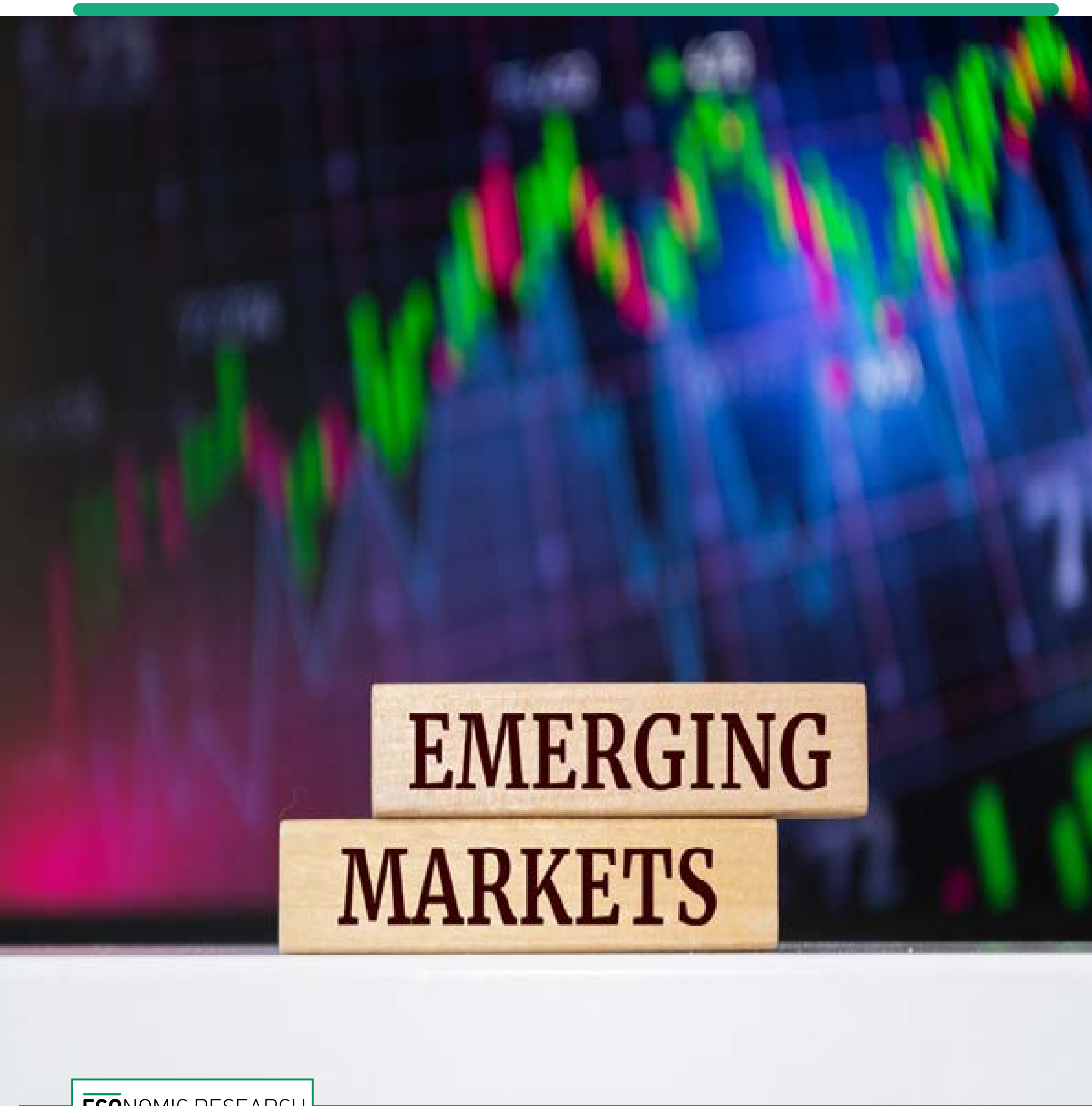
ECOEMERGING

1st quarter 2024



ECONOMIC RESEARCH

BNP PARIBAS

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SOMMAIRE

A SELECTIVE APPETITE FOR EM DEBT

Monetary and exchange rate conditions in emerging economies are more favourable in this early part of the year than they were at the end of 2022 and beginning of 2023. The relaxation of monetary policies made possible by lower inflation and upward revisions of economic growth forecasts has attracted portfolio investment. Despite the increase in geopolitical risk, sovereign risk is likely to reduce except for the most fragile countries, which were already under pressure in 2023. For low-income countries, 2024 will be a high-risk year as governments' external debt repayments will remain very heavy, just as they were in 2023.

A RELAXATION OF FINANCIAL CONDITIONS IN MOST EMERGING ECONOMIES…

Monetary and exchange rate conditions in most emerging economies (EMs) eased significantly in the final quarter of 2023, for both external and internal reasons: expectations of an easing of US monetary policy, an across-the-board appreciation of currencies against the dollar, and the continued slowing of inflation, helped by falling commodity prices. Most central banks in Latin America and Central Europe continued to cut policy rates. Bond yields followed this trend, but without amplifying it. Yields also fell in countries where policy rates were held steady (mainly in Asia), and even in Turkey where monetary tightening was still ongoing.

Appetite of fund managers for EM debt has returned. Excluding China, non-resident portfolio investments in bond markets were particularly strong in November and December, contrasting with the picture seen in late 2022 (see chart). According to IMF economists, bond yields in emerging economies over the last monetary cycle have been less sensitive than in the past to changes in US bond yields. Relative to the 'taper tantrum' of 2013, the sensitivity coefficient has fallen by two-thirds for Latin American countries and by 40% for those in Asia.

