	6.6	7.0	8.5	8.1	8.3
Forex reserves, in months of imports	2.9	3.4	3.9	3.6	3.6

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

SOVEREIGN BOND SPREADS

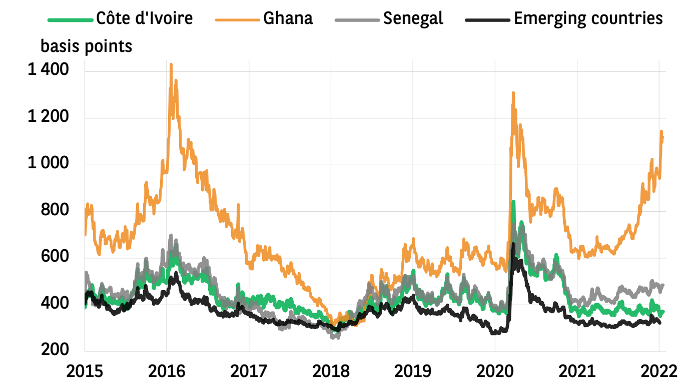

CHART 1

SOURCE: JP MORGAN

DANGEROUSLY HIGH DEBT BURDEN

It is thus highly unlikely that the authorities will meet their fiscal targets in the short and medium term, unless they are forced to comply. We expect a higher budget deficit than the government's forecasts (9.4% of GDP in 2022, 8% in 2023, *cf.* chart 2), which means the debt ratios will continue to deteriorate, at least for the next two years. At 84% of GDP at year-end 2023, public debt would swell to dangerously high levels. Moreover, its structure makes it vulnerable to multiple shocks, such as a sharper than expected growth slowdown in the emerging countries, especially in China, or the tightening of US monetary policy.

At mid-2021, non-resident investors held nearly 20% of domestic debt, the equivalent of USD 5.8 bn, compared to foreign reserves of less than USD 9 bn. As a result, despite a moderate current account deficit and an export base whose price trends are rarely synchronised (gold accounted for 47% of exports in 2020, oil for 20% and cacao for 16%), Ghana is still exposed to major capital outflows with potentially strong pressures on the exchange rate. In addition, nearly half of its public debt is denominated in foreign currency; the debt ratio automatically increases by 4 points of GDP with every 10% depreciation of the cedi.

The deterioration in external financing conditions would not be limited to pressures on external liquidity. The government plans to cover 80% of its financing needs on the domestic market. But with total bank assets accounting for 40% of GDP, the financial market is rather small. Moreover, banks are already rather highly exposed to sovereign risk. At the end of June 2021, government loans outstanding accounted for 46.5% of banking system assets, compared to 37.5% at year-end 2019. In the absence of an alternative to funding from the international market, the authorities may have to turn to the central bank again. In 2020, a monetisation programme equivalent to 2.6% of GDP helped cover a quarter of the government's domestic financing needs. However, the central bank's policy rate increase in November seems to indicate that monetary stability is being given priority again. It also risks increasing even more the already very expensive cost of government borrowing. Treasury bond rates fluctuate between 16% and 19% for maturities of 1 to 3 years. Interest payments already absorb nearly half of fiscal resources, 80% of which is for locally-issued debt instruments. The government's manoeuvring room is all the narrower since it must refinance 42% of the domestic debt over the next three years. Fortunately, the next major Eurobond does not mature before 2025.

ECONOMIC GROWTH IS BOUND TO SLOW

So far, economic activity has held up fairly well. The economy managed to escape recession in 2020, and the figures for the first 9 months of 2021 were surprisingly favourable, with average growth of 5.3%, thanks to a strong rebound in the services sector. The government's forecast of 4.4% made as part of its budget presentation is likely to be exceeded.

In contrast, the official 2022 growth forecast of 5.8% seems to be extremely optimistic. We rather expect economic growth to slow to 4.7% due to the tightening of financing conditions and monetary policy. The authorities are notably calling for a 29% increase in public investment in 2022. However, it is highly probable that the latter will serve as an adjustment variable. Another constraint stems from the persistence of major fiscal deficits.

In the banking sector, the loan-to-deposit ratio has fallen to a historically low level of 52%, nearly 10 points less than at year-end 2019. In a fragile economic environment, Ghana's banks will tend to favour the safer government securities. Yet with a non-performing loan ratio of 16.4% in November (14.3% at year-end 2019), credit risk is high. Moreover, the tightening of monetary policy will continue to deteriorate lending conditions and will further strain the growth of bank lending to the private sector, which was already negative in real terms at the end of November (-0.8%).

