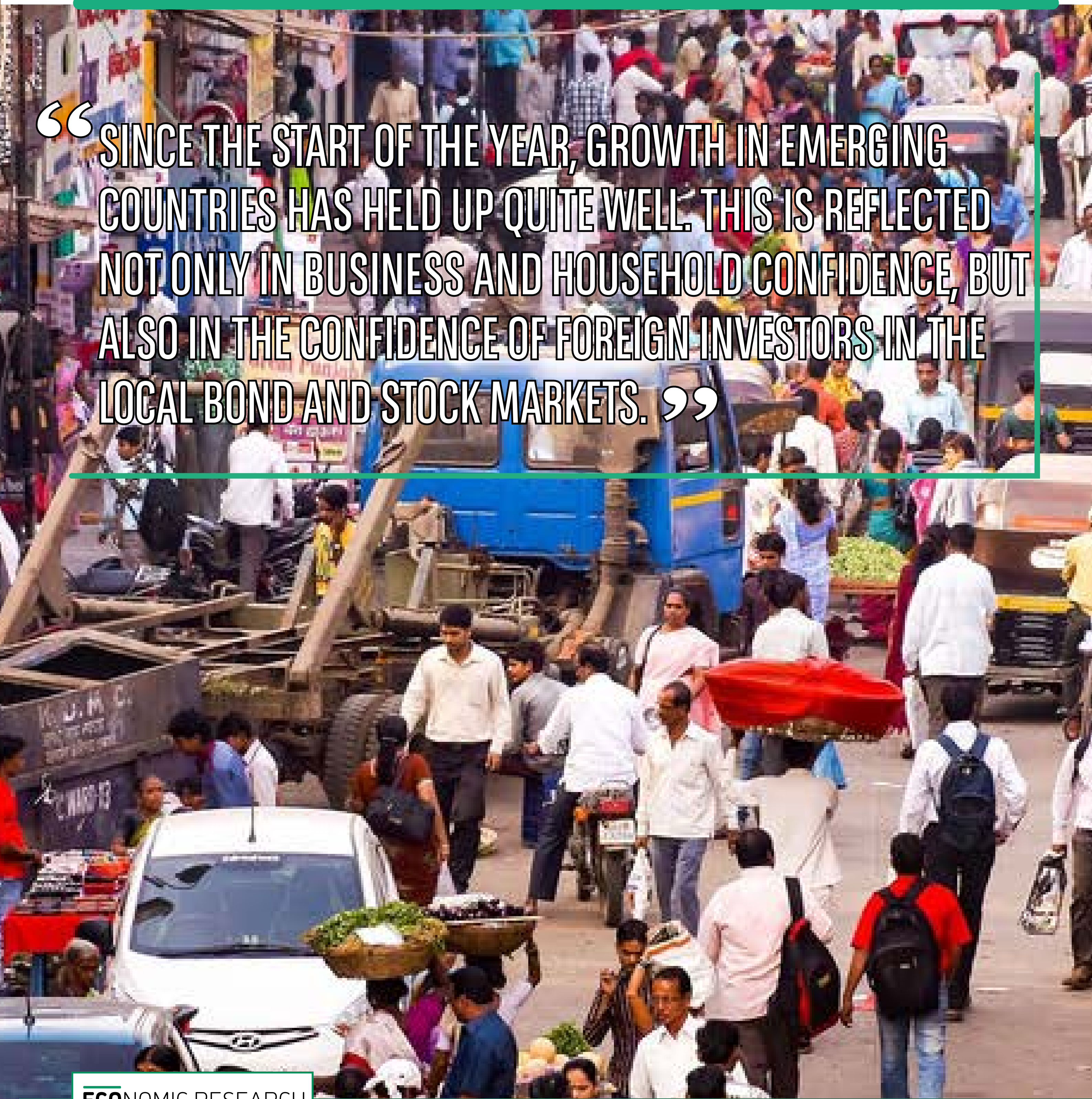
ECOEMERGING

3rd quarter 2024
July 2024



"SINCE THE START OF THE YEAR, GROWTH IN EMERGING COUNTRIES HAS HELD UP QUITE WELL. THIS IS REFLECTED NOT ONLY IN BUSINESS AND HOUSEHOLD CONFIDENCE, BUT ALSO IN THE CONFIDENCE OF FOREIGN INVESTORS IN THE LOCAL BOND AND STOCK MARKETS."

ECONOMIC RESEARCH

BNP PARIBAS

The bank
for a changing
world

TABLE OF CONTENT

EDITORIAL

3 **Emerging economies: the mainsprings of confidence**

Since the start of the year, growth in emerging countries has held up quite well. This is reflected not only in business and household confidence, but also in the confidence of foreign investors in the local bond and stock markets. The tightening of US monetary policy from early 2022 to mid-2023 did have a major negative impact on portfolio investment flows. However, this impact was largely offset by the attractiveness of emerging markets for both private and institutional investors, whether for purely financial reasons (carry trade strategies) or as part of a diversification strategy. The forthcoming monetary easing in the United States should, in this way, should lower local bond yields and, in so doing, curb the rise in interest charges on public debt in a large majority of countries over the recent years.

CHINA

5 Dual circulation still difficult

INDIA

7 Less free rein

TAIWAN

9 Solid growth in a divisive climate

CENTRAL EUROPE

11 A fairly successful integration

HUNGARY MAKE OR

13 Fiscal consolidation will constrain growth

BRAZIL

15 The real economy and markets: the quest for synchronicity

MEXICO

17 A challenging political shift

ARGENTINA

19 Make or break

ALGERIA

21 Positive signs but major challenges

NIGERIA

23 Ongoig reforms

LOW CARBON TRANSITION

25 Latin America and Gulf Cooperation Council: different ways to face the low carbon transition

EMERGING ECONOMIES: THE MAINSPRINGS OF CONFIDENCE

Since the start of the year, growth in emerging countries has held up quite well. This is reflected not only in business and household confidence, but also in the confidence of foreign investors in the local bond and stock markets. The tightening of US monetary policy from early 2022 to mid-2023 did have a major negative impact on portfolio investment flows. However, this impact was largely offset by the attractiveness of emerging markets for both private and institutional investors, whether for purely financial reasons (carry trade strategies) or as part of a diversification strategy. The forthcoming monetary easing in the United States should, in this way, should lower local bond yields and, in so doing, curb the rise in interest charges on public debt in a large majority of countries over the recent years.

Since the start of the year, growth in the emerging world has help up quite well, and has even strengthened in several countries. In Q1 2024, the aggregate GDP of our sample of 26 EM countries continued to grow at a rate of just over 1% q/q for the third consecutive quarter. Over a year, the increase stood at 4.7%. Excluding China, the global picture is the same. However, unlike China, the main emerging economies have not benefited, or at least not to the same extent, from the recovery in exports.

Whether it is an explanatory factor in per se mirrors other factors, business, investor and, to a lesser extent, household confidence has improved, supporting domestic demand and limiting the impact of US monetary tightening and local monetary policies on domestic interest rates.

RENEWED CONFIDENCE AMONG HOUSEHOLDS, BUSINESSES AND FOREIGN FINANCIAL INVESTORS

During Q2, the PMI indices consolidated or remained well above 50, the threshold above which manufacturing activity is considered to be expanding. The only exception is South Africa, where the PMI stagnated.

Household confidence presents a more mixed picture, with a clear improvement until the last few months for Central European countries, and, in the majority of cases, a levelling off since the end of 2023 following a clear upturn in 2022-2023, in line with i) the slowdown in inflation, often coupled with monetary policy easing, ii) the wage catch-up and iii) employment growth. In China, however, household mood has remained low since the start of the property crisis, with the after-effects still being felt (see below). In Argentina, household confidence has plummeted since the start of the year as a result of the shock therapy inflicted on the population by President Milei in an attempt to curb hyperinflation (see below). In South Africa, it is stagnating below the waterline against a backdrop of a near recession. Finally, in Turkey, household confidence is in between, with an improving trend since 2022, but it is still at a historically low level and, above all, has a very erratic profile.

Foreign investor confidence in the local stock and bond markets is holding up well, and has shown surprising resilience/capacity to bounce back after external real or financial shocks over the last four years. This has also been the case over the last six months, despite the heightened geopolitical risks and the revision by financial markets of the timing and the scale of US monetary easing.

According to balance of payments data, net portfolio investment inflows from non-residents (in debt securities and equities) into the main

PORTFOLIO INVESTMENTS NET INFLOWS TO THE MAIN EMERGING MARKETS (USD BN)

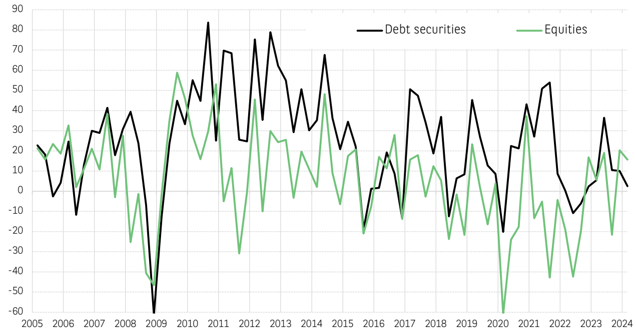


CHART 1 SOURCE : IIF - BNP PARIBAS ECONOMIC RESEARCH

emerging markets (see chart 1) stood at USD 179 bn from November 2023 to May 2024 (USD 95 bn excluding China) and USD 277 bn since the US Federal Reserve (FED) first raised its key rate in March 2022 (USD 338 bn excluding China). However, US monetary tightening has been particularly pronounced (+525 basis points between 17/03/2022 and 27/07/2023).

Could it be that the emerging financial markets have become less sensitive to monetary tightening on the other side of the Atlantic?

US MONETARY POLICY AND PORTFOLIO INVESTMENT IN EMERGING COUNTRIES: A VERY STRONG CAUSAL LINK REMAINS

According to the IMF, a 100 basis point rise in US long-term bond yields leads to an equivalent rise in domestic interest rates in emerging countries after two years[1]. We can therefore assume that US monetary tightening has had a significant knock-on effect on portfolio investment flows in debt securities by non-resident investors (commonly known as the «flight to quality»). However, this negative impact has clearly been more than offset by other factors.

In order to verify these assumptions, we modelled and simulated the (net) inflows of investments in debt securities by non-residents using a simple linear equation, estimated on a panel of 16 countries observed over the period Q1 2012-Q4 2019, with the dependent variable being investment flows (as a % of GDP) and the explanatory variables being 1) quarter-on-quarter real GDP growth, 2) a measure of the carry trade between government bond yields in local currency and US government bond yields, 3) the FED funds rate and 4) a time trend (the same for all countries)[2].

1 Fiscal Monitor - April 2024

2 The sample of countries includes Brazil, Chile, Colombia, Mexico, India, Indonesia, Malaysia, the Republic of Korea, Taiwan, Thailand, Hungary, Poland, This equation reproduces investment flows satisfactorily over the recent period (applied to the aggregate variables for the 16 countries, the simulation of the equation gives weak residuals that are not very autocorrelated since 2021 - see graph 2).

According to our equation, the latest US monetary tightening would have generated significant investment outflows since 2022: -3.6% of GDP cumulatively over the period Q1 2022-Q1 2024, or USD -384 bn, compared with observed cumulative flows of USD 51bn. Changes in the carry trade variable suggest that around USD 34 bn of capital inflows would have resulted from purely speculative arbitrage transactions. Finally, the contribution of real GDP growth was practically zero.

Therefore, it was the time trend that essentially offset the outflows resulting from US monetary tightening. This variable, which serves as a control variable in the equation, probably captures investors' diversification strategies in favour of emerging markets, against a backdrop of growing financing requirements for governments and companies on their local bond markets. This is particularly true for institutional investors (sovereign wealth funds and central banks), who have very different motivations than carry traders.

The confidence of non-resident investors is also reflected in their portfolio investments in equities. The econometric estimate of investment flows, using the same methodology as the one used for debt-security investment flows, but with a slightly different set of explanatory variables, is of a much lower quality[3]. Over the recent period, the equation significantly overestimates and then underestimates the trends observed (see chart 2). A financial stress variable specific to the COVID crisis would help to reduce these discrepancies[4]. However, beyond the econometric caveats, the impact of US monetary tightening was as strong as for debt investment flows, as the value of the elasticity to the Fed Funds rate is very close in both equations and investment flows were of an equivalent amount at the end of 2019.

In 2024, the expected easing of US monetary policy should generate portfolio investment inflows to emerging markets and therefore, all other things being equal, should lower bond yields, even if this driver is, in principle, less powerful than it was previously[5]. Households and businesses could in turn benefit if this fall is passed on to bank lending rates. Above all, it would help to curb the rise in interest charges on public debt that we have seen in recent years.

RESIDUALS OF EQUATIONS OF PORTFOLIO FLOWS TO EM (IN STANDARD DEVIATIONS OF INVESTMENT FLOWS)

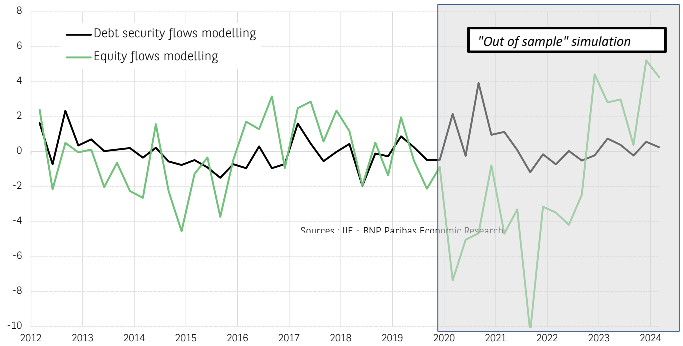


CHART 2

SOURCE:BNP PARIBAS ECONOMIC RESEARCH

François Faure
francois.faure@bnpparibas.com

the Czech Republic, Turkey, Russia and South Africa. It does not include China because, compared with other countries, portfolio investments are still being highly regulated. The period begins in 2012 only because of lack of data for yields and deliberately stops in Q4 2019, as the data beyond this date are affected by purely exogenous external shocks (COVID crisis and the war in Ukraine). However, extending the time horizon for the sample at the cost of introducing two additional time indicator variables does not improve the accuracy of the estimate.
The carry trade variable is the bond yield spread divided by the volatility of the exchange rate against the USD (calculated over a 5-year period).
The parameters were estimated by applying the ordinary least squares method to data in deviation from individual mean values (Within estimator) in the simplest dynamic form (i.e., with an endogenous variable with a one-quarter lag). Estimates by instrumental variable (which is in principle recommended for dynamic models) are not necessary given the low autocorrelation of the residuals.

3 The carry trade variable is replaced by the government bond yield (in local currency) as a proxy for the discount factor. The overall quality of the estimate is much lower than the estimate for the previous equation; the average residual, measured as the standard deviation of the endogenous variable, is 1.2 compared with 0.7 for debt-security investment flows. The estimate gives a value of -0.14 (statistically significant) for the Fed funds rate, -0.07 for the bond yield (statistically non-significant) and 0.01 for real GDP growth (statistically non-significant). As with the debt flow equation, the time trend coefficient is positive and statistically significant.

4 However, this is to the detriment of the frugality condition imposed by the finite size of the sample in its temporal and, above all, individual dimensions. This is a second reason why we have restricted the estimate to the pre-Covid period.

5 The share of government bonds denominated in local currency held by non-resident investors has fallen since (at least) the middle of the decade, from around 25% to 15%.

CHINA

DUAL CIRCULATION STILL DIFFICULT

In China, manufacturing activity remains dynamic, but rising tensions with most of its trading partners and an increase in protectionist measures are now weighing on export prospects. At the same time, domestic demand continues to be held back by the crisis in the property sector, and credit growth is slowing despite monetary easing measures. Therefore, the authorities are expected to continue to ease cautiously their economic policy in the coming months. The financial difficulties of local governments and, more generally, the deterioration in public finances have reduced the fiscal room for manoeuvre. The central government is being pressed to take a more direct role in support measures.

PROTECTIONIST THREAT

The various components of Chinese economic growth have exhibited varying trajectories since the beginning of 2024. Overall performance is somewhat lacklustre. Following a rebound to +1.6% q/q in Q1 2024, growth is expected to slow in Q2.

In recent months, economic activity has been largely driven by the momentum seen in the export-oriented manufacturing sector, which itself has been supported by the Chinese authorities' very ambitious industrial policy. Although slowing slightly in May, growth in industrial production reached +6.2% year-on-year (y/y) over the first five months of 2024 (compared to +5.2% in H2 2023). This growth rate is close to rates posted in pre-Covid years (*Chart 1*). Meanwhile, investment in the manufacturing sector has increased at a steady pace since the beginning of the year (+9.6% y/y compared to +6.5% in 2023).

Growth in the industrial sector has been largely driven by the production of goods for export in the high-tech and green-technology sectors. For example, chip production and electric vehicle (EV) production jumped by more than +30% y/y over the first five months of 2024. Exports valued in current dollars recorded a modest increase over the first four months of 2024 (+2% y/y), and then rebounded by +7.6% y/y in May. It is worth noting that volumes of exports reached record levels (+10% y/y in Q1 2024), with Chinese companies gaining global market share thanks to lower sale prices.