BOND FUNDS DEDICATED TO EMERGING COUNTRIES

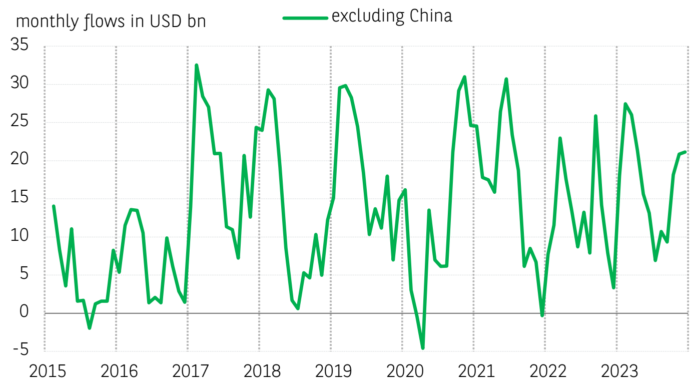

CHART 1 SOURCE: IIF, BNP PARIBAS

…BUT SOVEREIGN RISK IS RISING FOR THE MOST FRAGILE EMERGING ECONOMIES AND FOR LOW-INCOME COUNTRIES

In general terms, the solvency of EM governments should improve in 2024, thanks to the combined effects of lower interest rates and upgraded economic growth prospects. The IMF has increased its forecast for global growth by 0.2 percentage points since October 2023, with a notable increase in its forecast for the US, where it expects the landing to be much softer than previously thought (2.1% growth in 2024, from 2.5% in 2023). The Fund has also uprated forecasts for several of the major emerging economies (Brazil, India, Mexico, Russia). It continues to expect growth in China to slow (from 5.2% to 4.6%), but by less than it predicted last autumn.

Be this as it may, amongst the emerging economies the risk of a sovereign default has increased for three countries which were already under pressure in 2023, namely Argentina, Egypt and Tunisia (see below). Tunisia's financing requirement has more than doubled, rising to 17% from 8% of GDP before the pandemic. In Egypt, the debt interest burden will account for 70% of government revenue, which looks unsustainable.

In Argentina, the 2020 debt restructuring lightened the government's interest burden but that of the central bank has ballooned to sterilize the monetary financing of the budget deficit; the cost for the central bank has reached 8% of GDP. In addition, the governments in these three countries have a large part of the debt in foreign currency whereas official foreign exchange reserves are low. Argentina is on financial life-support from the IMF, but support to Egypt was interrupted in 2023 and Tunisia has still not reached an agreement.

2024 will be a high-risk year for low-income countries (LICs) as well. Geopolitical risk remains very high, with the continuing war in Ukraine and tensions in the Middle East with Israel's military intervention in Gaza. And the LICs clearly suffer the most from the economic consequences of these conflicts. The IIF notes that more than half of the 73 countries that have had access to the debt service suspension mechanism have a high level of sovereign risk or are in a position of debt distress (15 are in default). As in 2023, repayments of long-term external debt by these countries will be very high in 2024, at USD78 billion, after USD75 billion in 2023 – twice as much as in 2020.

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CHINA

PERSISTENT PESSIMISM

The post-Covid recovery in China's economic activity was not as strong as expected in 2023. The property sector crisis deepened further at the end of the year, the demand for housing did not pick up again, and weak household confidence continues to weigh on household consumption. Conversely, the export-oriented manufacturing sector performed better than expected in the last quarter, in contrast with the performances of domestically oriented sectors. The authorities are maintaining an accommodative policy. However, the weak financial situation of local governments is constraining public investment, and the People's Bank Of China has little room for manoeuvre to revive credit growth. The banking sector is facing an increase in credit risk, but this is seemingly still under control.

Chinese economic growth stood at 5.2% in 2023, up from 3% in 2022. This recovery was largely due to the post-Covid normalisation of domestic demand and base effects. It has also been supported by cautious and gradual monetary and fiscal policy easing since last summer. However, the Chinese economy continues to deal with a large number of fragilities that are likely to persist in the short term.

DOMESTIC DEMAND IS LACKING MOMENTUM

These fragilities are concentrated in domestically oriented sectors and weigh on investment and private consumption. In particular, the property sector is still in the depths of a major crisis, which further intensified in late 2023 (Chart 1).

Property investment contracted by around 8% in value in 2023, just as it did in 2022. Property transaction volumes fell by 23% y/y in December and by 18% over 2023 as a whole, and the apparent recovery in housing starts seen in November (after falling for 31 consecutive months) was seemingly a false dawn. Only the number of completed projects has continued to improve (+16% in 2023, after a drop of 15% in 2022) thanks to the measures implemented by the authorities to finance the completion of unfinished projects. Conversely, the measures introduced to rekindle demand for housing have not made a difference. For the first time, total mortgages outstanding shrank in 2023 (-1.8% y/y). Unsold housing stocks are still excessively high, while property developers continue to face enormous financial difficulties. Access to loans for the financially healthiest developers improved slightly in 2022 and H1 2023, but has deteriorated again in recent months. Growth in total bank loans to developers accelerated from +1.5% y/y in June 2022 to +4.9% y/y in June 2023 (vs. +15% per year on average in 2015-2019), but it slowed down in Q4 2023.

Property prices have continued to fall. In December, the average drop in housing prices in China's 70 largest cities stood at -4.1% year-on-year and -0.8% month-on-month, which are the biggest falls since the correction in the property sector began in 2021. However, the overall fall in prices since the crisis began is relatively moderate: at the end of 2023, housing prices were estimated to be around 9% below their mid-2021 level on average.

The loss of confidence among households, private investors and lenders has significantly contributed to the property sector crisis not abating. Weak household confidence is also at the root of the weaker than expected recovery in private consumption in 2023, despite the effects resulting from the end of mobility restrictions. Retail sales volumes were up 7%, after contracting by around 2% in 2022.