FISCAL AND DEBT INDICATORS

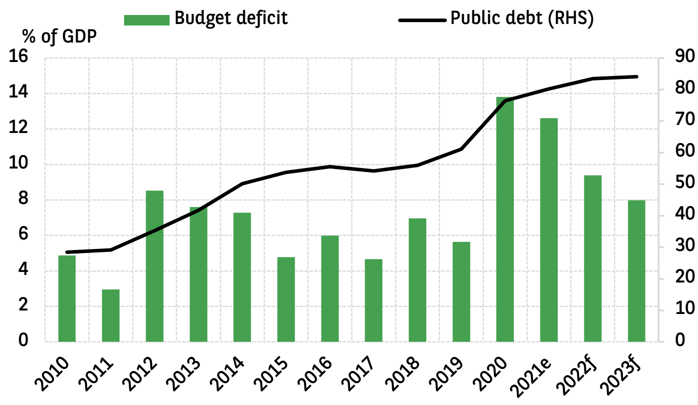

CHART 2 SOURCE: MOF, BNP PARIBAS

Looking beyond Ghana's economic growth momentum, the main source of concern is the risk of a new episode of macro-financial stress. In 2015, after the cedi had declined by nearly 50% against the USD in two years, the authorities decided to sign a funding agreement with the IMF. For the moment, the authorities do not think they will need to call on this assistance, but the warning signals are multiplying.

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SAUDI ARABIA

A PERIOD FAVOURABLE TO REFORMS

Economic recovery is likely to be strong in 2022, driven by buoyant household consumption and rising oil GDP. Labour market reforms are having a positive effect on domestic demand, most notably via a significant increase in women's participation rates. Inflationary risk remains moderate, even though wage pressures have increased recently. With the increases in oil prices and output, there is likely to be a budget surplus this year. This is due in particular to progress in the diversification of fiscal revenue. The higher level of oil prices will be a test for the government's willingness to continue the budget consolidation process. Despite ambitious development plans, economic diversification has so far made only marginal progress, due most notably to weak levels of foreign direct investment. Over the medium term energy will remain a major area for investment.

A MORE BALANCED RECOVERY IN 2022

The economic recovery has gathered pace since mid-2021 thanks to the combination of rising oil production and a rebound in Saudi household consumption. However, for the year as a whole, GDP growth is likely to have been 2.8%, due to the drop in oil GDP (-0.9% expected). In line with the policy adopted by OPEC+ members (OPEC plus Russia, essentially), crude oil production was reduced until April 2021. The recovery in global demand and OPEC+'s dominant position in the oil market has allowed member countries to ramp up production since mid-2021 (adding some 400,000 barrels/day each month). From a low point in April, Saudi production increased by 21% to 9.9 million barrels/ day by November 2021. Non-oil GDP is likely to have grown by 5.2% in 2021, driven by recoveries in household consumption and investment, each of which grew by around 11% on average over the first three quarters of the year.

Growth is likely to rebalance and accelerate in 2022, reaching 5.7%. Rising oil production, if it continues, is likely to push oil GDP 8.8% higher over the year as a whole. Household consumption and investment will remain the main engines of non-oil GDP growth (expected at 3.7%). The policy of Saudisation of employment in certain sectors and improving access to the labour market for women has had a positive effect on household disposable income. Although the participation rate amongst men has been stable at around 65% over the past two years, that for women has increased significantly, from 20% at end-2018 to 34% in September 2021. In parallel with these changes in the labour market, the number of non-Saudi workers has fallen since 2020. However, this category remains dominant, representing 76% of the total active population in 2020.

Consumer price inflation should ease slightly this year (to an expected 3% from an estimated 3.5% in 2021), in the absence of any further increase in VAT. The acceleration of wage rises seen since mid-2021 (more than 5% y/y in both Q2 and Q3 2021) is likely to support consumer spending in the short term. However, wage pressures could fuel core inflation.

The recent spread of the Covid-19 Omicron variant is a source of particular uncertainty. For the time being, mobility indicators have shown no slowing of consumption. However, government spending is unlikely to support growth. The proposed budget for 2022 includes virtually stable current spending and a significant reduction in investment, which has been transferred to the Public Investment Fund (PIF), the country's sovereign wealth fund. The PIF plans to invest around USD 40 billion per year (some 5% of GDP) in the national economy. However, the capacity of the Saudi economy to absorb such investment is limited and the fund was only able to spend half of this sum in 2021.

FORECASTS

	2019	2020	2021e	2022e	2023e
Real GDP growth (%)	0.4	-4.1	2.8	5.7	2.3
Inflation (CPI, year average, %)	-1.2	3.4	3.1	3.0	1.7
Central. Gov. balance / GDP (%)	-4.5	-11.2	-1.4	3.6	2.5
Central. Gov. debt / GDP (%)	23	33	29	25	23
Current account balance / GDP (%)	4.8	-2.8	3.8	6.8	2.5
External debt / GDP (%)	24	34	30	30	29
Forex reserves (USD bn)	500	454	470	503	507
Forex reserves, in months of imports	27	30	28	28	26