These strategies have led to heightened tensions between China and most of its trading partners. Consequently, while the export outlook remains positive in the very short term, it could be quickly dampened by the surge in protectionism. In fact, various protectionist barriers have been implemented or are being considered: i) the European Union will be imposing tariffs on imports of Chinese EVs from July 2024, ranging from 17.4% to 38.1% depending on the automaker; ii) the United States has recently increased its tariffs on a range of Chinese goods such as EVs, semiconductors and medical devices (and presidential candidate Donald Trump is even threatening to apply, if elected, a significant increase in US tariffs on all Chinese goods); and iii) a growing number of emerging countries are following suit. Turkey, for example, has just announced additional tariffs on imports of Chinese vehicles, and a number of governments have launched investigations into Chinese subsidies (including Brazil in the steel sector and Vietnam in the wind power sector).

NEVER-ENDING CRISIS IN THE PROPERTY SECTOR

In the services sector, activity strengthened in May and increased by +5% y/y over the first five months of 2024 – compared to average growth of +7.6% over the three years preceding the pandemic. The services sectors benefited in May from the strengthening in retail sales growth, which nevertheless remained modest (+3.7% y/y in value). Inflation has accelerated slightly but remains very low; the consumer price index rose by +0.3% y/y in April and May, after 0% in Q1 2024 and -0.3% y/y in Q4 2023.

Above all, the main obstacle to domestic demand growth remains powerful, as the property crisis shows no signs of improvement. Housing sales volumes continued to contract (-24% y/y over the first five months of 2024), as did property starts (-25%).

FORECASTS

	2021	2022	2023	2024e	2025e
Real GDP growth, %	8.4	3.0	5.2	5.2	4.3
Inflation, CPI, year average, %	0.9	2.0	0.2	-0.1	1.2
Official budget balance / GDP, %	-3.1	-2.8	-3.9	-3.8	-3.6
Official general government debt / GDP, %	46.8	50.6	56.1	59.0	62.0
Current account balance / GDP, %	2.0	2.5	1.4	1.4	1.2
External debt / GDP, %	15.4	13.7	13.8	13.2	12.8
Forex reserves, USD bn	3 250	3 128	3 238	3 233	3 203
Forex reserves, in months of imports	12.6	11.9	12.4	11.8	11.1

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

CHINA: DIVERGENCES BETWEEN SECTORS

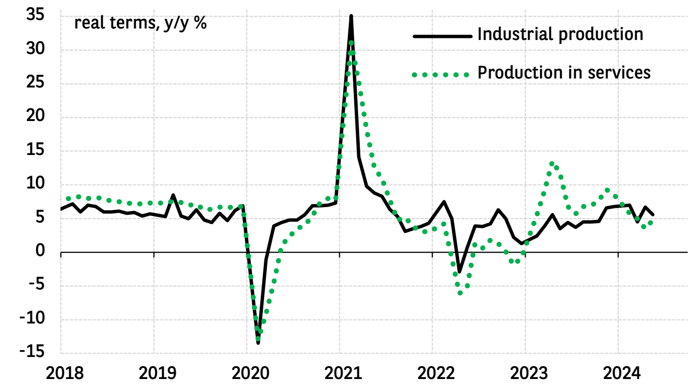


CHART 1 SOURCE: NBS, BNP PARIBAS

Real estate investment continued to fall (around -10% y/y over the first five months of 2024). In addition, the decline in property prices worsened (-7.5% y/y on average in May for second-hand homes in the 70 main cities, compared to -4.1% y/y in December 2023). The package of new support measures announced by the authorities in May has not yet been able to have a positive effect on activity in the property sector. These measures include a further easing of mortgage lending conditions (with a lowering in the minimum down payment requirement and measures aimed at reducing interest rates) and a programme for local governments to buy unsold homes, aimed at reducing developers' stocks of unsold homes and increasing stocks of social housing.

LOWER CREDIT GROWTH

More generally, growth in total domestic credit has slowed since the start of the year, despite the accommodative monetary policy stance (*Chart 2*). Total outstanding Aggregate Financing (TAF) rose by 8.4% y/y in May 2024 compared to +9.8% in December 2023, and total bank loans in local currency (representing 64% of TAF) rose by +8.9% y/y in May, compared to +10.9% in December. Conversely, central government and local government bond issues have increased at a slightly steadier pace since Q4 2023, in order to support the rise in public spending (in particular investment in infrastructure, environmental projects and social housing).

Given the persistence of the property crisis, the lack of vigorous activity in services and the emergence of new risks weighing on export prospects, the authorities are expected to ease their fiscal and monetary policies further in the coming months. Their approach will remain cautious. Firstly, the central bank's action is currently hampered by capital outflows and depreciation pressure on the yuan – which are expected to ease once the US Federal Reserve starts its rate cut cycle, i.e. in Q4 2024, according to our forecasts. Secondly, the authorities' room for manoeuvre to stimulate credit is still significantly constrained by the excessive level of corporate and local government debt. The central bank governor recently stated that support for economic activity should involve better credit allocation rather than a faster increase in total outstanding credit.

PUBLIC FINANCES NOT AS STRONG AS BEFORE THE PANDEMIC

The financial difficulties of local governments and, more generally, the gradual deterioration in public finances are also increasingly limiting the authorities' fiscal room for manoeuvre.

In fact, fiscal balances and government debt have deteriorated sharply in recent years. Based on IMF estimates, the total general government deficit increased from 3.9% of GDP on average over the years 2015-2019 to over 7.5% since 2020. This increase can be explained by the rise in public spending, linked in particular to the health crisis, by the weakening of tax revenues, and by the fall in local governments' land sales proceeds. Meanwhile, the "official" budget deficit increased from an average of 2.7% of GDP in 2015-2019 to 3.9% in 2023. But this deficit does not accurately reflect the situation of the public accounts as a whole, since it represents the general government balance adjusted for various transfers from other public accounts, on which the available data remains incomplete.

CHINA: MONETARY LOOSENING

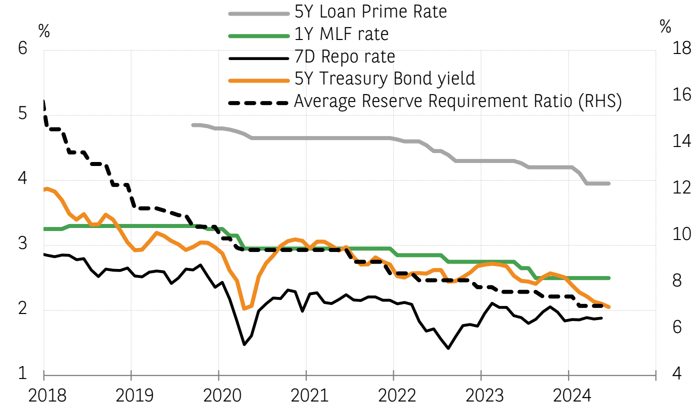


CHART 2 SOURCE: PBOC, NIFC, BNP PARIBAS

Between 2018 and 2023, the total official debt of the general government increased from 36.4% to 56.1% of GDP. This is budgeted debt, consisting of bonds issued by central government (23.8% of GDP in 2023) and local governments (32.3% of GDP). Central government bond debt alone is still at a moderate level and faces no refinancing risk. Its profile is very favourable, since it consists mainly of securities in local currency (98.9% of the total), issued at low interest rates and held by local financial institutions. Foreign investors held 8.7% of central government bonds at the end of 2023 (compared with a peak of 11.9% at the end of 2021).

As far as local governments are concerned, bond debt is at a higher level, and is becoming less and less sustainable for some provinces and municipalities. But above all, this "official" debt is aggravated by an indirect debt contracted by local government financing vehicles (LGFVs). LGFV debt rose from 38% of GDP in 2018 to 53% in 2023, according to IMF estimates, and is excessively high. The risk of default by LGFVs has risen sharply over the past two years. As a result, since last year Beijing has authorised certain local governments to issue new bonds to refinance the most fragile LGFVs and thus reduce short-term liquidity risk. However, these measures are modest in scale (debt swaps in 2023 represented just 1.2% of GDP). In addition, the liabilities of local governments are increasing, so the medium-term solvency risk remains. The authorities have also asked banks to restructure some of their loans to LGFVs (by extending maturities and/or reducing interest rates). But this solution also has its limits, as it weighs on the performance of the banking sector.

In addition, the central government is increasing its direct role in fiscal stimulus policy and support for local governments. In mid-May, for example, it launched a programme to issue very long-term bonds (20 to 50 years), worth RMB 1,000 billion for 2024 (0.8% of GDP). Half of this amount is to be used to cover the financial needs of the central government, and the other half is to be transferred to local governments. In the short to medium term, general government debt is expected to continue to rise, mainly due to the persistence of high fiscal deficits against a backdrop of structurally slower economic growth. At the same time, the central government's share of total outstanding debt is likely to increase gradually.

Christine Peltier
christine.peltier@bnpparibas.com

INDIA

LESS FREE REIN

Indian economic growth reached 8.2% for the fiscal year 2023/2024. However, this performance did not enable Narendra Modi's ruling Bharatiya Janata Party (BJP) to retain a majority in parliament. Over the next five years, the BJP will have to deal with the smaller parties that are partners in the coalition it leads to run the country. Adopting new reforms to further liberalise the economy could prove difficult. In addition, the Prime Minister may have to change the structure of budget spending in order to increase once again the share of subsidies and other social transfers, which have been falling for the past five years. Such a change in strategy could slow the ongoing fiscal consolidation and/or put the brakes on infrastructure development, which is essential to attract foreign direct investment and adapt to climate change. This would, in turn, have a negative impact on medium- and long-term economic growth.

GROWTH FORECAST FOR 2024/2025 REVISED UPWARDS

In the fiscal year (FY) 2023/2024 (ended in March 2024), India's economic growth exceeded the government's forecasts. It accelerated to 8.2% (the highest level among Asian countries) after reaching 7% in FY2022/2023. However, the rate of growth in value added, which better reflects the development of economic activity than GDP (because GDP includes the impact of indirect taxes), was lower (+7.2% compared with +6.7% the previous year).

Unlike in the last ten years, the main growth driver was not household consumption, which slowed significantly, but investment. The investment rate reached 33.5% of GDP (compared with 32.4% five years ago). Net exports, on the other hand, made a negative contribution to growth.

The growth outlook for FY2024/2025 has been revised upwards, due in particular to a favourable base effect in the fourth quarter of the FY2023/2024 (growth having reached +7.8% year-on-year). Economic activity is expected to reach 7.2% according to the latest forecasts from the Reserve Bank of India (RBI).

April's activity indicators show that industrial production remained strong (+5% y/y after growing by 5.1% in Q1 2024). Urban and rural household demand accelerated. Investment remained dynamic, albeit at a slower pace if the trend in bank credit is anything to go by (+7.4% y/y in April for the industrial sector compared with +8.8% in Q1 2024). Production capacity utilisation rates remained high and corporate balance sheets continued to improve. Business confidence strengthened and household confidence returned to pre-pandemic levels.

Inflationary pressures continued to ease, albeit at a slow pace (+4.7% y/y in May compared with +5% in Q1 2024). While the rise in energy prices eased, the rise in food prices remained high (+8.7% y/y in May). What's more, extreme heat in June and below-normal water reserves (-8% nationwide) are putting summer harvests and fruit and vegetable prices at risk. Fortunately, these inflationary factors could be offset by a fall in cereal prices compared with last year. According to forecasts made by the India Meteorological Department (IMD) at the end of May, the monsoon (which began at the start of June and will finish at the end of September, and which is decisive for the winter harvest) should be slightly more intense than normal this year. If these forecasts are confirmed, pressure on food prices could ease, allowing the RBI to ease monetary policy in the fourth quarter of 2024. Nevertheless, the RBI remains cautious about its inflation forecasts (+4.5% over the current 2024/2025 financial year as a whole).

FORECASTS

	2021	2022	2023e	2024e	2025e
Real GDP growth, % (1)	9.7	7.0	8.2	6.9	6.7
Inflation, CPI, year average, % (1)	5.5	6.7	5.4	4.7	4.3
General gov. balance / GDP, % (1)	-9.5	-9.6	-8.8	-8.3	-7.7
General gov. debt / GDP, % (1)	85.2	85.0	83.3	82.7	82.0
Current account balance / GDP, % (1)	-1.2	-2.0	-0.7	-1.5	-1.8
External debt / GDP, % (1)	19.7	18.4	18.7	19.0	18.5
Forex reserves, USD bn	618	562	618	578	620
Forex reserves, in months of imports	7.9	6.7	8.6	8.1	8.5

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

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

INDIA: STRONG REAL GDP GROWTH

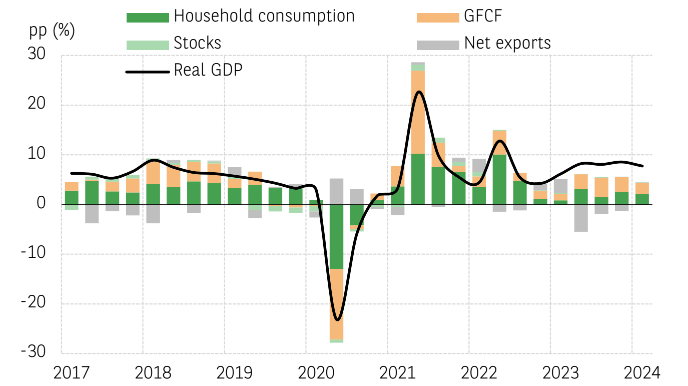


CHART 1 SOURCE: CEIC, BI, BNP PARIBAS

MODI'S PARTY HAS LOST ITS MAJORITY IN PARLIAMENT

Narendra Modi's party, the Bharatiya Janata Party (BJP), lost 63 seats in the Lower House of Parliament (*Lok Sabha*) in the June 2024 general elections. Its losses are concentrated in three states: Uttar Pradesh (-29 seats), Maharashtra (-13 seats) and Rajahsthan (-10 seats). With 240 out of 543 seats, it no longer has an absolute majority (272 seats).

However, its coalition party, National Democratic Alliance (NDA) has 293 seats, 59 more than the opposition alliance (I.N.D.I.A) led by the Indian National Congress. The latter won 47 more seats than in the last elections in 2019.

For its third term in office, the new Modi government's room for manoeuvre will therefore be less comfortable than when it took power in 2014 and 2019, when the BJP had an absolute majority. However, it is common practice in India for a prime minister to govern without their party having a majority. Remember that in 2014, it was the first time that a party had had a majority in the Lower House of Parliament since the victory of the Congress in 1984.

The composition of the new government, led for a third term by the outgoing Prime Minister, Narendra Modi, suggests that the policies pursued will be in line with those of previous governments. Of the 71 members of this new government, only 11 are from outside the BJP. Some key ministers, such as the finance minister, have been reappointed for a second term. But even if the political environment is expected to remain stable, the Modi government will find it more difficult to adopt new structural reforms to liberalise the country. In particular, it seems unlikely that it will succeed in convincing the parties in its coalition to vote in favour of the amendment on land acquisition that it had hoped to resubmit to Parliament, even though it would have encouraged the development of the industrial sector.

To date, apart from a freeze on reforms, the main risk posed by this coalition government is a slippage in public finances and/or a review of the budget structure.

PUBLIC FINANCES: BUDGETARY MARGINS ARE STILL TIGHT

Public finances are one of the biggest constraints for the new government. Even though the elections revealed the dissatisfaction of part of the population (due to high unemployment, particularly among young people, and a sharp rise in inequality), the government's fiscal room for manoeuvre to increase social spending is limited because fiscal revenues remain low and debt interest payment are high. Furthermore, an increase in social spending would run counter to the fiscal strategy pursued by the Modi government over the past two years, which has placed infrastructure spending at the heart of its development strategy, at the expense of social spending. Although on a favorable trend, the inadequacy and sometimes mediocre quality of infrastructure is stifling economic growth.

In FY2023/2024, the government deficit declined by 0.8pp to 5.6% of GDP, but it was still higher than the pre-pandemic level (3.8% of GDP over the 2016-2020 period). Similarly, the general government deficit remained high at 8.8% of GDP, according to initial estimates.

Government revenues, although still very low, rose slightly over the past year (+0.3pp) to 9.4% of GDP. They are at the same level as ten years ago. However, the increase in gross tax revenues over the last decade (+1.6pp) is to be welcomed, reaching 11.7% of GDP, a low but unprecedented level. This rise is mainly the result of an increase in the income tax base. In fact, corporation tax revenues fell as a result of the reduction in corporate taxation in 2019 to boost competitiveness. Customs revenues also fell.

Fiscal expenditures, which fell by 0.6pp over the past year to 15% of GDP, remained above the pre-pandemic level and the level that prevailed ten years ago. However, their structure has changed.