At the same time, deflationary pressures emerged over the course of the year, as a result of not only weak domestic demand, but also falling food prices (-3% y/y on average in H2 2023, after rising 2.5% in H1), the correction in residential property prices and lower energy prices (fuel prices declined 5.1% in 2023). Consumer price inflation eased from +0.7% y/y in H1 2023 to -0.2% in H2. Core inflation stabilised at +0.6% y/y in Q4 2023, compared to +0.7% over the previous six months, which is low compared to the pre-Covid years (core inflation was 1.6% on average in 2019).

However, the increase in household purchasing power remained moderate in 2023. Disposable income per capita grew by +6.1% in real terms on average in China, and by +4.8% in urban areas (vs. +5.7% per year in 2017-2019). Unemployment is still high among young people, and employment prospects are uncertain, particularly in service sectors where the regulatory framework has become more stringent. All of these factors adversely affect consumer confidence and spending.

FORECASTS

	2021	2022	2023e	2024e	2025e
Real GDP growth, %	8.4	3.0	5.2	4.5	4.3
Inflation, CPI, year average, %	0.9	2.0	0.2	1.5	1.7
Official budget balance / GDP, %	-3.1	-2.8	-3.8	-3.2	-3.5
Official general government debt / GDP, %	46.8	50.6	55.0	57.1	58.6
Current account balance / GDP, %	2.0	2.2	1.8	1.3	1.0
External debt / GDP, %	15.4	13.7	13.4	12.4	11.6
Forex reserves, USD bn	3 250	3 128	3 238	3 190	3 140
Forex reserves, in months of imports	12.6	12.0	12.5	11.7	11.0

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

CHINA: DEEPENING CRISIS IN THE PROPERTY SECTOR

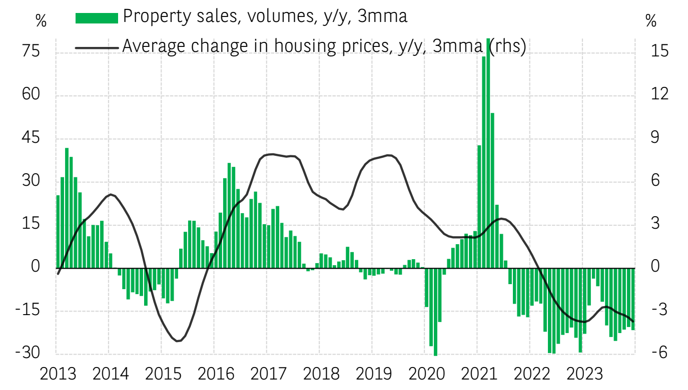

CHART 1

SOURCE: NBS, BNP PARIBAS

They are also compounded by the negative wealth effects of falling property prices and plummeting stock prices since 2021. The CSI 300 Index (a weighted index of 300 A-share stocks listed on the Shanghai or Shenzhen Stock Exchanges) fell 35% between June 2021 and December 2023.

THE EXPORT INDUSTRY IS PICKING UP STEAM AGAIN

The recovery in service-sector activity weakened in late 2023, because of the sluggishness of household demand and lower base effects. Services growth stood at +8.5% y/y in real terms in December, bringing an end to four consecutive months where it accelerated gradually. It is estimated to be +8% over 2023 as a whole (vs. -0.1% in 2022). By contrast, the performance of the manufacturing and export sectors has recently strengthened. Growth in industrial production further accelerated slightly in December (+6.8% y/y), with improvements seen in a large number of sectors, particularly in the automobile and renewable energy sectors. Over 2023 as a whole, industrial production increased by +4.6% (up from +3.6% in 2022). Meanwhile, manufacturing investment growth recovered slightly in Q4 2023 after falling for more than a year (it increased by 6.5% in value over the year as a whole).

Activity in the manufacturing sector is largely driven by exports, which ultimately performed better than expected in 2023, despite a lacklustre international environment. Goods exports stabilised in November and rose up again in December (+2.3% y/y in current USD), following six months of decline. Most notably, export volumes have strongly recovered in recent months, boosted by the reduced prices offered by Chinese companies in order to strengthen their market shares. China's share in total world goods exports grew again to 15.2% in Q3 2023 (vs. 14.7% in 2022 and 14.5% in H1 2023), which is a higher share than during the pre-Covid years (it stood at 13.3% in 2019). As a matter of fact, China has managed to develop its product range (from low value-added consumer goods to green technology products), gain a foothold on the electric vehicle market, and diversify its markets in an attempt to offset the drop in sales in the United States and the European Union.

BANKS ARE FACING AN INCREASE IN CREDIT RISKS

Since the summer, the authorities have been trying to boost activity, without giving up the needed adjustments in the property sector (deleveraging of developers, moderation of housing costs) and by taking into account strong constraints (downward pressures on the yuan, weak finances of local governments and, more generally, the high level of debt in the economy). Monetary and fiscal easing measures have mainly aimed to stimulate supply (manufacturing and construction) and investment (particularly in public infrastructure), and much less household consumption. So far, they have had very limited effects on private-sector demand, which is still plagued by a crisis of confidence.

In addition, the difficulties faced by Chinese financial institutions have both restricted the central bank's room for manoeuvre and weakened the transmission of monetary policy to credit activity. Between June and December 2023, growth in bank loans in local currency slowed from +11.6% y/y to +10.9% y/y in nominal terms and remained more or less stable in real terms. Growth in total outstanding social financing accelerated slightly (from +9.3% y/y to +9.8% y/y in nominal terms), thanks in particular to the increase in bond issues (Chart 2).

Since June 2023, there have been only small cuts to key policy rates (with the 1-year MLF rate decreasing from 2.75% to 2.5% and the 1-year Loan Prime Rate decreasing from 3.65% to 3.45%, for example). Reserve requirement ratios (RRRs) have also been reduced only slightly, but further cuts have just been announced (the weighted average RRR for the banking sector fell from 7.6% to 7.4% at the end of 2023, and to 7% at the start of February 2024).