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

TABLE 1

REAL GDP

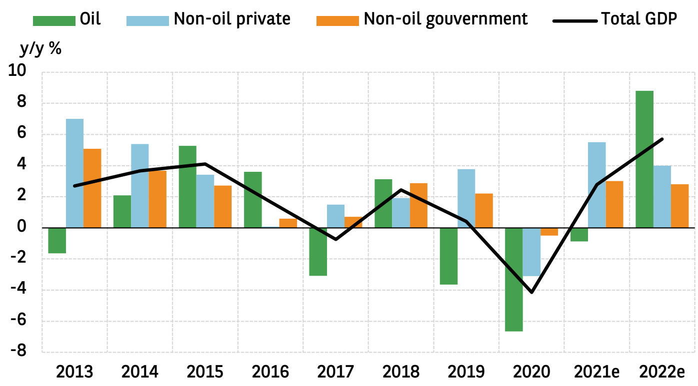

CHART 1 SOURCE: BNP PARIBAS

In 2023, growth is likely to slow to 2.2% as oil production stabilises. Public sector investment will remain a driving force, but the kingdom remains relatively unattractive for international investors. Foreign direct investment (FDI) was equivalent to 0.7% of GDP on average between 2016 and 2020. The exceptionally high levels seen during the first three quarters of 2021 (USD 17.4 billion, or 2.1% of GDP) was due to the sale of 49% of national oil company Aramco's oil pipeline division to a consortium of international investors. A similar deal, this time for the gas pipeline network (signed at the end of 2021), is likely to bring in a slightly higher amount in 2022. Although these financial transactions represent a significant boost to FDI they do not have direct consequences for productive investment in Saudi Arabia. Amongst the many investment programmes announced in recent years which have aimed to transform the Saudi economy, those in the energy sector, in the broad sense of the term, currently look the most promising.

From a more structural point of view, the diversification of the economic structure is making very slow progress. Although energy extraction has lost 7.5 points of its share of total GDP over the last decade, taking it to 35%, no other sector has seen a significant increase in its weighting in the economy. Only financial services (2.2 points) and real estate sector services (1.6 points) have made some small gains.

MASSIVE INVESTMENT IN ENERGY

The asset sales by Aramco should help it pursue its ambitious investment plan. Benefiting from a significant comparative advantage in terms of production costs and low levels of carbon emissions per barrel of oil extracted, oil production capacity could be increased by 1 million barrels/day (mb/d) to reach 13 m b/d in the medium term.

Against the global background of rapid changes in the energy sector, most notably with changes of strategy by some international oil companies, Aramco aims to remain a key energy market player in the medium and long term, and to contribute to the development of the Saudi energy mix towards less carbon-intensive sources. Currently national electricity production comes from oil (42%) and gas (57%). The authorities' goal is to achieve a 50-50 split between gas and renewables. Significant investment is planned to increase gas and solar power production. Over the longer term, the country's vast hydrocarbon reserves could fuel the production of blue hydrogen.

A RETURN TO BUDGET SURPLUS

In 2020, the combined fall in oil prices and production resulted in a record budget deficit, at 11.2% of GDP. This forced the government to continue its consolidation of the public finances, by tripling the VAT rate. These tax changes reduced the dependence of fiscal revenue on oil income. Non-oil revenue is now equivalent to between 35% and 40% of the total, from 10% in 2013. This has the positive consequence of reducing the oil price at which the budget is balanced. This fiscal breakeven price is likely to be below USD 70/barrel in 2022, compared to USD 84/barrel on average between 2015 and 2019.

The price of a barrel of oil (Brent equivalent) is likely to remain above USD 73 through to 2023, so a return to a budget surplus is expected from 2022 (3.6% of GDP in 2022, then 2.5% in 2023). Non-oil revenue is also likely to grow over the next two years, thanks in particular to strong household consumption. On the spending side, trends are less clear. The continued transfer of investment spending to the PIF will partly offset the expected increase in current expenditure.

With this return to surplus, government debt will continue to fall, reaching 23% of GDP in 2023. However, bond issues on international markets will continue, if only to cover significant debt principal repayments. Government assets held with the central bank (the most liquid) will continue to grow. In 2021 they increased by USD 20 billion, to USD 173 billion by November (21% of GDP).

FISCAL BALANCE

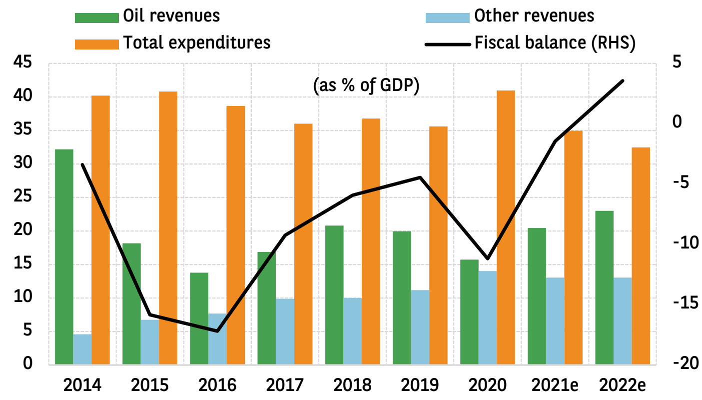

CHART 2

SOURCE: BNP PARIBAS

From an historical point of view, however, this is a low level, as such assets were more than 50% of GDP up until 2014. At the same time, the value of assets managed by the PIF will increase thanks to the sale of public assets, the use of leverage and the reinvestment of profits. The figure currently stands at around USD 450 billion, or 54% of GDP. If we take only the most liquid assets into account (thus excluding the PIF), the government's net asset position remains slightly negative, at -8% of GDP.

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