INDIA: PUBLIC EXPENDITURES

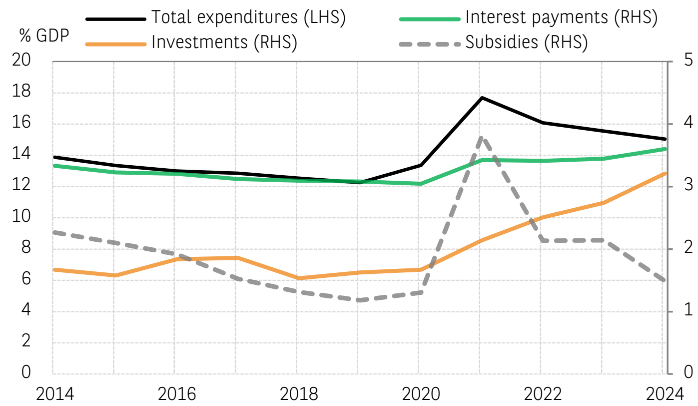


CHART 2 SOURCE: CEIC, MOF, BNP PARIBAS

Indeed, although debt interest payments still remain the largest item of budget spending (23.9% of total spending in 2023/2024, the same level as ten years ago), the weight of certain other spending considered to be "incompressible" has decreased. Subsidies, which had risen sharply at the time of the Covid-19 pandemic, fell to 1.5% of GDP in FY2023/2024; they accounted for 9.9% of total expenditures, a level below the average recorded over the five pre-pandemic years (11.3% of total expenditures). Similarly, spending on education, pensions and healthcare fell very slightly to 1.4% of GDP, and accounted for just 9.5% of total spending last year, compared with 12.7% five years ago.

On the other hand, investment has increased significantly since FY2020/2021. The Modi government reallocated part of its social spending to infrastructure, which reached 3.2% of GDP last year (compared with 1.6% of GDP five years ago). In FY2023/2024, 21.4% of total expenditure was given over to investment, 9.4pp more than ten years ago.

For the FY2024/2025 budget presented in February, the government aimed to reduce its deficit to 5.1% of GDP. This slight consolidation was based on a further reduction in spending, particularly subsidies. The aim was once again to reallocate the "saved" funds to infrastructure spending. However, given the low level of revenues (expected to fall by 0.1pp for the current fiscal year), the new government is now faced with a choice: increase social spending while keeping its investment targets unchanged, at the risk of widening the fiscal deficit, or reduce public investment at the risk of seeing foreign direct investment flows slow further, which would then weigh on medium-term economic growth and could weaken external accounts. The new government is due to announce a review of its budget in mid-July, which will give an initial idea of its new priorities.

Johanna Melka
johanna.melka@bnpparibas.com

TAIWAN

SOLID GROWTH IN A DIVISIVE CLIMATE

President Lai Ching-te took office on 20 May. He is expected to continue the domestic and foreign policy agenda of his predecessor, in a more tense climate. On the one hand, Beijing could increase its military manoeuvres around the island. On the other hand, Parliament is now dominated by opposition parties, which are expected to slow down or block many government projects. The new administration will at least be able to count on a favourable economic situation to start its mandate. Economic growth has been accelerating over the past year, driven by the rebound in the global electronics cycle. While Taiwan continues to maintain a very strong technological lead in the semiconductor industry, its manufacturing sector is experiencing changes related to the reorganisation of value chains in Asia.

NEW GOVERNMENT, NEW PARLIAMENT

On 20 May 2024, Taiwan's new President Lai Ching-te, of the Democratic Progressive Party (DPP), was appointed for a four-year mandate. His domestic and foreign policy agenda should be in keeping with that of his predecessor, Tsai Ing-wen, who came from the same party and remained in power for eight years. However, Lai Ching-te will have to deal with a much more tense climate. Firstly, while maintaining the official *status quo* in relations between Taipei and Beijing is the most likely scenario in the short term, pressure in the Taiwan Strait will remain intense. Beijing has increased the number of military exercises around the island in response to Lai Ching-te's offensive speech, and could gradually increase its intimidation tactics in the future. On the domestic front, the new government is expected to encounter significant difficulties in advancing its agenda, as the DPP lost the majority in Parliament[1] since the general election at the beginning of the year. The opposition parties could obstruct many projects, in a climate which may be, at times, chaotic, as recent incidents in Parliament suggest.

INDUSTRIAL ACTIVITY IS REBOUNDING

After a sharp slowdown in 2022 and early 2023, economic growth has recovered. It reached +1.3% in 2023 and +6.6% year-on-year (y/y) in Q1 2024, and is expected to be more than 4% on average this year (*chart 1*).

Taiwan enjoys a dominant position and a very significant technological advance in the semiconductor industry, which accounts for 39% of its total export goods and 34% of its industrial production. Economic activity is therefore highly dependent on the global electronic cycle. After reaching an all-time high at the beginning of 2022, export goods and industrial production contracted continuously from Q2 2022 to H1 2023 due, notably, to the turnaround in the electronic cycle. This momentum was then reversed again from summer 2023 onwards. Global semiconductor demand picked up, supporting the rebound in manufacturing production and exports. Taiwan's industrial production rebounded by +8.8% y/y over the first five months of 2024, after an average decline of -12.2% in 2023, and exports rose by +9.1% y/y in value over the same period (vs. -10% in 2023).

Growth in the industrial sector will remain strong in H2 2024, even though companies still have stocks to sell off. In fact, inventory levels in the manufacturing sector are still relatively high after more than a year of decline since the peak seen in Q1 2023. The global semiconductor demand forecasts for 2024 are favourable, especially in the AI and high-performance computer sector, which is particularly beneficial for Taiwan's factories.

FORECASTS

	2021	2022	2023	2024e	2025e
Real GDP growth, %	6.6	2.6	1.3	4.3	2.7
Inflation, CPI, year average, %	2.0	2.9	2.5	1.9	1.5
General government balance / GDP (%)	-0.2	0.2	-0.7	-0.6	-0.7
General government debt / GDP (%)	30.2	27.5	25.0	23.6	23.0
Current account balance / GDP, %	15.3	13.3	13.8	13.9	13.9
External debt / GDP, %	27.6	26.6	27.3	25.7	24.9
Forex reserves, USD bn	548.4	554.9	569.3	579.3	591.3
Forex reserves, in months of imports	18.5	16.5	19.4	18.7	18.3

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

TAIWAN: ECONOMIC GROWTH RECOVERY

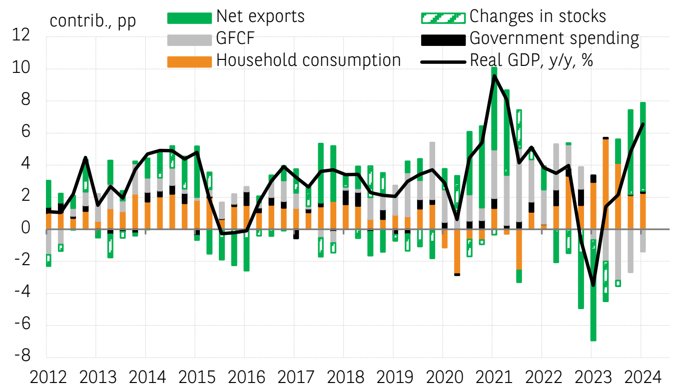


CHART 1 SOURCE: DGBAS, CEIC

REORGANISATION

Investment fell by 8.2% in real terms in 2023, driven by the drop in spending on machinery and equipment (-19.8%). This decline followed five years of sustained growth: the investment rate rose from 21.1% of GDP in 2017 to 28.1% in 2022, then to 25.5% in 2023. Investment suffered last year from the turnaround in the global electronics market, tighter financing conditions and concerns among entrepreneurs about the change of government in Taiwan and tensions with China.

1 The DPP now holds 51 seats in Parliament out of a total of 113 (previously 61), while the opposition party, Kuomintang, has 52 seats (previously 38) and the Taiwan People's Party has 8 seats. The remaining 2 seats are held by independents.

Investment continued to contract in Q1 2024 (-5.4% y/y), but is likely to recover soon, encouraged by the rebound in the electronic cycle.

However, other more structural causes explain the recent weakness of investment growth. In the period 2018-2022, the electronics industry in Taiwan strengthened its production capacities and position as a global leader in the highly sophisticated semiconductor industry. Its expansion was driven by the sharp increase in demand for electronic goods during the pandemic. In addition, trade tensions between the US and China have prompted some Taiwanese producers based in mainland China to relocate some of their business. They have invested in factories in other countries in the region, to benefit from lower production costs, but also in Taiwan - especially since financial and logistics support programmes have been put in place by the government. Since 2022, the geopolitical context has become more complex and the tech war between the US and China has intensified. Governments and multinationals have adopted de-risking policies, which aim to secure their production chains (including by immunising themselves against the potential repercussions of conflicts and Western sanctions against China) and their supply of strategic goods (including semiconductors and electronic equipment). This reorganisation of global production chains directly affects the manufacturing sector in Taiwan, given its specialisation and tensions in the Taiwan Strait. It could slow growth in domestic investment in the short and medium term. At the same time, there is little doubt that Taiwanese industry will be able to maintain its technological lead in microprocessors.

Changes in direct investment (DI) flows and the composition of exports reflect current adjustments. First, Taiwanese DI overseas rose sharply in 2023 (to USD 24.8 billion from USD 15.6 billion in 2022) and foreign DI in Taiwan fell slightly; as a result, net DI outflows (residents and non-residents) reached an all-time high of -USD 19 billion or -2.5% of GDP, compared to -0.7% on average in 2019-2022 (net DI flows are structurally negative and Taiwan is, overall, a net foreign creditor). Second, the composition of Taiwanese DI has changed: investment in China has been declining for several years, and the decline accelerated in 2023 (it represented 11% of total DI flows in 2023, compared to 33% on average in 2020-2022 and 50% in 2015). Conversely, Taiwanese DI in ASEAN countries and the US have increased at a steady pace.

Lastly, Taiwan's trade structure has also evolved as a result of the reorganisation of production chains, China-US tensions (which have led US importers to replace certain goods from China with goods purchased directly from Taiwanese producers), and the need for Taiwan to reduce its economic dependence on China. Over the first five months of 2024, exports from Taiwan to the US jumped +58% y/y and those to ASEAN-6 countries increased by 22%, while exports to mainland China and Hong Kong fell by 4%. The share of China and Hong Kong in Taiwan's total exports decreased from 43.9% in 2020 to 33.5% over the twelve-month period ending in May 2024; the share of ASEAN-6 countries increased from 15% to 18.3% (including 7.2% for Singapore) and that of the US from 14.6% to 20.6% (*chart 2*).

STRONG PRIVATE CONSUMPTION

Private consumption recovered from summer 2022 onwards, after a long period of health restrictions. Its growth reached a solid rate of +8.2% in 2023 (after +3.8% in 2022) and +4.4% y/y in Q1 2024.

TAIWAN: MAIN TRADE PARTNERS

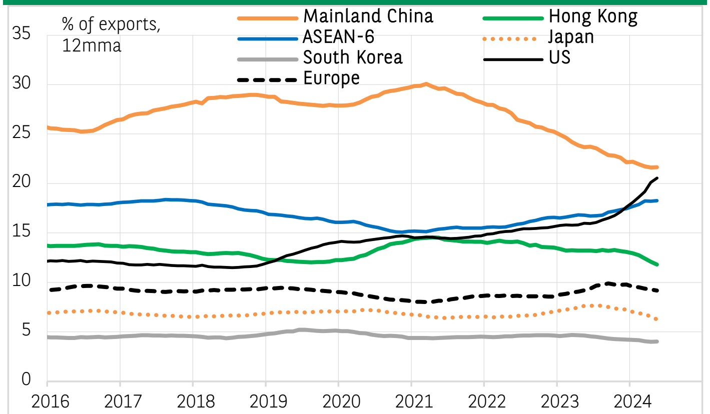


CHART 2 SOURCE: MINISTRY OF FINANCE, BNP PARIBAS

It was stimulated by government support measures, the recovery of the labour market in the wake of the rebound in manufacturing activity (the unemployment rate fell from 3.6% at the end of 2022 to 3.35% in May 2024), and positive wealth effects linked to rising prices of property and stock market assets. The property price index in Taipei was up +13.6% y/y in May 2024 and the TAIEX index rose 63% between December 2022 and June 2024, driven by high tech companies and breaking record highs for several weeks.

The recovery in tourism on the island from the end of 2022 onwards has also bolstered consumption. The number of visitors increased to 2 million in Q1 2024, but this figure remains 30% below pre-Covid levels in Q1 2019. This can be explained, in particular, by the slight uptick in the number of tourists from mainland China, who accounted for 38% of total visitors in 2018, but only 20% in Q1 2024.

Growth in private consumption will slow in the short term. There are still some supporting factors, in particular the good conditions on the labour market. However, tensions in the Taiwan Strait should prevent a more significant recovery in tourism. Regarding economic policy, fiscal measures should continue to support activity, but credit conditions should become more restrictive.

The central bank raised its main policy rate from 1.125% in early 2022 to 1.875% in March 2023 in response to the (moderate) acceleration in inflation. Consumer price inflation slowed in H2 2022 and H1 2023, but then rose again (to +2.6% y/y in December 2023). In addition, the property market is overheating once again, with growth in property loans to individuals accelerating again from +3.9% y/y in June 2023 to +8.6% in May 2024. The central bank therefore raised its policy rate again in March 2024 (to 2%). It also increased the reserve requirement ratio (to 5.75%) and further tightened the prudential rules governing mortgages. Inflation moderated in H1 2024 and is expected to slow further. In the short term, the central bank should leave its policy rate unchanged, but could introduce other measures to contain the rise in house prices.

Christine Peltier
christine.peltier@bnpparibas.com

A FAIRLY SUCCESSFUL INTEGRATION

The accession of several Central and Eastern European countries to the EU in 2004 has been accompanied by impressive growth in their respective economies. Improvements in labour productivity have enabled real wages to catch up over the last twenty years, but wage pressures have remained very strong over the recent period without, however, affecting the economies' competitiveness to date. The region also remains attractive for foreign direct investment and continues to benefit from nearshoring activities. In the short term, consolidating public accounts is a priority to comply with commitments under the Stability and Growth Pact. Some countries are already under EU's surveillance, with the opening of an excessive deficit procedure.

ECONOMIC CONVERGENCE HAS ACCELERATED

Four Central European countries (Poland, the Czech Republic, Slovakia and Hungary), along with six others, joined the EU twenty years ago. Romania and Bulgaria followed suit three years later. In retrospect, this membership has enabled these countries to catch up significantly from an economic perspective. GDP per capita in volume terms and in purchasing power parity, a measure commonly used to assess and compare income levels between countries, saw a spectacular growth between 2004 and 2024. Poland stands out from its neighbours with a doubling of its GDP per capita over this period. For the other countries in the region, it increased by around 1.5 times. The trend has been similar in Romania and Bulgaria since their accession in 2007. The increase in GDP per capita also reflects strong convergence with developed countries. In the region, the GDP per capita of Czech Republic is closest to that of Germany, with a gap of just 25% in 2023. The gap is 30% for Poland 40% for Hungary and Slovakia. Bulgaria is still a long way behind at 48%.

Over this same period, the European funds received by the Central and Eastern European Countries (CEECs) since their accession date have contributed to the implementation of reforms and strengthened their capacity to withstand international economic crises. Poland, Czech Republic, Slovakia, Hungary, Romania and Bulgaria received a total of EUR 376 billion between 2004 and 2022, or 23.8% of their GDP in 2022. From 2007 to 2009, during the major global financial crisis, the contraction of GDP in the Central European countries was quickly followed by a strong recovery in economic activity. The same was true in 2020 during the Covid-19 crisis. One key feature is that Poland was the only economy to escape a recession in 2009 and in 2020 it also reported a smaller contraction in GDP compared with its neighbours. This resilience also means that Central European countries have suffered relatively limited scarring effects from the shocks. This has contributed to the strengthening of their economic weight (mainly Poland) within the EU (16.5% of EU GDP in 2023 at purchasing power parity in current terms, compared with 12.5% in 2004).

EASTERN AND CENTRAL EUROPE: GDP PER CAPITA

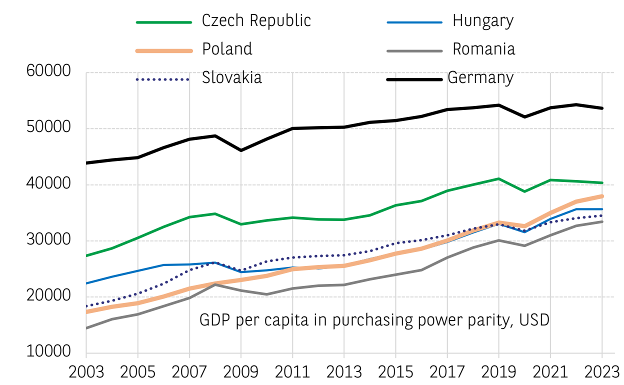


CHART 1 SOURCE: IMF, BNP PARIBAS

EASTERN AND CENTRAL EUROPE : LABOUR PRODUCTIVITY GROWTH

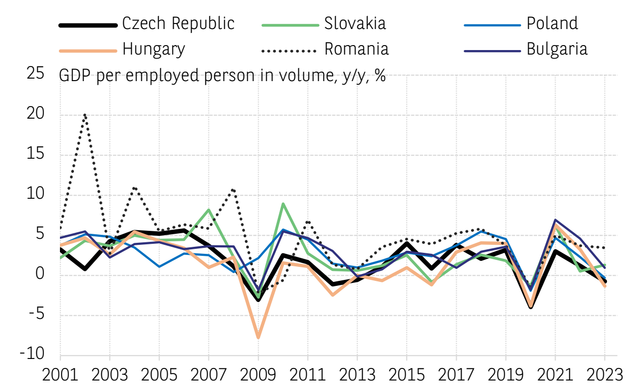


CHART 2 SOURCE: EUROSTAT, EUROPEAN COMMISSION, BNP PARIBAS

SUSTAINED COMPETITIVENESS

The economic model on which this economic catch-up has been based differs from country to country. Slovakia, the Czech Republic and, to a lesser extent, Hungary have all seen their economies become more open, making them more exposed to changes in external demand. Exports accounted for 89%, 77% and 76% respectively of GDP in Slovakia, the Czech Republic and Hungary in 2023 (compared with 64%, 57% and 53% in 2004). By contrast, Poland and Romania are economies whose growth is largely based on domestic demand. Besides, some countries such as the Czech Republic and Slovakia have specialised in the automotive sector (12.6% and 28.3% of total exports respectively), whereas Poland has focused on diversifying its industry.