CHINA: TENTATIVE REBOUND IN DOMESTIC CREDIT GROWTH

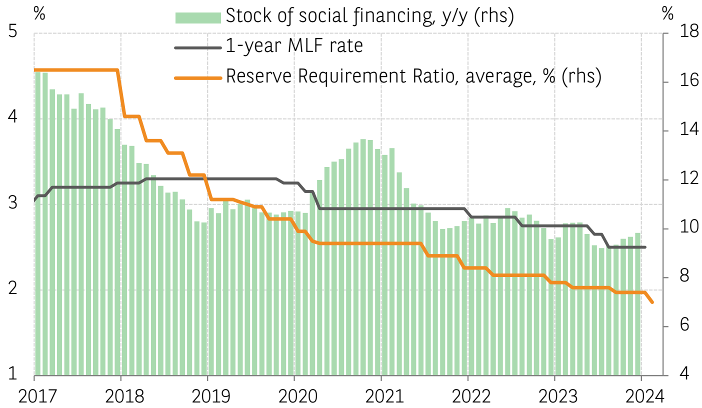

CHART 2

SOURCE: PBOC, BNP PARIBAS

The corresponding liquidity injection must help support the acceleration of central government and local government bond issues. In the short term, further monetary easing measures are expected, with the use of a wider range of instruments and more targeted credit measures.

The average quality of financial-sector assets has deteriorated over the past four years, due to the pandemic, the weak economic recovery last year, the property sector crisis and the financial difficulties of local governments. This deterioration is not large enough to trigger systemic instability. In particular, credit risks have affected non-bank financial institutions, small banks and bond markets more, while the asset quality deterioration of major commercial banks has been much more moderate. In addition, the liquidity risks faced by local governments and their financing vehicles in the short term have been reduced by the support measures recently implemented (including a programme to refinance debt of some financing vehicles with bonds issued directly by local governments, and a transfer of central government funds to local governments in Q4 2023).

In the banking sector, the average non-performing loan (NPL) ratio has remained low, standing at 1.6% in Q3 2023 (compared to 1.9% at the end of 2019). First and foremost, banks managed to contain the rise in NPL ratios thanks to large disposals of non-performing assets (which accounted for 0.5% of total loans over the Q1-Q3 2023 period). Secondly, risks on property loans are still manageable, even though these loans constitute a very large share of total outstanding bank loans (mortgage loans: 16.9% of the total in 2023, compared to 21.9% in 2019; loans to developers: 5.5% in 2023, compared to 7.4% in 2019). At the end of 2023, the NPL ratio on loans to developers was estimated to stand at 4% (by the Institute of International Finance), but the NPL ratio on mortgage loans was below 0.5% (compared to 0.3% in 2019), thanks in particular to the low loan-to-value ratios enforced by prudential regulations and to the moderate correction in housing prices.

Commercial banks are also facing deteriorating profits caused by lower net interest margins (which fell from an average of 2.22% at the end of 2019 to a historic low of 1.73% at the end of September 2023). While some small banks could see their capitalisation ratios dangerously weakened by the decline in their profits and asset quality deterioration, large nationwide banks are strong enough to ride out the difficulties and support the authorities, albeit cautiously, in their efforts to boost economic growth.

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INDIA

ROBUST GROWTH YET NOT ENOUGH APPEAL

India's economic activity remained healthy during the first half of the current fiscal year. Over the 2023/2024 full year, it is expected to be close to 7%, boosted mainly by sustained private and public investment. The rise in the investment rate for the second year in a row is particularly beneficial, as it addresses one of the country's structural fragilities. Up until now, the constraints on production factors (both labour and capital) and the country's lack of integration into global trade have made it less appealing, as evidenced by the further drop in FDI flows (-0.9% of GDP) over the first three quarters of 2023. However, the moderate current account deficit and large foreign exchange reserves are reducing the downward pressures on the rupee.

ROBUST ECONOMIC ACTIVITY

Over the first six months of the fiscal year (FY) 2023/2024 (April-September 2023), economic activity remained healthy in India. Real GDP was up 7.7% from the same period in FY2022/2023. Skyrocketing investment (+9.5%) more than offset net exports' dwindling contribution to growth.

Despite the expected slowdown during the second half of the current fiscal year, growth over the entire 2023/2024 year could hit 7.3% according to the Indian National Statistical Office (NSO). This is 0.3 pp higher than the level anticipated by the Reserve Bank of India (RBI) and 1 pp above the forecasts published in January 2024 by the World Bank.

Economic growth for 2024/2025 is expected to slow due to a combination of fading internal demand driven by monetary tightening, and weakening external demand. Over the period from April 2022 to December 2023, the hike in key policy rates (+250 bp) resulted in an increase in average rates on new loans of 183 bp (+469 bp in real terms).

RISKS TO GROWTH

Three main risks can be identified. First of all is the climate, which has a bearing on harvest levels. Due to El Niño, the rain levels in the 2023 monsoon season were 6.5% lower than normal across the entire country, but there were still very substantial disparities between regions. Even though there was an overall slight rise in the numbers of kharif crops planted compared to normal, this was still well down from the previous year. In addition, El Niño could increase temperatures in Q1 2024 and adversely affect the current year's crops. The Ministry of Agriculture & Farmers' Welfare currently estimates that grain harvests could be less than half of the previous year's. Poor harvests would, on the one hand, adversely affect raw material prices (and therefore household purchasing power) and, on the other hand, farmers' incomes. This is important, as the agricultural sector alone accounted for 42.9% of employment in 2022.

The second risk, which is contingent on the first risk, relates to monetary policy against the backdrop of re-emerging inflationary pressures. During the final two months of 2023, inflationary pressures intensified, hitting 5.6% on average, fuelled by rising food prices (which make up 45.9% of the household consumption basket). However, price rises remained below the target set by the monetary authorities (4% +/-2 pp) and core inflation (excluding food and energy prices) continued to ease, falling to +3.9% y/y in December. The RBI is therefore expected to keep its key policy rates unchanged during the upcoming Monetary Policy Committee meetings. However, if food prices were to remain firmly stuck at high levels, this could delay the monetary easing expected in Q4 2024.

The third risk is linked to the international environment. There are high geopolitical risks to global growth and any downward revision of global growth by 1 pp would lead to a drop in Indian growth of 50 bp.

FORECASTS

	2021	2022	2023e	2024e	2025e
Real GDP growth, % (1)	9.1	7.2	6.9	6.4	6.3
Inflation, CPI, year average, % (1)	5.5	6.7	5.4	4.7	4.3
General gov. balance / GDP, % (1)	-9.6	-9.2	-9.0	-8.1	-7.3
General gov. debt / GDP, % (1)	85.2	85.0	84.4	83.9	82.5
Current account balance / GDP, % (1)	-1.2	-2.0	-1.7	-1.9	-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

TABLE 1

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

INDIA: CONSUMER PRICES

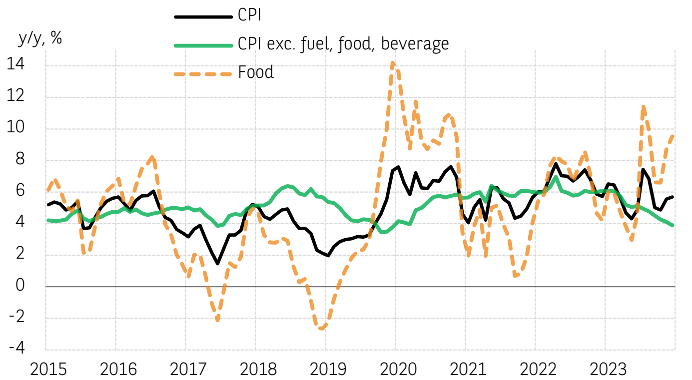

CHART 1 SOURCE: CEIC, RBI, BNP PARIBAS

In addition, India is still vulnerable to oil-price rises, even though this risk is much milder than before, as the country now buys more than 35.3% of its oil from Russia at a lower price than that paid to its suppliers in the Middle East.

Over the next five years, economic growth is expected to remain robust (between 6 and 6.5%), but the growth rate is expected to be lower than the one recorded over the past ten years (+7% over the 2010-2019 period). However, growth could become more dynamic if the investment rate continues on its upward trajectory and provided that, in addition, (i) the labour market is liberalised more effectively and (ii) women's participation rate increases.

SUSTAINED DOMESTIC INVESTMENT ACTIVITY…

The major structural constraints on India's development and appeal are infrastructure and equipment deficiencies, which reflect a lack of investment to meet the country's needs. Nevertheless, the investment rate (in volume) has hit 31.8% of GDP over the past decade, which is ahead of other Asian countries. However, almost 40% of the investments were made by households, mainly in their housing. Government investment in infrastructure accounted for just 9.4% of the total investment, and investment in machinery and capital goods made up only 25.4% of the total investment.

Nevertheless, for nearly two years, private and public investments have accelerated substantially, especially because banks' and companies' financial positions have strengthened. In 2022/2023, the investment rate rose by 1.3 pp to hit 34% of GDP, a level which had not been seen since 2013, and this positive trend continued during the first half of FY2023/2024. It is also likely to resume during the third quarter of the current fiscal year, in view of the business lending indicators and the production capacity utilisation rates rising above their long-term average. Furthermore, in its 2023/2024 budget, the government had in particular set out to increase its infrastructure investments by 0.6 pp to 3.3% of GDP (which had already risen by 1.1 pp over the previous three years). In view of the expenditure over the first eight months of the fiscal year, the government is seemingly managing to achieve its target, as its investments are up nearly 31% on the same period last year. The NSO forecasts that the investment rate could stand at 34.9% of GDP this year, a level never seen before.

In FY2024/2025, while public investment is expected to continue to strengthen, growth in private investment is expected to slow at least temporarily, as the interest rate hike and April/May 2024 elections will delay some projects.

… BUT STUBBORNLY LOW FDI

Over the first three quarters of 2023, the current account deficit plummeted to just 0.7% of GDP, compared to 2.5% of GDP over the same period in 2022. However, foreign direct investments (FDI) were not enough to offset this low current account deficit. India is still strongly dependent on portfolio investments and this will increase with Indian sovereign bonds being integrated into emerging indices at the end of June 2024. At the same time, there are still large foreign exchange reserves (standing at USD 546 billion at the start of January), which are more than adequate to cover the country's short-term financing needs and help the RBI to contain the depreciation of its currency.

Already low, FDI declined further over the first three quarters of 2023 and only stood at 0.4% of GDP (compared to 1.3% of GDP in 2022). This drop in investment in the run-up to an election is "normal", but it is happening even though FDI relative to GDP has been dwindling since 2021. In addition, FDI inflows in India are still particularly low compared to flows to other emerging countries, despite government measures to attract them.

INDIA: RISING INVESTMENTS

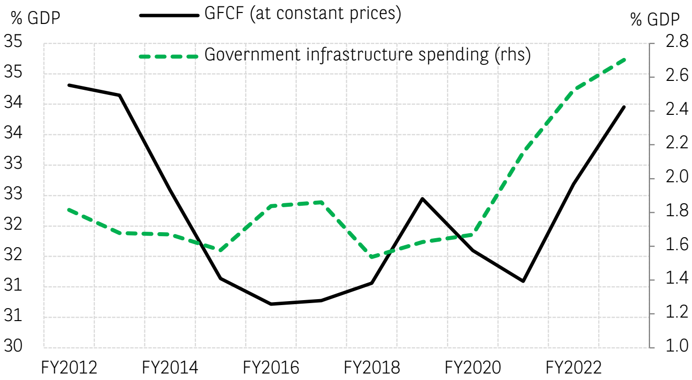

CHART 2 SOURCE: CEIC, RBI, BNP PARIBAS

According to data published by UNCTAD, in 2022, India only received 5.7% of FDI for emerging markets, compared to an average of 7.1% over the 2016-2020 period. By comparison, the share of FDI to China stood at 20.6%. The low FDI to India stems not only from the structural constraints on its economy (insufficient infrastructure, a very low women's participation rate, a high youth unemployment rate, a lack of skilled labour in industry and red tape), but also from its lack of integration into global trade. In 2018, the OECD estimated that its participation rate in global value chains (which is slightly lower than Indonesia, which also receives little FDI) was just 36.4%, compared to 55.1% in Malaysia and 62.1% in Vietnam.