Regardless of the choice of economic model, changes in labour productivity, calculated on the basis of GDP and employment, were significant within the CEECs over the period 2004-2008 and over the period 2015-2019. Calculating hourly labour productivity gives similar results. More importantly, the rise in real wages has been accompanied by an increase in this productivity. Recently, the situation seems to have changed for the worse. In 2023, productivity gains weakened in Poland and grew more slowly than real wages. The rise in unit labour costs since 2023 in y/y terms confirms this recent trend. Over the next few years, labour shortages will keep up wage pressures, so the priority will be to increase productivity further. However, good prospects for FDI and continued disbursements of European funds under the European budget and the Resilience and Recovery Plan should support investment (capped at around 20% of GDP for Poland, Hungary and Slovakia, 27% for the Czech Republic and 24% for Romania over the last twenty years), and in turn boost productivity. Efforts to improve the absorption rate of European funds, particularly for Slovakia and Romania, should further support investment prospects.

NEARSHORING OPPORTUNITIES

According to the latest UNCTAD report, by the end of 2023, the CEECs had received the equivalent of USD 914 billion in foreign direct investment (USD 94.6 billion in 2000). Within the region, Poland received the lion's share of FDI, to the tune of USD 335.5 billion. As a percentage of GDP, the ranking changes slightly, with the Czech Republic and Hungary being the main recipients of this type of capital, accounting for 65% and 56% of their GDP respectively in 2023.

The prospects for FDI flows in the short to medium term are strong, as the CEECs should benefit from the process of reorganising production activities that is underway in eurozone companies and is set to continue. Recurring arguments in favour of nearshoring include geographical proximity to the eurozone, reduced transport times and costs and generally favourable FDI regulations, as measured by the OECD's FDI restrictiveness index. Added to this is the comparative advantage of labour costs despite wage pressures (hourly cost of €14.50 in Poland, €12.80 in Hungary and €18 in the Czech Republic compared with €41.30 in Germany).

However, the difficulty lies in assessing nearshoring-related activities, as the process of reorganising is spread over time and some data are available with lags. A number of indicators can nevertheless be used to assess nearshoring activity and tend to confirm that the process is underway. Since 2018, despite geopolitical uncertainties, the scale of FDI and the number of projects to set up or expand in the region (so-called greenfield investments) testify to its attractiveness. FDI is mainly concentrated in the services sector (around 60% on average of FDI stock), with a certain strengthening of the «professional, scientific and technical activities» and «communication and information» sectors. Hungary stands out with a roughly equivalent proportion of manufacturing and services.

HEADING FOR AN EXCESSIVE DEFICIT PROCEDURE IN 2024?

In June 2024, the European Commission announced the opening of an excessive deficit procedure for seven European countries, including three Central European countries. As expected, Poland, Slovakia and Hungary are on this list. Romania has been on the list since 2020. On the foreign exchange market, the currencies of these countries showed little reaction, as the decision had already been

EASTERN AND CENTRAL EUROPE: FDI STOCK

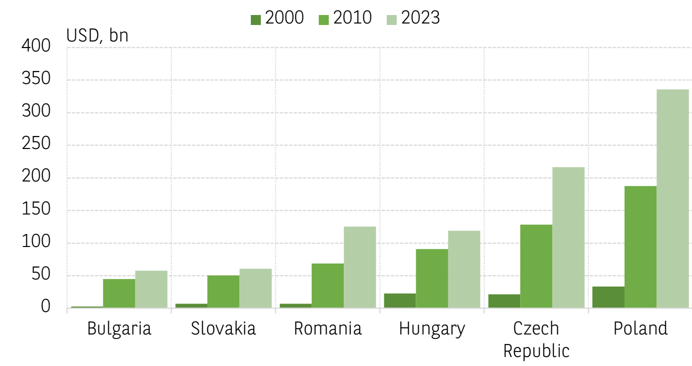


CHART 3 SOURCE: UNCTAD, WORLD INVESTMENT REPORT, BNP PARIBAS

anticipated by the markets. The Romanian leu was not affected either, as the currency is pegged to the euro under the European Exchange Rate Mechanism.

Overall, budget deficits have deteriorated sharply since 2020 under the combined effect of the Covid-19 crisis and the energy shock in 2022. As a result, the government debt-to-GDP ratio has risen sharply within four years (+14 points between 2019 and 2023 for the Czech Republic and Romania, followed by Hungary and Slovakia (+8.2 and +8.0 points respectively). Although the cost of supportive measures is easing, military spending and the interest burden on public debt are still weighing on the accounts. In 2023, Hungary's interest burden rose to 4.7% of GDP (11.1% of revenues) from 2.8% of GDP in 2022, even more than Italy's within the EU. This year, the interest burden will remain high.

However, public debt remains sustainable in the short to medium term owing to fiscal safeguards and buffers. The Central European authorities remain committed to complying with the Stability and Growth Pact. Should the countries find themselves in excessive deficit status (in line with the reforms agreed at the end of December 2023), a four-year adjustment period with the possibility of an extension of three additional years to bring the budget deficit below 3% will be imposed, otherwise the countries risk a suspension of European funds. Hungary, Romania and Slovakia had already put in place consolidation measures well before the European Commission's decision, albeit on a small scale. The priority will be to implement bold measures in the short term.

CEE countries can also rely on the relatively strong profile of their debt, which is largely contracted at fixed rates and in local currency with the exception of Romania (52% of total debt in foreign currencies). Average maturity is relatively high, hence liquidity risk is contained. In addition, the easing of yields observed on bond markets should continue in the short term, helping to reduce the debt burden. In the CEECs, the ratio of public debt-to-GDP remains well below the 60% threshold, which leaves a certain budgetary margin, except in Hungary where the ratio is close to 70%.

Cynthia Kalasopatan Antoine
cynthia.kalasopatanantoine@bnpparibas.com

HUNGARY

FISCAL CONSOLIDATION WILL CONSTRAIN GROWTH

Economic growth prospects are improving for 2024, but the recovery is likely to be limited by still sluggish domestic demand. On the foreign exchange market, the Hungarian forint has come under downward pressure recently. On public accounts, the fiscal consolidation that began in the summer of 2022 has not significantly reduced the deficit. For 2024, the deficit will probably be less pronounced than last year, but will remain high in any case (around 5% of GDP). As a result, Hungary will probably be subject to an excessive deficit procedure in 2024. On the international political scene, the focus will be on the Hungarian Presidency of the Council of the European Union, which will begin on 1st July 2024 (for a period of six months) against a backdrop of strong diplomatic tensions with the European institutions.

A MODERATE RECOVERY IN 2024

In the first quarter, Hungary returned to positive economic growth (0.8% q/q, 1.7% y/y), following a recession in 2023. The recovery is nevertheless unbalanced, driven mainly by the adjustment of inventories and net exports. Consumption is struggling to recover, with retail sales showing little growth and import volumes of consumer goods still declining. At the same time, investment has remained sluggish. The outlook for the coming quarters is slightly better, with moderate growth for both 2024 and 2025.

This year, private consumption should improve under the combined effect of falling inflation and persistent wage pressures (averaging around 14% y/y over the first four months of the year). This comes on top of renewed optimism amongst households as a result of supportive measures in their favour (mortgage rate cap extended till the end of 2024, pension and public sector salary increases, subsidies for energy renovations and first-time home buyers).

However, households are likely to adopt a cautious stance in the short term. Although the unemployment rate has fallen slightly, the labour market has recently shown some signs of slowdown. The number of job vacancies has fallen, particularly in the manufacturing sector. Similarly, the ratio of jobseekers to vacancies is deteriorating. It has risen slightly (3.34 in Q1 2024, 3.03 in Q4 2023 and 2.9% in Q3 2023). Employment is also growing more slowly in the services sector.

As far as investment is concerned, prospects for an improvement in its public component remain limited, given the postponement of government projects. European funds, which usually come as a support, will play a relatively small role in the short term, as Hungary has so far received only a tiny fraction of the amount in its favour under the recovery and resilience plan (EUR 0.14 billion out of EUR 6.5 billion, or 2.2% of the total). Finally, the much hoped-for revival in private investment is constrained by external demand, insofar as the eurozone will not see a more marked acceleration in its imports until 2025.

DEPRECIATION OF THE HUNGARIAN FORINT

The Hungarian forint has come under depreciation pressure in recent months. It has lost 3.6% and 5.8% of its value against the euro and the dollar respectively since the start of the year, thus positioning it as one of the worst-performing currencies not only in Central Europe but also in the emerging countries. In the region, the Czech koruna fell by 1% against the euro and the Polish zloty appreciated by 1% over the same period.

FORECASTS

	2021	2022	2023e	2024e	2025e
Real GDP growth, %	7.0	4.6	-0.7	3.3	3.2
Inflation, CPI, year average, %	5.1	14.5	17.6	3.8	3.6
General gov. balance / GDP (%)	-7.2	-6.2	-6.7	-5.0	-4.5
General gov. debt / GDP (%)	74.5	71.7	69.5	70.0	70.1
Current account balance / GDP, %	-4.1	-8.4	0.3	0.8	0.5
External debt / GDP, %	87.0	92.0	85.8	86.6	85.1
Forex reserves, EUR bn	38.4	38.7	41.4	48.5	49.8
Forex reserves, in months of imports	3.8	3.0	3.4	4.0	3.9

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

HUNGARY: INFLATION AND REAL WAGE GROWTH

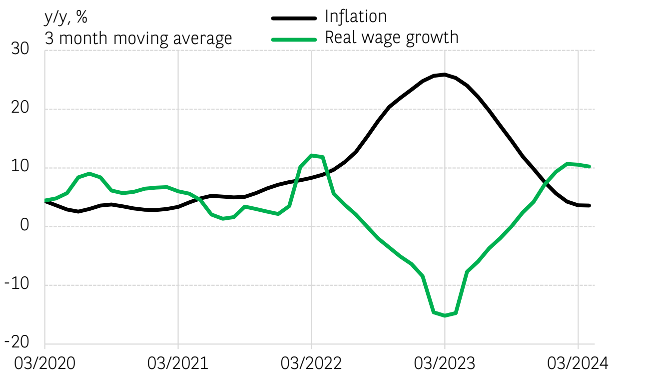


CHART 1 SOURCE: EUROSTAT, CENTRAL STATISTICAL OFFICE, BNP PARIBAS

The forint was trading at 396 units against the euro at the end of June, above its average value of 340 over the last 10 years. The forint's weak performance compared with neighbouring countries can be explained primarily by the divergence in monetary policy strategy. The Hungarian monetary authorities have opted for an aggressive monetary easing with a cumulative 600 basis point cut in the key rate since October 2023, while the other central banks in the region have either maintained a monetary *status quo* over the same period or reduced their key rates more modestly.

Concerns about public debt are also exerting downward pressure on the Hungarian currency. Uncertainty still looms over European funds, an important resource for financing the needs of the economy. The European Commission's decision on the release of funds at the end of 2023 has been questioned by the European Parliament and is still pending.

In the short term, the depreciation trend remains in place, with a probable breach of the 400 forint/euro mark by the end of December. However, a number of factors should help to mitigate the downward pressure. External accounts have improved significantly since 2023, with the current account back in surplus last year alongside with significant capital inflows. The current account continued to show a surplus, standing at of EUR 1.8 billion, or 4.4% of GDP in Q1 2024 (up from 0.3% of GDP in 2023), and it is likely to remain in surplus for the rest of the year. Similarly, net foreign direct investment flows averaged 1.8% of GDP between 2019-2023, despite the many shocks to the economy. The country could attract more FDI flows in the future as a result of the reorganisation of activities related to eurozone companies in the region, as well as the country's ambitions to become a global leader in battery production.

Portfolio flows will likely be supported by the positive short-term interest rate differential. The spread between Hungarian and German five-year government bond yields remains high at 430 basis points at the end of June. Finally, the Central Bank's recent recalibration towards a more cautious monetary policy through a smaller cut in the key rate would also support the Hungarian forint.

HUNGARY: EXCHANGE RATE

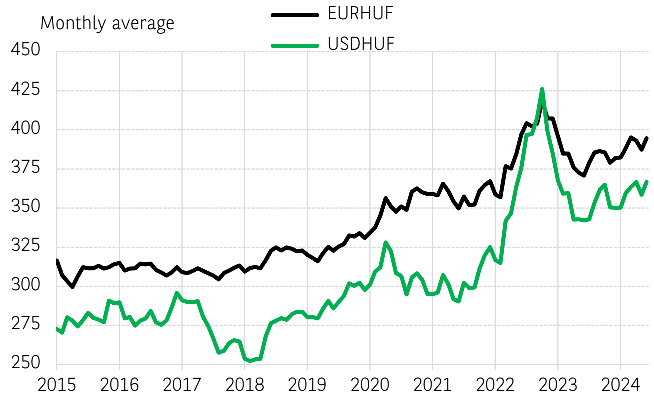


CHART 2 SOURCE: SOURCE: CENTRAL BANK OF HUNGARY, BNP PARIBAS

BUDGET EFFORTS TO CONTINUE

The consolidation efforts that begun in the summer of 2022, combined with a high nominal GDP, reduced the budget deficit by one point compared with the previous year, to 6.2% of GDP in 2022. However, this ratio worsened last year (to 6.7% of GDP) as a result of an increase in pensions, the extension of some of the government support measures introduced in 2022 and the rise in debt interest payments. The latter weighed heavily on the budget, mainly due to the increase in the debt servicing linked to inflation-indexed bonds. It should be noted that inflation reached 17.6% on average in 2023 (14.5% in 2022 and 5.1% in 2021). In 2023, interest payments as a percentage of government revenue almost doubled to 11.1% compared with 6.6% in 2022.

Despite the consolidation measures, the budget deficit will inevitably exceed the threshold of 3% of GDP set under EU's Stability and Growth Pact in 2024 and 2025. The authorities are expecting the budget deficit as a percentage of GDP to be less pronounced than last year but have revised it upwards to 4.5% of GDP in 2024, compared with the 2.9% initially forecast in the 2024 budget. The cumulative deficit for the first four months of the year has already reached 3.2% of GDP. The interest burden will continue to weigh on spending in the short term, even if the temporary halt to inflation-indexed bond issuance and the slight fall in bond yields should provide some respite. The government debt-to-GDP ratio could cross the 70% threshold as early as this year, and then rise until at least 2026.

As a result of this situation, in its latest report in June, the Commission announced its intention to open an excessive deficit procedure as early as July. This situation may be a cause for concern. However, public debt remains sustainable in the short and medium term. The authorities are committed to tightening fiscal discipline, which suggests that new measures could be announced shortly. In the short term, the adjustment process is likely to be gradual, given the many challenges facing the country (the need to step up military spending in the face of geopolitical tensions, the presence of support measures, the gradual withdrawal of taxes on windfall profits in the short term). The parliamentary elections scheduled for 2026, which are generally accompanied by generous pre-election measures, will limit the country's ability to contain the budget deficit in the short term. Against this backdrop, a return to a primary surplus is unlikely before 2027.

As part of the reforms of the Stability and Growth Pact, an adjustment process over the next four years is planned in the event of an excessive deficit, in order to bring the budget deficit below 3% of GDP. Otherwise, the country would risk a suspension of European funds.

Cynthia Kalasopatan Antoine
cynthia.kalasopatanantoine@bnpparibas.com

BRAZIL

THE REAL ECONOMY AND MARKETS: THE QUEST FOR SYNCHRONICITY

The messages sent out by the Brazilian financial markets and those of the real economy have become increasingly incongruent. Robust economic growth, low unemployment and relatively subdued inflation have become steadily overshadowed by rising political and fiscal risks, which have weighed more heavily on the currency, equity prices and the yield curve. Lula's parliamentary setbacks, his frictions with the Central Bank and increased interventionism have rattled investors already shaken by major revisions to global and local interest rate projections. The challenge for the second half of the year will be to bolster economic agents' confidence in an effort to stabilise expectations.