India's market share in global trade is still small and has not increased a great deal over the past decade. In 2022, India's exports of goods and services only accounted for 1.9% and 4.3% of global exports, respectively, compared to 1.6% and 3.2% in 2012. For comparison purposes, China's market share for goods exports was 14.7%.

India's lack of integration into global trade is mainly due to its much more protectionist trade policy than other Asian countries, and there are still major tariff and non-tariff trade barriers with the country. According to the WTO, the average rate of customs tariffs imposed by India on imports from partner countries is 18.1%, compared to just 8% in Indonesia and 2.3% in China. In addition, over the past decade, India's customs duties have risen (+3.7 pp) while other countries in the world have fallen (-0.6 pp). Finally, India has signed few trade agreements compared to other countries in Asia.

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MALAYSIA

SOLID ACTIVITY, BUT SOME WEAKNESSES MUST BE MONITORED

In Malaysia, economic growth remained robust in 2023 even if it decelerated due to unfavourable base effects. Domestic demand was the principal driver, whereas exports contracted substantially. The outlook for 2024 remains positive and economic growth is expected to recover slightly. The main areas of concern are the developments on the property market and in the construction sector (which contains a large number of the most fragile companies), the consolidation of public finances (which is still happening very gradually) and the evolution of external accounts. Even though Malaysia has a large number of selling points that may attract international investors looking to relocate some of their manufacturing plants outside China, it is facing stiff competition from other ASEAN countries, such as Vietnam.

BELOW TARGET REAL GDP GROWTH

According to the initial estimates from the Malaysian Statistical Institute, real GDP growth stood at 3.8% in 2023 (compared to 8.7% in 2022), which is 0.2 pp below the low end of the government forecast (between 4% and 5%). Domestic demand was the principal driver, while net exports made a negative contribution.

Growth is expected to recover slightly in 2024 but downside risks remain high, in particular due to the expected world economic slowdown. The Malaysian economy is still highly vulnerable to an external shock (Singapore, China and the United States are its top three export partners) and dependent on the global electronics market. In November, the industrial production of electrical and electronic products declined for the sixth consecutive month (-6.8% y/y). The strong labour-market performance and the easing of inflationary pressures should continue to shore up domestic demand in 2024. At the end of 2023, the unemployment rate stabilised at 3.3% (compared to 3.7% a year earlier), while the labour participation rate hit an all-time high of 70.1%. At the same time, real wages continued to grow (+1.3% in Q3 2023) thanks to rising nominal wages and falling inflation. In December 2023, headline inflation was still contained to just +1.5% y/y while core inflation (excluding food and energy) decelerated slightly to +1.9% y/y, below its long-term average (2% over the 2011-2019 period). Inflationary pressures could accelerate in 2024 due to the reduction in food and energy subsidies, but they do not pose a risk to growth.

The risks to the Malaysian economy are still moderate. The first area to monitor worth mentioning is the property market. In fact, sales volumes declined in the second half of 2023 and prices rose by just 0.1% y/y in Q3 2023 (compared to an average of 4.6% in the first half of 2023). The second area to monitor, in connection with the first, relates to the financial positions of households and companies (particularly in the construction sector), as their level of debt is high. Household debt rose again in 2023, standing at 81.9% of GDP in Q2 (after falling to 81% of GDP at the end of 2022). Even though their assets still covered 2.1 times the value of their debt in mid-2023, downward pressures on the property market must be closely monitored, given their level of debt. Furthermore, despite the fact that, according to the Bank for International Settlements (BIS), corporate debt fell to 88.6% of GDP (compared to 95.5% of GDP in Q2 2022), their ability to meet their payments has slightly eroded. Margins fell with rising production costs (the costs of imported products remained relatively high due to the depreciation of the ringgit). The interest coverage ratio fell, but it generally remained very comfortable. Median pre-tax profits still covered interest expenses 5.5 times in mid-2023, compared to 6.5 times at the end of 2022 (with the minimum coverage ratio set at 2). Nevertheless, the Bank Negara of Malaysia (BNM) estimates that 26% of companies had an interest coverage ratio below the prudential threshold (which is 5.7 pp more than over the 2015–2019 period), with this proportion standing at 41.1% for companies in the construction sector.

The final two areas of concern are related to the performance ofpublic finance and pressures on external accounts.

FORECASTS

	2021	2022	2023e	2024e	2025e
Real GDP growth, %	3.1	8.7	3.8	4.3	4.8
Inflation, CPI, year average, %	2.5	3.4	2.5	2.8	2.4
General gov. balance / GDP, %	-6.4	-5.6	-5.0	-4.4	-3.9
General gov. debt / GDP, %	63.3	60.3	63.8	63.9	63.4
Current account balance / GDP, %	3.9	3.1	2.1	2.6	2.9
External debt / GDP, %	70.0	63.9	69.0	67.6	68.0
Forex reserves, USD bn	104	103	101	103	104
Forex reserves, in months of imports	5.7	4.6	4.5	4.5	4.6