CONSUMPTION, BOOSTED BY FISCAL POLICY LEVERS

Activity data for the first half of the year show that consumer spending remains very dynamic. Household consumption – which has been at the heart of the Lula government's measures to support activity – has relied on three main levers to emerge as the main engine of growth: i/ the rescheduling of household debt via the *Desenrola*[1] programme, designed to prevent the over-indebtedness of the COVID years from hindering consumption, ii/ wage growth, supported by a buoyant job market (the unemployment rate was again down in May reaching 7.1%); and iii/ transfers to households (in addition to the Q1 settlement of court injunctions, or *precatorios*, social security spending and other forms of assistance increased from BRL 1,000 bn in 2021 to BRL 1,300 bn in 2024 at constant prices). The credit lever – which Lula wishes to stimulate further – remains modest for now and is coming up against the interruption of the monetary easing cycle. The creation of a guarantee fund (FGO), as part of the new *Acredite* programme, should however allow banks to provide up to BRL 12 bn in loans to individuals and businesses.

Meanwhile, investment – which had returned to growth in Q4-2023 – accelerated further in Q1 2024 (+4.1% q/q and +2.7% y/y). As a sign of a vigorous domestic demand, imports grew faster than exports over the same period (+6.5% vs. +0.2% q/q). On the supply side, growth in services remained strong while industry experienced a slight decline. Despite lower cereal harvests, agricultural output proved resilient, buoyed by the beef and soybean sectors.

The damage caused in May by heavy storms and flooding in nearly 90% of the municipalities of the state of Rio Grande do Sul[2] is expected to shave off some 0.2 pp from annual GDP growth figures. The shortfall (i/ in terms of agricultural production – the state accounts for about 70% of the national rice production an 48% of wheat production and represents some 12% of Brazil's agricultural GDP – and ii/ in terms of vehicle production – factories have stopped production, and vehicle sales in the state fell by 64% in May compared to April) should, however, be partially offset by reconstruction efforts. Activity should also benefit from increased financing in the agricultural sector (BRL 476 bn in subsidized credits under the new *Plano Safra* 2024/25, +7% y/y) as well as the launch of a new initiative (*Rota Quadrante Rondon*) aimed at developing infrastructure at the country's borders in order to boost trade in South America.

FORECASTS

	2021	2022	2023	2024e	2025e
Real GDP growth, %	5.1	3.1	2.9	2.2	2.0
Inflation, CPI, year average, %	8.3	9.3	4.6	4.1	4.1
Fiscal balance / GDP, %	-4.3	-4.6	-8.9	-7.0	-6.9
Gross public debt / GDP, %	77	72	74	77	80
Current account balance / GDP, %	-2.8	-2.9	-1.3	-0.9	-1.3
External debt / GDP, %	42	36	37	42	40
Forex reserves, USD bn	362	324	355	348	350
Forex reserves, in months of imports	14	11	12	13	12

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

BRAZIL: RISING BOND YIELDS AND SHARP WEAKENING OF THE BRL

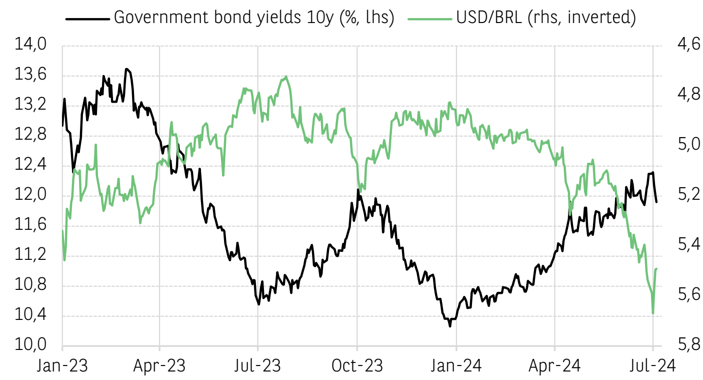


CHART 1 SOURCE: MACROBOND

SHIFTS IN THE RATES OUTLOOK

Despite inflation remaining within its target range (3% +/-1.5pp), the sharper deterioration in inflation expectations in recent months led the Central Bank to halt its monetary easing cycle in June, thus putting an end to 7 consecutive cuts to the SELIC policy rate

1 The programme, which was implemented in 2023 and affects 70 mn Brazilians who recorded unpaid bills between 2019-22, has been extended until May 2024.
2 The country's southernmost state, whose economy is comparable in size to those of Uruguay and Paraguay put together, accounts for about 6.5% of the national GDP. The human toll has been high with nearly 180 deaths and more than 50,000 victims who have lost their homes. The cost of reconstruction has been estimated between BRL 110 bn (USD 21 bn) and BRL 176 bn by the Federasul business association.

(cumulative decline of 325 bps between August 2023 and May 2024 to 10.5%). Markets are no longer anticipating rate cuts this year (after having forecast a terminal rate at 9% at the start of the year). Aside from the evolution of the external scenario, the revised outlook on Brazilian rates is based, above all, on a triptych of factors affecting expected inflation.

First, the conditions for stabilizing the public debt ratio – which has risen by some 20 percentage points in 10 years – seem less and less in place. Lula is keen to maintain a certain level of public spending but is struggling to approve a rise in revenues in Congress. In particular, his attempts to tackle tax loopholes have so far been unsuccessful. In addition to downward revisions to budget targets for the period 2024-2028, markets have become more concerned about the rise in mandatory spending (social security, health, education) and the retention of optimistic growth assumptions in the budget orientation bill. The fiscal losses and increased spending incurred to respond to natural disasters in the south of the country are also of concern (approval of extraordinary credits, suspension of Rio Grande do Sul's debt repayments to the federal government for three years, launch of *Auxílio Reconstrução*, a programme designed to transfer funds to families who have lost their homes, etc.). At a time when rising market rates in both nominal and real terms are pushing up interest payments, the government seems less equipped to rein in a deficit that could near 7% of GDP this year.

Second, markets fear a more dovish stance by the Monetary Policy Committee (COPOM) on inflation by 2025 (by which time Lula will have appointed the majority of COPOM members). This fear is fuelled by tensions between the executive and the Central Bank[3], but also by the memory of the past: between 2011 and 2016, the BCB, then closer to the Government, opted to lower its key rate in a context of rising inflation expectations, which ultimately contributed to accentuate some macroeconomic imbalances.

Third, the more persistent than expected tensions in the labour market could suggest a more lasting bias on inflation (particularly in services). Several signals indicate that the economy may be operating closer to full employment and therefore that the gap between potential and real GDP (i.e., the output gap) may in fact be lower than measured by the Central Bank. Some evidence from the national accounts and the balance of payments seem to support this thesis. Indeed, the economy has not been able to expand output fast enough to meet internal demand (i.e., growth of domestic demand has outpaced that of real GDP). This has led to an increase in imports, which profile reveal insights into some of the underlying tensions at work in the economy. The widening trade deficit in manufactured goods reflects the competition between industry and services for scarce labour in particular. Unlike the manufacturing sector (which is more exposed to international competition), the service sector can more easily pass on the increase in unit labour costs to its prices. Therefore, the tertiary sector has greater flexibility in increasing its production capacity in the face of an expanding domestic demand, as substantiated by the data (with GDP growth in services outpacing that of manufacturing). If indeed the signs that the economy may be operating closer to full employment withstand the test of time, this could limit the prospects of witnessing further rate cuts to avoid overheating the economy.

BRAZIL: UNDERPERFORMANCE OF THE EQUITY MARKET

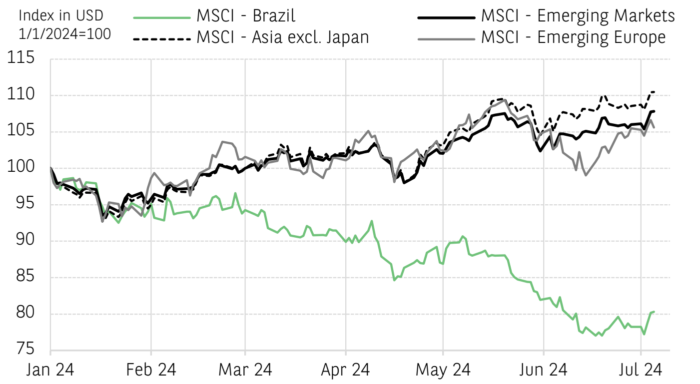


CHART 2 SOURCE: MACROBOND, BNP PARIBAS

THE EQUITY AND FX MARKETS UNDER PRESSURE

Despite overall positive economic results, the recovery in commodity prices, and the relative attractiveness of Brazilian equities compared to other emerging markets, the stock market and the currency have undergone a significant correction since the start of the year. The main stock index, B3 Ibovespa, lost nearly 15% in dollar terms whilst the MSCI Emerging Markets index gained 5%. The decline in the stock market, valued in dollars, is partly attributable to the depreciation of the *reais*, which has lost more than 12% against the greenback this year, the third worst performance among emerging markets. The *reais*, which has hit its lowest level against the USD since Lula took office, is suffering from the effects of the strengthening dollar following the changing interest rate outlook in the United States. But it also reflects a reassessment of political and fiscal risks on the part of local and foreign investors. Notably, the government's interference with large listed companies such as Petrobras or Vale – to influence investment strategies, alter dividend distribution policies, steer fuel pricing policies, and decide on new appointments – largely explains the turmoil on the FX and stock markets in recent months, especially since Vale and Petrobras together account for 25% of the B3 Ibovespa index.[4]

This interference, combined with the attraction of better risk-adjusted returns in North American markets, led to net sales of equity securities by non-residents (estimated at USD 6.6 bn from January to May according to IIF data). Non-residents, who account for about 55% of the daily trading volume on the stock market, were joined in their selling spree by local counterparts, drawn, amongst other factors, by rising government bond yields.[5] A high interest rate environment has historically channelled private savings into government debt instruments, diminishing the capital pool available for private sector investment and slowing the development of the local capital market.

Salim Hammad
salim.hammad@bnpparibas.com

3 Lula's Workers' Party recently filed a lawsuit against the governor of the BCB for being too political and close to the markets.
4 Vale's share price has also been affected by the downward trend in iron ore prices since the start of the year and that of Petrobras, by the announcement of a 24% (t/t) drop in its net profit in Q1 (-38% y/y).
5 To preserve the real value of their investments in the face of anticipated higher inflation, investors have, in recent months, been demanding an additional risk premium to hold medium- to long-term government debt securities.

MEXICO

A CHALLENGING POLITICAL SHIFT

Claudia Sheinbaum was elected President of Mexico on 2 June. The political and economic challenges she will face during her mandate are numerous, and mainly concern the sustainability of public finances, the reform of the energy sector (a particularly sensitive point in Mexico, especially in the context of nearshoring and renewed appeal to foreign investors) and the renegotiation of the trade treaty with Canada and the United States (UMSCA) in 2026. In the short term, as a member of the Morena party of the former outgoing President, the new President needs to find the appropriate distance from Andres Manuel Lopes Obrador and his supporters. Discussions relate in particular to the reform of the justice system that AMLO himself had proposed.

LANDSLIDE VICTORY FOR THE MORENA PARTY

On 2 June, Claudia Sheinbaum was elected President of Mexico for the next six years. The new President (leader of the Morena party, former Head of Government of Mexico City and protégée of the outgoing President) was elected by a large majority (60% of votes cast), even bigger than that of her predecessor, Andres Manuel Lopes Obrador (AMLO, elected with 53% of votes cast in 2018). On the same day, 128 Senators, 500 Members of the Chamber of Deputies, 8 State Governors and the new Head of Government of Mexico City faced the voters for renewal of their mandate.

Overall, the results are broadly in favour of the former President's Morena party: the legislative coalition is in a position to enjoy a qualified majority (i.e., two-thirds of the votes) in both chambers. In other words, the next government should be able to implement its economic and social policy relatively easily. This also means that the next government, if it so wishes, will be able to enact reforms amending the Constitution (which the outgoing President was unable to do during his mandate, despite repeated attempts). Morena party candidates also won governorships in six of the eight States, and retained the governorship of Mexico City.

THE ISSUE OF REFORM OF THE JUDICIAL SYSTEM

In accordance with the Mexican Constitution, the elected President will take office on 1st October, and the parliamentary session will begin in early September. This interval should allow her to clarify the direction she would like her mandate to take. For the time being, she seems to be indicating a more consensual path than AMLO, focusing on renewable energies and increasingly open to private investors (especially foreign investors). However, the move away from AMLO's policy should be gradual; this is a question of not offending the President or his numerous supporters and retaining the majority in order to secure the adoption of draft laws. During the campaign, Claudia Sheinbaum had already ensured that she would respect the independence of the Central Bank and the justice system, that she would remain "fiscally responsible" and that she would create conditions favourable to significantly increasing private investment.

However, the peso and the Mexican stock market index fell the day after the election (chart). But rather than distrust of the new President, the sharp reaction of the financial markets reflects the fear that AMLO will use the short period of having a qualified majority until September (when the parliamentary session opens, before he leaves office the following month) to get several constitutional reforms passed, including the highly contested reform of the judicial system. This reform proposes reducing the number of Supreme Court judges (from 11 currently to 9) and the term of their mandate (from 15 to 12 years). The judges and magistrates of the High Courts of Justice would also have to be appointed by a popular vote. However, opponents to this law fear above all that the majority of elected judges will come from the presidential majority, which would no longer guarantee the independence of the judicial system.

FORECASTS

	2021	2022	2023e	2024e	2025e
Real GDP growth, %	5.7	3.9	3.2	1.7	1.8
Inflation, CPI, year average, %	5.7	7.9	5.6	4.0	3.1
Budget balance / GDP, %	-3.8	-4.3	-3.3	-5.0	-4.0
Public debt / GDP, %	47.8	46.9	46.5	49.1	51.0
Current account balance / GDP, %	-0.3	-1.2	-0.3	-1.0	-1.0
External debt / GDP, %	47.5	42.9	34.8	35.2	35.1
Forex reserves, USD bn	202.4	194.0	207.0	210.0	215.0
Forex reserves, in months of imports	5.1	4.8	4.1	4.3	4.5

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

TABLE 1

MEXICO: STOCK INDEX AND EXCHANGE RATE AGAINST USD

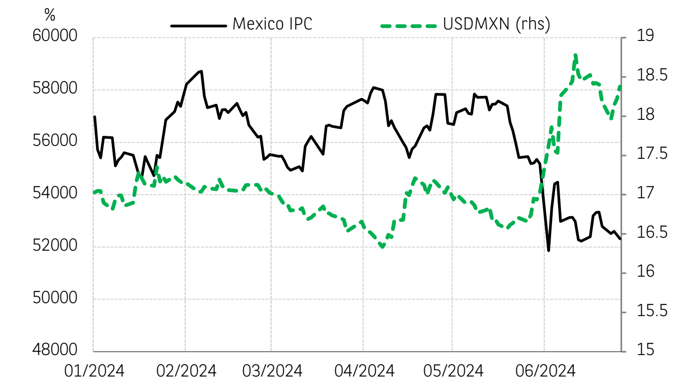


CHART 1

SOURCE: CENTRAL BANK

Another very controversial point of the reform is the elimination of the "suspensions" created by what is known as the "injunction" law, i.e., the possibility given to a citizen or a political party to request an injunction when a law that they consider unconstitutional has just been passed. If the injunction is granted, the law will be suspended until the Supreme Court has ruled on the constitutionality of the law. Several injunctions have been requested during AMLO's mandate, in particular concerning the reform of the energy sector.

Opponents to abolition of the injunction law fear that it will prevent the thorough examination of legislative proposals that could permanently change the country, and in particular its economic framework. This could significantly impact the business environment, and more particularly FDI inflows in a context of relocation to Mexico (especially of US companies).

Concerns are already apparent: the total amount of FDI increased in 2022 and 2023, but due to two special operations (the restructuring of the airline Aeromexico and the merger of the two audiovisual companies Televisa and Univision, respectively). Notably, the amount of "new investments" has decreased steadily since the beginning of 2022 (Chart). Claudia Sheinbaum has not formally objected to the plan submitted by AMLO, but has stated that public consultations would take place and that the independence of the Mexican judicial system was not under threat.

BROAD OUTLINES OF ECONOMIC POLICY

In June, the President's Office revealed the names of several members of the next government team, including the retention of the current Minister of Finance (Rogelio Ramirez de la O) and the appointment of the former Secretary of Foreign Affairs (Marcelo Ebrard) as Minister of the Economy. The latter's experience could prove an important asset in the potential renegotiation of the trade treaty with the United States and Canada (UMSCA) planned for 2026.

Regarding the energy sector, the various statements are currently contradictory and not very detailed. During the campaign, Claudia Sheinbaum, who is a former member of the IPCC, pronounced herself in favour of accelerating the country's low-carbon transition and increased the number of commitments in principle. One of the objectives is to extend to all companies the environmental standards with which foreign companies comply, in particular by improving the most decarbonised electricity supply possible, while taking full advantage of the opportunities offered by nearshoring. In the area of renewable energies, private investments could be favoured, but the details are not yet known.

Paradoxically, the new government nevertheless seems to want to remain on the line drawn by AMLO of "energy sovereignty", with a predominant role of the State in energy-related projects (old and new). According to its preliminary statements, the government does not plan to change the economic model of the national oil company PEMEX, nor would it consider regular financial support to the company.