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

MALAYSIA: INFLATION UNDER CONTROL

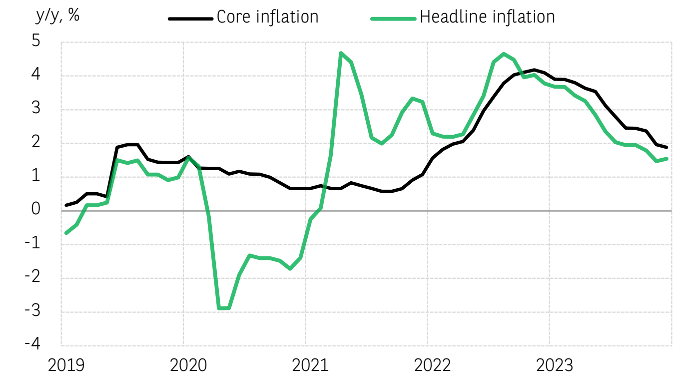

CHART 1 SOURCE: CEIC, BNM, BNP PARIBAS

A MODEST CONSOLIDATION OF PUBLIC FINANCES

The government has limited room for manoeuvre in order to support economic growth. The country's fiscal base, which is already modest, shrank in 2023 and is expected to continue falling in 2024, due to declining oil-related revenues.

The government is still not planning to reintroduce the goods and services tax, which would, however, increase the tax base and reduce its dependence on oil revenues.

In 2023, the deficit is expected to remain high, albeit slightly lower than last year. It should hit 5% of GDP (compared to 5.6% of GDP in 2022), which is above the average recorded over the 2015–2019 period (3.3% of GDP). Total revenues are expected to fall by 0.1 pp to 16.3% of GDP, due to the sharp fall in commodity prices. On a positive note, the burden of interest payments on debt fell slightly, accounting for 13.7% of government revenues over the first three quarters of 2023, compared to 14.1% for the same period in the previous year.

In its 2024 budget, the government is setting out to reduce the deficit by 0.7 pp to 4.3% of GDP. However, this reduction is not reflective of a fully fledged structural consolidation.

On the revenue side, the main measure is the 2-pp rise in the service tax rate, which will be accompanied by measures to expand its base. The government also intends to introduce taxes on luxury goods and capital gains. However, these increases will not be enough to offset the expected drop in dividends received from the national oil company Petronas (-0.4% of GDP). According to government forecasts, revenues will fall to 15.5% of GDP, which is 0.7 pp below the average recorded over the 2018–2022 period.

On the expenditure side, a 0.9-pp cut is planned. The government intends to reduce subsidies (-0.6% of GDP), but the savings made will be used to finance targeted social spending for the most in need. In reality, the reduction in the deficit will essentially mirror the cuts to investment spending, which had risen sharply in 2023 as a result of paying 1MDB's debt. If this one-time expense is excluded, expenditure is expected to be relatively stable in 2024.

In 2023, government debt increased by 2.3 pp to hit 63.8% of GDP (compared to 52.4% of GDP at the end of 2019). However, the debt structure still does not pose a great deal of risk, as it is denominated in domestic currency and held by resident investors.

INCREASED PRESSURE ON THE RINGGIT

During 2023, downward pressures on the currencies of emerging countries, and in particular Asian countries, intensified due to the widening yield spreads between domestic and US bond prices. The Malaysian ringgit experienced one of the sharpest falls against the US dollar (-9.6%) out of all Asian currencies. In nominal and real effective terms, the ringgit depreciated by 3.9% and 4.7% respectively against the currencies of its main partners' countries. This muted depreciation was due to both the declining current account surplus (caused, in particular, by the plummeting trade surplus) and major net capital outflows.

Over the first three quarters of 2023, the trade balance declined by20.5% year-on-year. Exports suffered an even harder decline than imports. Malaysia was hamstrung by the falling demand for electrical products (36.3% of its total exports in 2022) and, in particular, integrated electronic circuits (22.2% of its exports), but also by the decline in prices of exported commodities (mineral fuels and vegetable oils accounted for 17.2% and 6.7% of its exports in 2022, respectively).

The decline in the services deficit, driven by the rise in tourism revenue (which is still 21.4% below its pre-COVID-19 level, however), was not enough to offset the shrinking trade surplus.

MALAYSIA: PRESSURES ON EXTERNAL ACCOUNTS

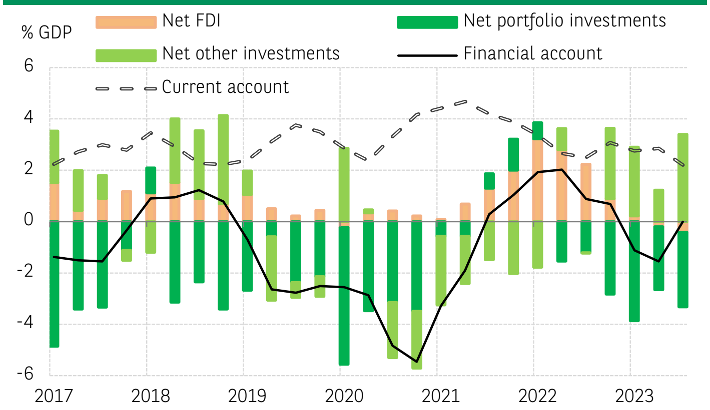

CHART 2

SOURCE: CEIC, BNM, BNP PARIBAS

The current account surplus fell to just 1.7% of GDP over the first three quarters. Even though a slight increase is expected in Q4 2023, it is unlikely to rise above 2.1% of GDP over 2023 as a whole (compared to 3.1% in 2022).

At the same time, net capital inflows plunged. Resident investments abroad increased, whereas non-resident investments in the country (both FDI and portfolio investments) fell.

Inward foreign direct investment decreased by 49% over the first three quarters of 2023 to 1.8% of GDP, which is low in comparison to the FDI inflows over the 2015–2019 period (3.1% of GDP on average). This fall is partially due to a correction after the sharp increase seen in 2021. However, it also mirrors a wider movement that affected many ASEAN countries (-16%, according to UNCTAD), driven by higher financing costs and weaker growth prospects.