MEXICO: FDI INFLOWS

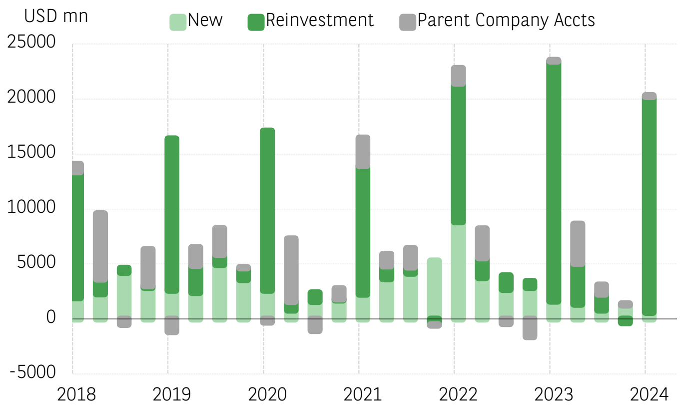


CHART 2 SOURCE: CENTRAL BANK

Details regarding support for PEMEX and, more generally, the new government's fiscal policy are much anticipated, particularly by rating agencies and investors: the budget deficit has widened in recent years (more than 5% of GDP is expected in 2024, after 3.6% in 2023) and debt interest payments have risen significantly (they represented 15.1% of government revenue in 2023, i.e., over 2.5% of GDP). In March, the outgoing government presented the preliminary elements of the budget (which will be voted on in November), which the President has endorsed. The primary objective is to reduce the deficit (to around 2.5% of GDP), almost exclusively by reducing expenditure, while maintaining expenditure on major infrastructure projects in progress (such as the Tren Maya).

To date, Claudia Sheinbaum and her team are not considering any tax reform aimed at increasing income, while the rigidity of expenditure increased significantly during AMLO's mandate (increased support for the national oil company PEMEX, increase in cash transfer programmes, particularly to older people, depletion of sovereign funds).

We are therefore expecting a much slower reduction in the deficit: on top of higher debt interest payments, the new government will still have very limited room for manoeuvre.

Hélène Drouot
helene.drouot@bnpparibas.com

ARGENTINA

MAKE OR BREAK

The *Ley Bases* (a set of measures designed to liberalise the economy and, more generally, society) presented by Javier Milei after his inauguration last December was finally adopted at the end of June. As the President's party has no majority in either the Chamber of Deputies or the Senate, the final version was watered down. However, it is a victory for Milei, who is racing against time between an economy sinking into deep recession and the first signs of disinflation. For the government, the fight against inflation justifies the drastic cuts in public spending and the maintenance of a strategy of real exchange rate appreciation. Beyond the spectacular recovery in the public accounts and the trade balance since the start of the year, the question is whether this shock treatment, however useful it may be in controlling inflation, will not weaken the economy more than necessary.

After a six-month battle between the executive and members of parliament, punctuated by demonstrations and riots, Javier Milei's government succeeded in pushing through its reform package (originally 600 articles, since reduced to 238). The government had to make concessions, but emblematic tax measures were passed at third and final reading in the Chamber of Deputies.[1] The outcome of this confrontation was unexpected given the lack of a majority for the presidential party in both houses. Tensions in financial markets have abated somewhat.

However, the calm remains precarious. Argentina's economy is sinking into recession and, although the extreme fiscal restrictions succeeded in reducing the surge in inflation at the end of 2023/ beginning of 2024, the inflationary hydra is far from being defeated. The central bank's foreign exchange reserves, which had recovered in the first few months after Javier Milei's election, have plateaued. Fortunately, the country still enjoys the support of the IMF and China's central bank.

DRASTIC REMEDY

In Q1 2024, GDP contracted by 2.6% q/q after -2.5% in Q4 2023. Year-on-year, the decline was already 5.1%. Activity in the construction sector collapsed at a rate comparable to that seen during the Covid-19 crisis, testifying to the severity of the downturn (see chart 1). Industrial production has fared little better, falling by more than 10% compared with its average level in 2023. With consumer prices soaring (up 115% in cumulative terms between November and April for the official CPI), real wages in Q1 2024 were down 20% year-on-year in the private sector and 30% in the public sector, and the unemployment rate rose to 7.7% from 5.7% in Q4 2023. Without the fall in the household savings rate (retail sales fell by just 2% year-on-year in real terms in Q1 2024) and the very positive contribution of foreign trade in terms of the change in the trade balance, the fall in GDP would have been even more marked.

The deepening recession is the consequence of the contraction in private demand, but also of the drastic cuts in public spending, in line with the promises made by Milei before he was elected. Thus, over the January-April period compared with the same period in 2023, central government primary spending (i.e. spending excluding interest) was cut by 19% in real terms, including -13% for the wage bill and other current expenditure, -20% for social transfers, -47% for transfers to non-central government bodies and -80% for capital expenditure. Only certain transfers to the most deprived were maintained (in real terms).

FORECASTS

	2021	2022	2023	2024e	2025e
Real GDP growth, %	10.4	5.2	-1.6	-4.0	2.5
Inflation, CPI, year average, %	48.4	72.4	133.5	220.0	50.0
General gov. balance / GDP, %	-4.5	-4.3	-4.6	-2.8	-1.0
General gov. debt / GDP, %	80.0	85.5	153.7	55.0	40.0
Current account balance / GDP, %	1.4	-0.7	-3.5	1.4	2.0
External debt / GDP, %	55.0	58.8	113.7	55.0	57.0
Forex reserves, USD bn	39.7	44.6	23.1	30.0	35.0
Forex reserves, in months of imports	6.6	5.5	3.1	3.8	4.2

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

ARGENTINA: ACTIVITY INDICATORS (Q4 2019=100)

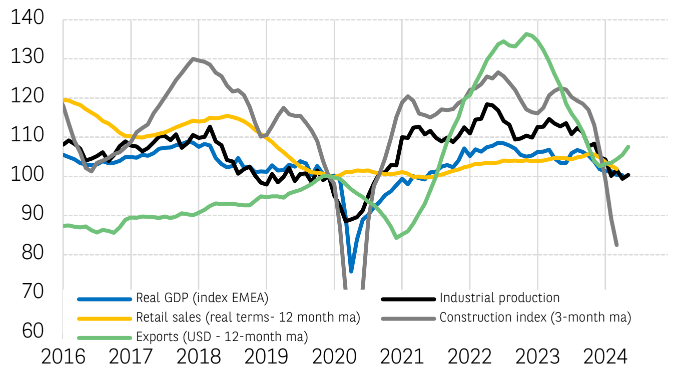


CHART 1 SOURCE: INDEC, ISAC, BNP PARIBAS

PERSISTENTLY LOW FOREIGN EXCHANGE RESERVES

This shock treatment made it possible i) to slow inflation from a double-digit rate of increase from November to March (17% per month on average) to 4.2% in April; ii) to generate a surplus in the central government budget (+1.3% of GDP over the January-April

1 The number of privatisations announced has fallen from around forty to less than a dozen. On the other hand, the lower limit of personal income tax has been lowered to tax monthly salaries from ARS 1.8 m (USD 1,936 at the current official exchange rate) and, conversely, the tax base for wealth tax has been raised from ARS 27 to 100 m (i.e. just over USD 1 million at the current official exchange rate).

period for the primary balance, +0.1% for the total balance) and in the balance of current payments (USD 7.6 bn over January-April compared with a deficit of 4.8 bn over the same period in 2023).

However, this rebalancing has not led to a rebuilding of official foreign exchange reserves, which have plateaued at just over USD 29 bn despite i) the contraction in imports, ii) continued direct investment, and iii) net capital repatriation by non-financial residents (including in the form of conversion of dollars into pesos). The explanation is essentially twofold: i) 20% of export revenues were authorised to be exchanged on the foreign exchange market instead of being converted directly with the central bank (BCRA) ii) the Argentinian authorities repaid, in net terms, USD 4 bn to international financial institutions (other than the IMF) and official bilateral creditors.

As a result, the gap between the main parallel exchange rate (the blue chip swap rate) and the official exchange rate against the US dollar, which had narrowed to 10% at the beginning of April (from 200% at the end of November), has widened to 50%. However, the narrowing of this gap was a key factor in the sharp deceleration in monthly inflation between December and April. When the gap exceeds 50%, the sensitivity of price rises to changes in the exchange rate increases twofold. We could therefore expect inflation to pick up again in the coming months, unless the BCRA decides to completely change its strategy and tighten monetary policy. And that is precisely what it is about to do.

A CONSISTENT MONETARY AND EXCHANGE RATE STRATEGY

Over the last six months, monetary policy had been dictated by the need to put an end to the exponential cost of sterilisation by the BCRA, i.e. the interest paid on notes issued by the latter (LELIQs) to cover the monetary financing of the budget deficit (15.5% of GDP in cumulative terms between 2019 and 2023). Last year, with the yield on LELIQs soaring well above 100%, this burden had reached, according to our estimates, 9% of GDP (compared with 5.1% in 2022 and 2.8% in 2021). It was therefore urgent for the BCRA to ease this constraint, which it did by lowering its main refinancing rate from 133% in mid-December to 40% at present. At the same time, Treasury bills (used for repo transactions) have replaced sterilisation notes on its balance sheet. In total, the cost of sterilisation was reduced to 3.5% of GDP over the first five months of the year.

The monetary authorities have announced that real interest rates will return to positive territory from June, which, all other things being equal, can only increase the cost of sterilisation. However, the sources of money creation for the budget deficit (temporary advances and transfers from the central bank to the Treasury) have completely dried up, and the other Treasury operations that affect changes in the monetary base are now making a negative contribution.

The monetary factors behind inflation are therefore likely to disappear. However, in Argentina, monetary-based inflation is so endemic that controlling the monetary base alone is not enough, even if it is necessary.

ARGENTINA: FOREIGN EXCHANGE RESERVES AND EXCHANGE RATE GAP

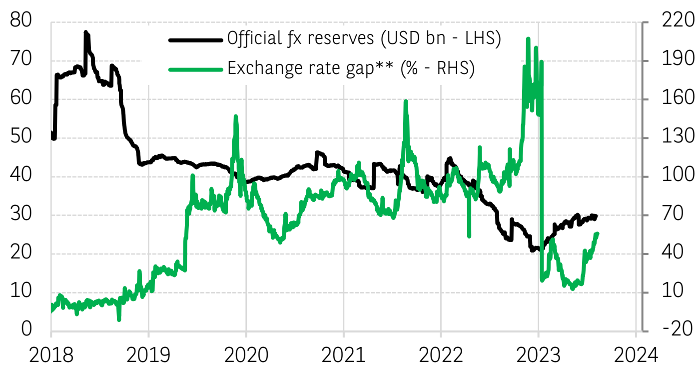


CHART 2

(**) GAP BETWEEN THE BLUE CHIP SWAP RATE AND OFFICIAL USD/ARS
SOURCE: BLOOMBERG, BCRA, BNP PARIBAS

The fight against inflation requires the central bank to keep the rate of depreciation of the official exchange rate as low as possible (the authorities have set it, in agreement with the IMF, at 2% per month against the dollar) in order to make parallel exchange rates converge towards the official exchange rate.

Indeed, the real appreciation of the exchange rate as a means of credibly and sustainably anchoring disinflation expectations is an essential strategy for any commodity-exporting country faced with hyperinflation. Administrative price controls are generally ineffective in balancing external accounts (a "forced" depreciation of the real exchange rate improves the current account balance only marginally) and, above all, are counterproductive for investment and hence growth in the medium term.
The objective of anchoring the real exchange rate accelerates the disinflation process. Over time, however, it needs to be complemented and reinforced by structural reforms to combat monopolies and, more generally, barriers to entry to the goods and services markets. This is the task of Federico Sturzenegger, a former governor of the BCRA (under Mauricio Macri) and current principal economic adviser to Javier Milei, who has been charged with bringing these reforms to fruition. Whether they will be accepted by the population remains to be seen.

François Faure
francois.faure@bnpparibas.com

ALGERIA

POSITIVE SIGNS BUT MAJOR CHALLENGES

Buoyed by relatively high global energy prices and sustained demand for its gas, the Algerian economy continues to perform strongly. In 2023, economic growth was one of the strongest among the region's hydrocarbon-producing countries, and the outlook for 2024 remains favourable. However, the expansionary stance of economic policy is beginning to show some limitations, not least because of rising fiscal imbalances. While the risks of macroeconomic instability are largely contained in the short term, rebalancing the engines of growth remains a major challenge in the medium term. A number of recent decisions by the authorities are moving in the right direction, but efforts to diversify the economy will need to be continued. This will become all the more necessary in the global context of a low-carbon transition.

GROWTH: GOOD MOMENTUM CONTINUES

Thanks to strong growth, Algeria is on the verge of joining the three largest African economies. Since 2022 and the energy shock that hit Europe, economic activity has grown by an average of 3.8% a year, three times faster than before the pandemic. The economic growth rate even exceeded 4% in 2023 for the first time since 2014, a performance to be compared with that of the other hydrocarbon-producing countries in the region (Chart 1). For the latter, growth averaged only 1.7% in 2023 as a result of the cuts in oil production quotas agreed under OPEC+. Algeria has done its bit. Crude oil production fell to 973 mb/d in 2023 from 1,020 mb/d in 2022. But this has been more than offset by a rise of almost 6% in natural gas production, which continues to play a major role in the extractive sector: natural gas accounts for 60% of Algeria's total hydrocarbon production and export volumes. Unlike most of its regional peers, Algeria's real hydrocarbon GDP grew by 4.5% last year. Excluding hydrocarbons, the dynamic has also been robust with GDP growth of more than 4% in 2022-2023 thanks to an expansionary economic policy. Despite the sharp rise in inflation (9.2% in 2022, 9.3% in 2023), the central bank has maintained its key rate at 3%. Above all, fiscal support has been massive, boosting household consumption (+3.5% in 2022, +3.8% in 2023) and investment (+8.4% in 2023).

Economic growth is expected to remain close to 4% in 2024. Despite the extension of OPEC+'s restrictive policy until the end of the year, the development of the gas sector and the significant increases in public spending planned in the budget law should enable Algeria to record one of the highest performances in the region. Moreover, the risks to growth appear to be contained. In particular, the easing in food prices has reduced inflationary pressures. In April, the Consumer Price Index (CPI) rose by just 2.4%. Excluding food, the decrease in inflation is less pronounced (5.1% in April compared with 5.9% at the end of 2023). But as money supply growth has also slowed, reaching less than 6% at the start of the year after peaking at 16.7% in March 2023, fears of a surge in prices linked to too strong a stimulus to demand have partly subsided. In an unstable geopolitical environment, Algeria's low exposure to disturbances in the Red Sea is also reassuring. Finally, Algeria's external accounts and public finances remain sufficiently strong to protect the country from any downturn in global energy prices, at least in the short term.

MACROECONOMIC STABILITY: RISKS CONTAINED IN 2024

Thanks to the marked improvement in its external accounts since 2022, Algeria has been able to rebuild its foreign exchange reserves. From USD 47 billion in 2021, they rose to USD 62 billion the following year, then to USD 70 billion in 2023, before remaining relatively stable over the first few months of 2024. After reaching 8.4% of GDP in 2022, the current account surplus fell to 2.3% of GDP in 2023, mainly as a result of the 16% fall in hydrocarbon exports. The marked increase in imports of goods has also weighed on external accounts. Up by almost 10% in 2023, imports have been driven by a sharp rise (+49.3%) in purchases of machinery and transport equipment, following renewed investment and the relaxation of import controls on passenger and commercial vehicles.

FORECASTS

	2021	2022	2023e	2024e	2025e
Real GDP growth (%)	3.8	3.6	4.1	3.8	3.1
Inflation (CPI, year average, %)	7.2	9.2	9.3	5.7	5.0
Gen. Gov. balance / GDP (%)	-6.1	-2.5	-3.0	-6.9	-7.2
Central. Gov. debt / GDP (%)	54.6	47.8	48.5	47.5	47.9
Current account balance / GDP (%)	-2.5	8.4	2.3	1.4	-1.2
External debt / GDP (%)	1.8	1.3	1.3	1.2	1.2
Forex reserves (USD bn)	47	62	70	75	74
Forex reserves, in months of imports	12.8	15.8	15.9	15.4	14.0

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

ALGERIA: REAL GDP GROWTH

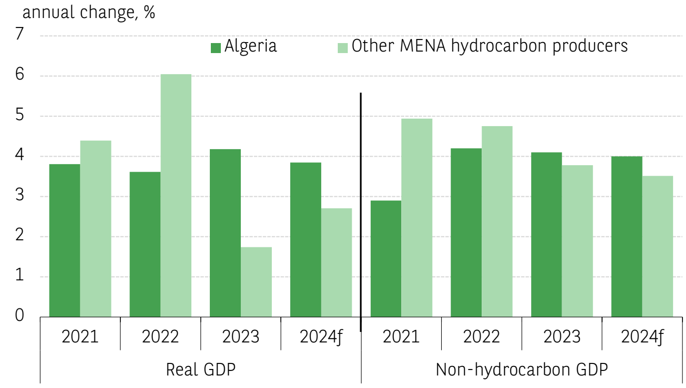


CHART 1 SOURCE: IMF, ONS, BNP PARIBAS

The strategy adopted by the authorities in recent years to limit imports and encourage local production therefore seems to have reached its limits. The rapid rise in imports will continue in 2024, but Algeria should still be able to run a new current account surplus thanks to a Brent crude oil price above USD 80. In addition, foreign exchange reserves now cover 16 months of imports of goods and services, and the country has no external debt.

Public finances are not a major concern for 2024 either, although they are under greater pressure. According to the IMF, oil prices would have to reach USD 126 a barrel for Algeria to balance its budget, the highest level among the region's hydrocarbon producers, along with Bahrain (Chart 2). Since the authorities adopted an expansionary policy stance in 2022, public spending has increased by more than 20% on average each year, and a similar increase is expected for 2024. After returning to a moderate level of 2.5-3% of GDP in 2022-2023, the budget deficit is expected to widen to 7% of GDP this year. At such a level, the question of how to cover financing needs could arise, as was the case between 2017 and 2019, when the central bank had to make massive purchases of government debt. But the current context is different as the Treasury will be able to draw on the Revenue Regulation Fund (RRF). These oil savings, which were still completely depleted in 2020, now exceed 8% of GDP. As a result, public debt will remain below 50% of GDP in 2024.

ALGERIA: FISCAL BREAKEVEN OIL PRICE, IN 2024

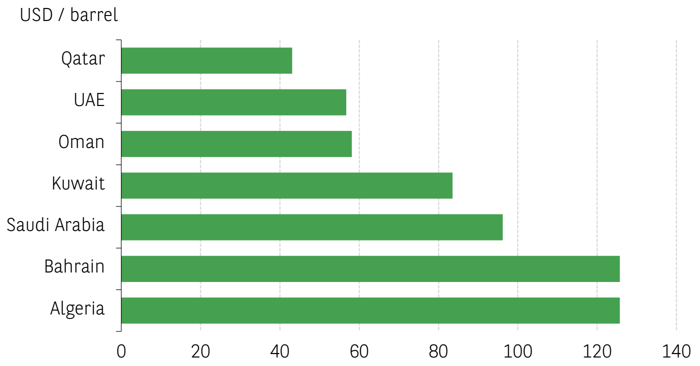


CHART 2

SOURCE: IMF, BNP PARIBAS

The same applies to foreign direct investment, which rose from USD 254 million in 2022 to USD 1.2 billion in 2023. Despite this strong growth, it represents only 0.5% of GDP, making Algeria the least attractive economy in the region.

DIVERSIFICATION AND DECARBONISATION: TWO MAJOR MEDIUM-TERM CHALLENGES

The lights are green, but for how long? While the stability of external accounts does not appear to be under threat, Algeria's economic development could once again come up against a financing constraint linked to budgetary imbalances. At current deficit levels, the government could exhaust its financial savings as early as 2025. This would require a rationalisation of spending and therefore less support for activity from public investment. Current spending, which is more difficult to reduce, now accounts for 80% of the budget, compared with 63% in 2019, due to the increase of social measures in recent years. Consequently, without the support of private investment, economic growth could gradually slow down to stabilise at around 2% from 2027 (IMF). Another option would be to allow budget deficits to slide, with the risk of returning to unconventional financing strategies. Furthermore, with an increasingly rigid spending structure, public finances have become increasingly vulnerable to fluctuations in hydrocarbon revenues.

Diversifying the economy therefore remains a priority. Several measures testify to the authorities' determination to act in this direction, starting with the introduction of a new investment code in 2022 and the opening of the capital of a public bank (CPA) on the Algiers stock exchange. The decision to set up banking subsidiaries in several African countries also reflects the desire to support exporters in new markets. Against this backdrop, the acceleration in growth of bank credit to the private sector is encouraging. After several years of sluggishness, it reached 9.5% in April, outpacing inflation. However, the low level of bank penetration (total outstanding loans to the private sector represent less than 20% of GDP) still limits the scope of this dynamic.

The need to develop the private sector is reinforced by another challenge: the low-carbon transition. Algeria has two advantages in this still uncertain process. Firstly, the cost of extracting oil remains low, which would enable it to maintain its market share in an adverse transition scenario. Secondly, its subsoil is full of gas reserves, whose peak demand is in principle further away than that of oil. Nevertheless, we must also expect greater volatility in energy prices and downward pressure in the years ahead. In the short term, the introduction of the carbon tax in Europe also risks affecting non-hydrocarbon exports, which are mainly made up of energy-intensive products (cement, fertiliser, iron and steel). In addition, the authorities have pledged to reduce the country's greenhouse gas emissions by 7% to 22% by 2030, in particular through the development of renewable energies. There are many challenges. Firstly, the challenge is huge, as 95% of electricity production is currently gas-fired. Secondly, Algeria needs to maintain its export capacity. Local consumption currently absorbs 45% of gas production, compared with one-third in 2010. It will be difficult to reverse this trend without diversifying electricity production. This will also undoubtedly require an overhaul of the subsidy system, which inflates energy consumption while ensuring that Algerians enjoy some of the lowest oil and gas prices in the world.

Stéphane Alby
stephane.alby@bnpparibas.com

ONGOING REFORMS

Since the beginning of 2024, the Nigerian authorities have accelerated the implementation of reforms aimed at curbing the deterioration in external accounts and restoring macroeconomic stability. By relaxing the exchange rate regime and raising interest rates, the central bank has sent a strong signal to foreign investors. However, it will take time and the implementation of major structural reforms for capital inflows to take off significantly and durably. At the same time, fiscal consolidation is being complicated by an unprecedented inflationary shock and its impact on economic growth. The high cost of implementing reforms could force the government to backtrack.

REFORMING THE EXCHANGE RATE REGIME

Since 2015, Nigeria's external accounts have deteriorated as a result of the downward trend in oil production and negative price shocks. Faced with this situation, the Central Bank of Nigeria (CBN) has worked to maintain exchange rate stability, in order to limit inflation via rising import prices. However, maintaining the exchange rate at an artificially overvalued level has been to the detriment of two elements. On the one hand, to support the naira, the central bank has drawn on foreign exchange reserves, which have declined steadily since 2019 (with the exception of a brief rebound in mid-2021 due to a Eurobond issuance and the granting of IMF special drawing rights). On the other hand, the CBN has had to introduce capital controls on several occasions to ration access to foreign currency, creating distortions on the official foreign exchange market that have discouraged foreign capital inflows, which are already historically low.

Acknowledging this untenable situation, the authorities who came to power in May 2023 immediately broke with their predecessors by embarking on an in-depth reform of the exchange rate regime, with the aim of eventually returning to an exchange rate determined by market forces. As a first step, they carried out an unprecedented devaluation of the naira, with the aim of closing the gap between the official exchange rate and the rate prevailing on the parallel market in May 2023. However, in the absence of additional measures, the gap with the official rate widened further, reaching 37% in October 2023.

The authorities had to speed up reforms aimed at eliminating the many distortions on the foreign exchange market. In October 2023, the CBN repealed an eight-year-old ban on access to foreign currency for imports of 43 categories of goods. In February 2024, it put an end to exchange rate ceilings on interbank transactions and international money transfer operations. At the same time, it improved the transparency of the official market by making public the methodology used to calculate the overnight exchange rate.

Combined with a further devaluation in January 2024, this wave of reforms seems to have borne fruit: since last February, the gap between the official and parallel exchange rates has closed. However, capital controls persist. In order to attract foreign capital despite this, the CBN is counting on a return to a more orthodox economic policy.

TOWARDS A RETURN TO MONETARY ORTHODOXY

The CBN has long pursued objectives that conflict with its mandate to combat inflation, notably due to the frequent monetisation of the budget deficit.

In order to restore confidence in monetary policy, it was therefore crucial for the new authorities to signal a change of course. With a new governor at the helm, the CBN suspended budget deficit financing in H2 2023 and reiterated the long-standing rule that all new advances contracted by the government from the CBN must be repaid within three months. At the same time, the government has paid off half of the advances that were taken out in H1 2023, and plans to repay the remaining NGN 4,000 billion (1.7% of GDP) in the coming months. With this reduced burden, the CBN has been able to act more freely to combat inflation, albeit belatedly. Between February and the end of May 2024, the main policy rate was raised by 750 basis points to 26.25%. At this level, the *ex ante*

FORECASTS

	2021	2022	2023	2024e	2025e
Real GDP growth, %	3.6	3.3	2.9	3.3	3.0
Inflation, CPI, year average, %	17.0	18.8	24.7	26.3	23.0
Gen. Gov. balance / GDP (%)	-5.2	-6.7	-4.8	-4.7	-4.2
Gen. Gov. debt / GDP (%)	35.7	39.4	46.4	46.7	47.0
Current account balance / GDP, %	-0.7	0.2	-0.2	0.5	-0.1
External debt / GDP, %	18.5	18.8	22.7	32.9	34.8
Forex reserves, USD bn	33.2	32.8	27.3	27.7	28.6
Forex reserves, in months of imports	5.9	5.1	4.5	4.8	5.0

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

NIGERIA: EXCHANGE RATE ON THE OFFICIAL AND PARALLEL MARKETS

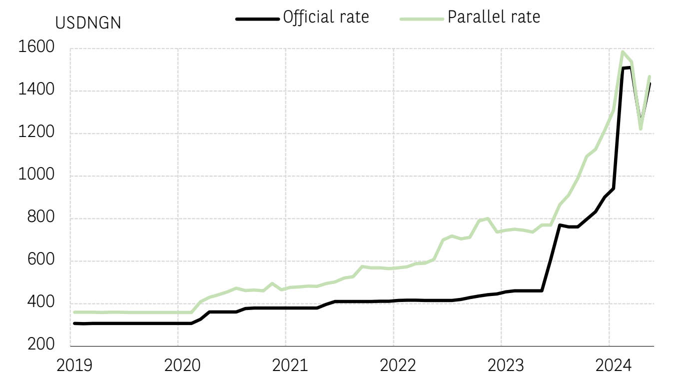


CHART 1 SOURCE: CBN, NIGERIAGALLERIA, BNP PARIBAS

real interest rate is now estimated to be slightly positive, as inflation is expected to fall in H2 2024. Further increases in the policy rate cannot be ruled out. The CBN has also resumed open market operations aimed at absorbing banks' excess liquidity.

By giving priority to the fight against inflation and reforming the foreign exchange market, the CBN has sent a strong signal to investors. As a result, according to data from the National Bureau of Statistics, net foreign capital inflows jumped to USD 3.4 billion in Q1 2024 (compared with USD 1.1 billion in the previous quarter). Driven mainly by net portfolio investment inflows (61% of total net capital inflows), they reached a level not seen since Q1 2020. This helped the CBN to honour its arrears on the foreign exchange market, which had been totalling USD 7 billion for several months. In addition, the exchange rate appreciated in March and April for the first time in over a year. However, the improvement was short-lived. The naira depreciated again in May, and is likely to remain highly volatile over the coming months. Above all, foreign exchange reserves remain at an alarmingly low level. According to the CBN, after a period of volatility in April-May, they reached USD 34 billion at the end of June, the same amount as a year earlier. However, according to the IMF, almost a quarter of these assets are illiquid. In order to attract capital on a sustainable basis and regain a comfortable level of external liquidity, the authorities will need to maintain their new policy mix over the long term and introduce major structural reforms. However, the difficulties are mounting, given the challenging pursuit of fiscal consolidation and the unprecedented inflationary shock.

FISCAL CONSOLIDATION INCREASINGLY DIFFICULT

With fiscal revenue of less than 10% of GDP, of which an average of 40% comes from oil, public finances are very fragile. In addition, against a backdrop of high oil prices, fuel subsidies had become increasingly costly, absorbing 24% of fiscal revenue in 2022.

The new government has therefore inherited a challenging situation in terms of public finances too, and has set the goal of fiscal consolidation. In 2023, the deficit contracted to 4.8% of GDP, compared with 6.7% in 2022. Non-oil revenue increased by one percentage point of GDP, thanks to improved tax collection. The government also moderated its spending. However, despite the shock announcement in May 2023 of the end of fuel subsidies, these have been reintroduced implicitly through the devaluation of the naira, which has had an impact on consumers and the government. Indeed, while pump prices have risen for consumers (they rose by 129% in June 2023 and were relatively stable thereafter until April 2024), the government has continued to sell fuel on the local market at a price significantly lower than the cost of its refined oil imports. As a result, indirect fuel subsidies still represented 0.8% of GDP in 2023, and are expected to rise to 2.8% of GDP in 2024, taking into account last January's devaluation. At present, the government has no plans to raise the domestic price of fuel towards a price determined by global market forces, as the impact of such a measure would be devastating for an economy already stifled by record inflation. To support households, the government plans to increase social benefits, some of which were suspended in 2023 because of embezzlement scandals. Overall, further fiscal consolidation will therefore prove difficult in 2024, and the deficit is likely to remain close to its 2023 level. Given the tense social climate, the risk of fiscal slippage is high.

NIGERIA: MONETARY ENVIRONMENT

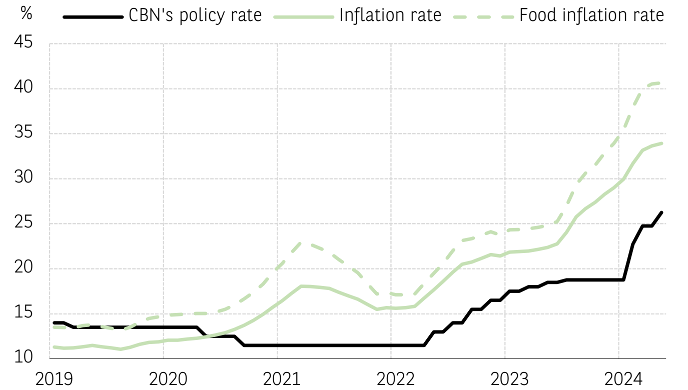


CHART 2 SOURCE: CBN, BNP PARIBAS

In addition, the drastic rise in domestic interest rates is likely to weigh heavily on interest payments on the public debt, which were already absorbing 35% of fiscal revenue in 2023. On a positive note, thanks to the reforms, increased support from multilateral donors in the form of loans at concessional rates should mitigate somewhat the upward trend in the interest burden on public debt. Besides, at 46% of GDP in 2023, public debt is still moderate.

RAMPANT INFLATION AND SLUGGISH ECONOMIC GROWTH

Rising fuel prices and the depreciation of the naira (by 71% between May 2023, before the first devaluation, and mid-June 2024) have plunged Nigeria into a deep economic crisis. The country is a net importer of food products, which make up 51% of the consumer price index basket. Year-on-year inflation reached 34% in May 2024, a level not seen since 1996. In recent months, there have been numerous demonstrations across the country, notably against the rise in electricity prices imposed by the government, and for an increase in the minimum wage. While economic growth is expected to accelerate to 3.3% in 2024 thanks to the upturn in oil production, non-hydrocarbon activity could be affected by a slowdown in demand and the rise in public unrest.

The current crisis comes on the back of years of virtual economic stagnation. Between 2015 and 2023, Nigeria's GDP grew at an average annual rate of 1.5%, well below the population growth rate of 2.6%. In 2023, the poverty rate reached 46% of the population, and according to the United Nations, more than 26 million Nigerians will be exposed to food insecurity in 2024. This social context could force the authorities to reconsider some of their recent policy mix reforms.

In addition, a number of structural reforms are yet to be implemented, for example to improve infrastructure in the energy sector and increase aid to the agricultural sector – which would support the CBN in the fight against inflationary pressures through supply-side measures.

Lucas Plé
lucas.ple@bnpparibas.com

LATIN AMERICA AND GULF COOPERATION COUNCIL: DIFFERENT WAYS TO FACE THE LOW CARBON TRANSITION

Energy and mineral commodities are central to the low carbon transition process. Latin America, which boasts abundant amounts of minerals and key metals for the transition, and GCC[1] countries, which are dependent on revenue from hydrocarbons, are seemingly, on the face of it, taking contrasting paths on the transition journey. However, the macroeconomic consequences cannot easily be determined currently. Gulf countries have some advantages in the oil market, but the pace of the transition could affect revenues more quickly than expected. In Latin America, while the size of critical minerals reserves is brightening the outlook, various national strategies and numerous constraints could curb the scale. Beyond possible short-term growth gains, the shared objective of all of these countries would be to move away completely from relying on commodities and to move up value chains.

LOW CARBON TRANSITION AND COMMODITIES

The core component to combatting climate change is the low carbon transition, which should enable countries to shift from a fossil fuel economy (relying on coal, oil and gas) to an economy that emits as little greenhouse gas (GHG) as possible, thereby reducing fossil energy consumption as much as possible.

The consequences of this process will vary significantly from country to country, depending on whether the country is among the economies which emits the highest amounts of GHG emissions (dependent on fossil energy production or production sectors with high GHG emitters, heavy industry in particular), or is among the economies with assets which will help to make the transition a reality (high-demand minerals and high renewable-energy potential). As a matter of fact, the faster pace of the transition is inextricably linked to increased demand for specific minerals and metals required for the electrification of uses (copper and lithium, for example) and some key technologies for the transition, such as renewable energy production, being implemented.

HYDROCARBONS: AN UNCERTAIN OUTLOOK

Irrespective of the scenario envisaged, the low carbon transition will negatively affect the medium- and long-term fossil-energy demand. According to International Energy Agency (IEA) STEPS[2] scenario (the most conservative about the pace of the transition), global fossil-fuel demand could fall structurally from 2030, sharply for coal, and more slowly for oil and gas. The start of the decline in oil demand is due in particular to the electrification of road transport (45% of global oil demand), furthered by increased sales of electric vehicles (EVs) (+35% in 2023 worldwide) in developed countries and China (60% of global sales of electric vehicles in 2023).

However, the slowdown in oil demand is expected to be very gradual. Over the past 50 years, the relative proportion of hydrocarbons within total energy consumption has decreased from 80% to 77%, despite more than doubling in volume terms. This proportion is expected to continue falling over the next few decades, but the first step in the transition is likely to be a long-term accumulation of hydrocarbons and renewable energy.

MAIN MINERAL COMMODITIES AND GHG EMISSIONS PER ZONE

	reserves		GHG emission/hab (t eq CO^2)
	Copper	Lithium	
Latin America	63	54	8
	Crude oil		
Gulf Cooperation Council	30		28

TABLE 1

SOURCE: US GEOLOGICAL SURVEY, OIL STATISTICAL REVIEW OF WORLD ENERGY, OUR WORLD DATA

PRIMARY ENERGY CONSUMPTION PER SOURCE

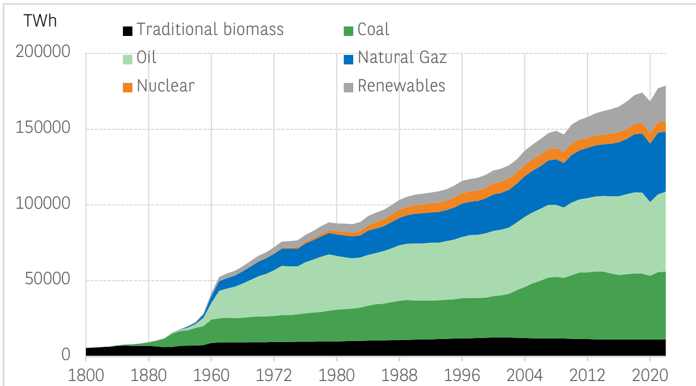


CHART 1

SOURCE: ENERGY INSTITUTE

In addition, the low carbon transition involves significant technological changes (new energy production infrastructure, carbon capture facilities, and hydrogen production), which could generate a "rebound effect" in global energy demand and potentially in the global hydrocarbon demand as a result.

1 GCC: Gulf Cooperation Council, which includes Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.
2 Stated Policies Scenario, i.e., a continuation of the current transition policies.

Beyond this basic trend, the consequences of the transition on the oil-market balance and therefore on prices remain uncertain. The pace of the transition is a key factor, which is still very difficult to anticipate, as it depends on many factors, such as changes in consumption habits, the introduction of regulations, large-scale carbon taxation and technological advances. Some alternative scenarios anticipate an accelerated drop in oil demand and prices over a relatively short timeframe of around two decades. According to estimates by Boer et al.[3], the oil price outlook for 2050 varies greatly (ranging from USD 15/barrel to USD 300/barrel), depending on whether the transition is primarily driven by demand (the electrification of transport is stepped up, for example) or by supply (regulations restricting production, for example).

STRONG INCREASE IN DEMAND FOR CRITICAL MINERALS

Conversely, the demand for minerals and metals is expected to rise substantially with the transition. According to the IEA's medium scenario (APS)[4], demand for critical minerals[5] is expected to double by 2030. In 2023, around 30% of the demand for these materials was linked to the low carbon transition (renewable energy production, batteries, EVs, electricity grid and hydrogen), and this proportion could double by 2040. In particular, this presupposes that demand for nickel and cobalt will double compared to 2023 and that demand for lithium will increase ninefold. For copper, a key material in the electrification process, global demand could increase 1.5 times by 2040. Furthermore, if we refer to the scenario arising from the Paris Agreements[6], which is optimistic but increasingly unlikely, demand for the various materials would increase twentyfold on average by 2040 too.

LATIN AMERICA: EVIDENT STRENGTHS, BUT NOT WITHOUT A NUMBER OF CONSTRAINTS

The critical minerals demand outlook suggests that there will be significant growth opportunities for a number of Latin American countries. More than 60% of the total lithium resources are located in the region, including 56% in three countries, Argentina, Bolivia and Chile (known as "the Lithium Triangle"). 21% of the world's copper reserves are located in Chile, while Peru and Mexico have 15% of them. Latin American countries are expected to maintain a major market share in critical minerals mining by 2030 (USD 120 billion out of a total of around USD 500 billion, according to the IEA APS scenario).

However, Latin American countries dominating the global critical minerals market in the coming decades seems unrealistic, not least because of hugely contrasting mining strategies across the region.

Lithium is a good example of this. In Bolivia, this metal has been a national issue for a number of decades. Resources are nationalised, foreign investments are very limited and regulated, and development projects have been met with resistance from local populations.

LITHIUM PRODUCTION AND RESERVES

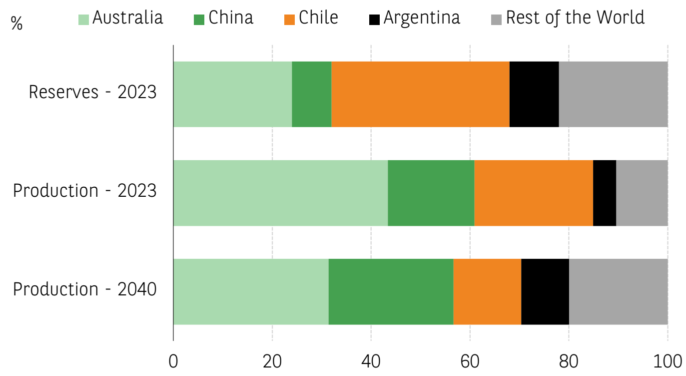


CHART 2

SOURCE: INTERNATIONAL ENERGY AGENCY

The national strategies are different again in Chile and Argentina, with mining only undertaken by private companies in Argentina, while the situation is more "hybrid" in Chile (a national public company, an American company and a Chinese company share mining operations).

The legal environments and hugely contrasting national strategies are already having an effect: while Bolivia has the greatest resources, extraction and production are very underdeveloped and its outlook is not particularly positive.

From a technical standpoint, lithium extraction is also time-consuming and complex, and must be adapted to each extraction site. The available infrastructure (access to energy and water resources) must also be taken into account. Unlike oil, lithium supply cannot be adjusted easily or over a short period of time.

And lastly, technology is evolving rapidly (lithium-free batteries could be manufactured on a large scale in a relatively short time) and recycling techniques are improving, which could further limit prospects for producer countries. The proportion of recycled materials in the total demand could hit an average of 15% in 2040, compared to its current level of less than 5% (around 10% for copper).

In addition, Latin American countries must take into account the growing number of projects in other countries. Even though their outlook is favourable, the proportion of these countries could decrease in the coming years.

GULF COUNTRIES: A FAVOURABLE POSITION THAT SHOULD BE PUT INTO PERSPECTIVE

Gulf countries dominate the global oil market, accounting for a quarter of the world's oil production and a third of the world's reserves.

3 Boer L., Pescatori A., Stuemer M., 2023, "Not All Energy Transitions Are Alike: Disentangling the Effects of Demand and Supply-Side Policies on Future Oil Prices", WP/23/160, IMF.
4 Announced Pledges Scenario in which the climate targets set by the various governments are achieved.
5 The availability of a specific category of minerals is made critical by the transition. The criticality of minerals is based on the level of the risks relating to their production, their use and their end of life management. Other factors to consider include demand in a large number of industrial sectors, limited short-term substitutability, geographical concentration of reserves and production, and high valuation. Copper fulfils all of these criteria; the main lithium reserves are concentrated in a limited number of countries, while the cobalt reserves are almost exclusively concentrated in the Democratic Republic of the Congo, a country which is experiencing a range of political tensions. Nickel, graphite and rare earths can also be added to this list.
6 This means limiting global warming to 2°C compared to the pre-industrial era.

They are the core members of the OPEC cartel and some of the only members with some flexibility in their production that could influence the market.

Gulf economies are shaped by oil revenues, which account for around 2/3 of their total exports and more than half of fiscal revenue. These countries currently have relatively low debt and have substantial sovereign funds, but their economic situation could deteriorate rapidly if there was a sustained fall in oil revenues. The fiscal breakeven oil price is currently relatively high and is averaging at USD 75/b, with prices above USD 100/b for Saudi Arabia, for example.

The low cost of oil extraction is the main factor that could enable Gulf countries to enjoy oil revenues for longer than other producing countries. However, this aspect should be put into perspective, given, firstly, the need for a relatively high price in order to preserve the sustainability of public finances, and, secondly, the recent developments in the oil market. As a matter of fact, the difference in extraction costs between the Gulf and other producers is getting smaller. The growth of shale oil in the United States (currently the world's largest producer) has come alongside significant advances in extraction techniques that have reduced the cost of production in this region. Against this backdrop, there are no guarantees that Gulf countries will be able to hold up any better than other major producers should there be a sharp drop in demand and/or prices.

THE NEED TO BREAK RELIANCE ON COMMODITIES

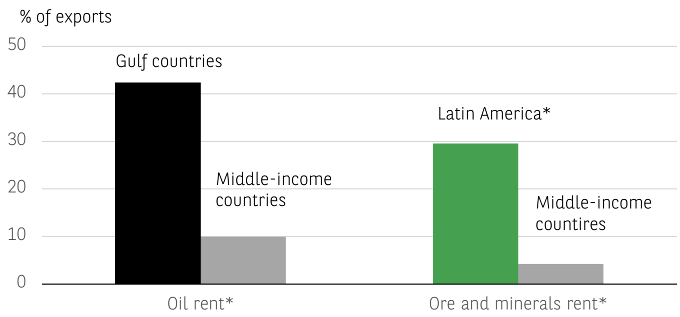
Despite, at first glance, constrasting situations, Gulf countries and Latin American countries are wrangling with the same challenge: breaking their reliance on commodities. For Gulf countries, the expected fall in revenue is only a matter of time, while for Latin American countries, the potential benefits of the dynamic minerals market will depend on a significant number of constraints.

According to revenue indicators calculated by the World Bank, these two groups of countries have a far greater reliance on commodities than the global average or than middle-income countries. More broadly, although it is a potentially major revenue source, reliance on commodities is negatively affecting the economic development of producing countries. It is a source of macroeconomic instability linked to price volatility (with the exception of copper, prices of critical minerals fell in 2023 after three years of continued rises), and may slow the development of other exporting sectors by increasing the appreciation in the exchange rate (what is known as "Dutch disease"). Lastly, reliance on commodity-linked fiscal revenues can pose economic governance problems.

In order to break this reliance on commodities, the priority is to diversify production, especially export production, by moving up value chains in order to bolster long-term growth.

In the GCC, progress is being made on diversifying the economy, but there is still some way to go with diversifying exports. In the United Arab Emirates, services account for a major proportion of GDP (standing at around 50% of the total, dominated in particular by the tourism, real estate and transport sectors), while in Saudi Arabia, energy-intensive industrial activities, for example, petrochemicals and, more recently, services, have increased their share within the composition of GDP.

COMMODITIES AND RENTS



* Argentina, Bolivia, Brazil, Chile, Peru
** 2017-21 average

CHART 3 SOURCE: WORLD BANK

However, the composition of exports has changed relatively little over the past twenty years; hydrocarbons continue to dominate and only very energy-intensive industrial sectors have increased.

In sectors linked to the low carbon transition, GCC countries have major ambitions in the mining sector (Saudi Arabia) or hydrogen production (all countries), but also in producing batteries and electric vehicles. In addition, Aramco and ADNOC, the two national oil companies of Saudi Arabia and the United Arab Emirates, are considering extracting lithium from oilfield brine, but have not specified any production targets, as the technology being used is still unproven. There is still major uncertainty as to whether these sectors will be able to generate enough revenue and supplement declining oil revenue. As a matter of fact, in these markets linked to the low carbon transition, Gulf countries will face very strong international competition, and will therefore not have the capacity to lead the market as they have been able to do on the hydrocarbon market.

For the time being, in short, the lithium value chain is split into two parts: firstly, countries which extract and produce commodities (which, therefore, include Argentina and Chile) and, secondly, countries which produce electrodes, components and the battery itself, which are currently mainly located in Asia. China has a special position in the entire value chain and leads the way in the critical-minerals refining and processing segments. It does not occupy quite such a dominant position in the extraction segment, with its extraction operations relating mainly to graphite and rare earth. China's investments (at home or abroad) in the mining sector are also growing significantly, and hit a ten-year high in 2023. This is the case not only for lithium, but also for nickel and cobalt.

For Latin American countries, the challenge is to move up the value chains and implement appropriate policies, such as funding the necessary infrastructure and building know-how. In addition, the development of a lithium-ion battery industry is inextricably linked to the prospect of a large-scale electromobility industry in a neighbouring geographical area being developed.

Hélène Drouot
helene.drouot@bnpparibas.com

Pascal Devaux
pascal.devaux@bnpparibas.com

GROUP ECONOMIC RESEARCH

William De Vijlder Chief Economist	+33 1 55 77 47 31	william.devijlder@bnpparibas.com

OECD ECONOMIES AND STATISTICS

Hélène Baudchon Deputy chief economist, Head	+33 1 58 16 03 63	helene.baudchon@bnpparibas.com
Stéphane Colliac France, Germany	+33 1 42 98 43 86	stephane.colliac@bnpparibas.com
Guillaume Derrien Eurozone, United Kingdom - Global trade	+33 1 55 77 71 89	guillaume.a.derrien@bnpparibas.com
Anis Bensaidini United States, Japan	+33 1 87 74 01 51	anis.bensaidini@bnpparibas.com
Lucie Barette Southern Europe	+33 1 87 74 02 08	lucie.barette@bnpparibas.com
Veary Bou, Tarik Rharrab Statistics		

ECONOMIC PROJECTIONS, RELATIONSHIP WITH THE FRENCH NETWORK

Jean-Luc Proutat Head	+33 1 58 16 73 32	jean-luc.proutat@bnpparibas.com

BANKING ECONOMICS

Laurent Quignon Head	+33 1 42 98 56 54	laurent.quignon@bnpparibas.com
Céline Choulet	+33 1 43 16 95 54	celine.choulet@bnpparibas.com
Thomas Humblot	+33 1 40 14 30 77	thomas.humblot@bnpparibas.com
Marianne Mueller	+33 1 40 14 48 11	marianne.mueller@bnpparibas.com

EMERGING ECONOMIES AND COUNTRY RISK

François Faure Head – Argentina, Türkiye – Methodology, Modelling	+33 1 42 98 79 82	francois.faure@bnpparibas.com
Christine Peltier Deputy Head – Greater China, Vietnam – Methodology	+33 1 42 98 56 27	christine.peltier@bnpparibas.com
Stéphane Alby Africa (French-speaking countries)	+33 1 42 98 02 04	stephane.alby@bnpparibas.com
Pascal Devaux Middle East, Balkan countries	+33 1 43 16 95 51	pascal.devaux@bnpparibas.com
Hélène Drouot South Korea, Philippines, Thailand, Andean countries	+33 1 42 98 33 00	helene.drouot@bnpparibas.com
Salim Hammad Latin America	+33 1 42 98 74 26	salim.hammad@bnpparibas.com
Cynthia Kalasopatan Antoine Ukraine, Central European countries	+33 1 53 31 59 32	cynthia.kalasopatan.antoine@bnpparibas.com
Johanna Melka India, South Asia, Russia, Kazakhstan	+33 1 58 16 05 84	johanna.melka@bnpparibas.com
Lucas Plé Africa (Portuguese & English-speaking countries)	+33 1 40 14 50 18	lucas.ple@bnpparibas.com

CONTACT MEDIA

Mickaelle Fils Marie-Luce	+33 1 42 98 48 59	mickaelle.filsmarie-luce@bnpparibas.com

GROUP ECONOMIC RESEARCH

ECOCONJONCTURE

Structural or thematic topics.

ECOEMERGING

Analyses and forecasts for a selection of emerging economies.

ECOPERSPECTIVES

Analyses and forecasts with a focus on developed countries.

ECOFLASH

Data releases, major economic events.

ECOWEEK

Recent economic and policy developments, data comments, economic calendar, forecasts.

ECOCHARTS

Easy-to-read monthly overview of inflation dynamics in the main developed economies.

ECOPULSE

Monthly barometer of key economic indicators of the main OECD countries.

ECOTV WEEK

MACROWAVES

Our economic podcast.

HOW TO RECEIVE OUR PUBLICATIONS

SUBSCRIBE ON OUR WEBSITE

see the Economic Research website

&

FOLLOW US ON LINKEDIN

see the Economic Research linkedin page

OR TWITTER

see the Economic Research Twitter page

Published by BNP PARIBAS Economic Research

Head office: 16 boulevard des Italiens – 75009 Paris France / Phone : +33 (0) 1.42.98.12.34
Internet: www.group.bnpparibas - www.economic-research.bnpparibas.com

Head of publication : Jean Lemierre / Chief editor: William De Vijlder

Copyright: Sladkozaponi

BNP PARIBAS

La banque
d'un monde
qui change