However, some ASEAN countries, including Vietnam, saw their FDI inflows increase slightly. Therefore, there are grounds to question how much Malaysia could be challenged by Vietnam. According to national data from the Malaysian Investment Development Authority (MIDA), investment projects in Malaysia are currently still performing well, particularly in the electrical and electronics sector. Malaysia could benefit from some of the relocation of production plants in China in the integrated electronic circuits sector in particular. Malaysia has already capitalised on the trade tensions between China and the United States to increase its market share, which stood at 7.3% of global exports in 2022, compared to 6.3% over the 2017–2021 period.

Its external accounts are expected to recover in 2024, thanks to an expected recovery in demand for electrical and electronic products and an increase in net capital inflows driven by the anticipated decline in bond yields in developed countries. Foreign exchange reserves (down USD 1.7 billion in 2023) are expected to rise slightly to USD 102 billion, which is equivalent to 4.5 months of goods and services imports.

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THAILAND

A LACKLUSTRE RECOVERY

Strong household consumption and the return of tourists should help economic growth to accelerate over the next few quarters. The lack of competitiveness of the export sector and the effects of El Niño are the key risks to growth and exports. In addition, the political situation remains tense and the government coalition looks fragile. Budgetary slippage may occur and the Bank of Thailand is expected to pause its monetary easing.

A FEEBLE ACCELERATION IN GROWTH

Over the first nine months of 2023, economic growth stood at 1.9% y/y. Recent quarters have seen an uneven recovery in demand components. Household consumption remained the main growth driver, accelerating steadily to hit 8.1% y/y in Q3, buoyed by tax incentives to households and the strong labour market performance. Trends across other components were more mixed, as private investment grew at a more moderate pace (1.7% on average y/y over the first three quarters), goods exports suffered as a result of the slowdown in the global economy, and tourism revenues continued to grow, albeit at a much slower pace than anticipated.

In 2023, Thailand welcomed just over 28 million tourists, which is more than 150% up on 2022, but still 30% down on 2019. By nationality, trends have not really altered from the pre-Covid period, thanks to special measures introduced by the Thai government, such as the (temporary) visa exemption for visitors from India, Taiwan and Kazakhstan, and incentives for extended trips (by offering discounts on a number of services, such as accommodation, hospitality, healthcare and domestic flights). On the other hand, the number of tourists from China is only creeping up very slowly. Travel bans for Chinese nationals were gradually lifted during 2023, but government subsidies to promote domestic tourism likely put a dampener on the recovery in 'international' travel. The total number of Chinese tourists in 2023 was still 70% lower than in 2019.

Economic growth is expected to pick up in the quarters ahead, with real GDP anticipated to increase by 3.7% in 2024, up from 2.3% in 2023, still being driven by household consumption, which has been buoyed by an expansionary fiscal policy and the gradual return of tourists (according to the Bank of Thailand's estimates, the 2019 level should only be hit by the end of 2025).

However, the effects of *El Niño* are difficult to measure and Thailand may not be able to take full advantage of the upturn in global growth and the increased demand for electronic components, due to the country's structural difficulties (the political climate, weak investment and a lack of infrastructure are inhibiting the competitiveness of the export sector). In particular, weaker-than-anticipated Chinese growth is expected to hit Thai growth hard.

On the monetary side, favourable base effects and the larger-than-anticipated drop in energy and unprocessed foodstuff prices led to a rapid deceleration in inflation during the year. The year-on-year rate of inflation has even been in negative territory since October (standing at -0.8% y/y in December). Core inflation also eased during the year, but is still slightly above its pre-Covid average (standing at 0.6% y/y in December). The Bank of Thailand hiked its key rate most recently in September to 2.5% (after a cumulative increase of more than 200 basis points since August 2022) and is expected to hold it steady during the months ahead. It is anticipating slightly higher inflation in 2024, in view of the upward pressure on energy and agricultural prices. Inflation is expected to be kept within the target range (between 1% and 3%) however.

FORECASTS

	2021	2022	2023e	2024e	2025e
Real GDP growth (%)	1.5	2.5	2.3	3.7	4.5
Inflation (CPI, year average, %)	2.2	6.1	1.4	2.4	2.0
General gov. balance / GDP (%)	-7.9	-4.4	-3.0	-3.7	-3.5
General gov. debt / GDP (%)	58.4	60.6	62.3	62.5	62.1
Current account balance / GDP (%)	-2.2	-3.2	1.0	2.9	3.6
External debt / GDP (%)	39.0	40.4	38.9	36.7	35.0
Forex reserves (USD bn)	246	217	217	228	238
Forex reserves, in months of imports	11.0	9.0	9.3	9.6	10.0

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

THAILAND: GRADUAL RETURN OF INTERNATIONAL TOURISTS

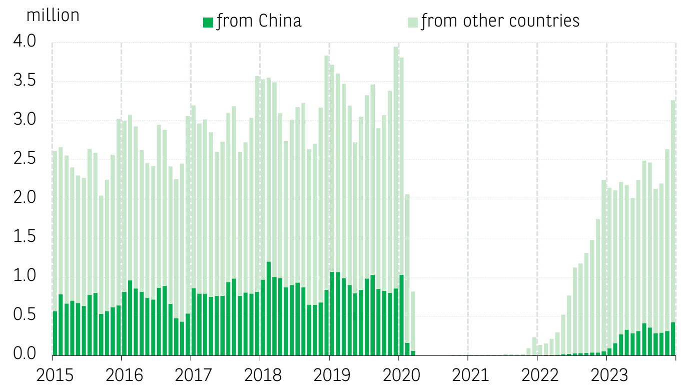

CHART 1

SOURCE: MINISTRY OF TOURISM AND SPORTS, BNP PARIBAS

A NEW POLITICAL LANDSCAPE

Political instability is still a major concern. However, the recent elections and the subsequent formation of the new government point to a changing political landscape. The decades-long hostility between (generally speaking) the royal and military elite and the rural population is slowly giving way to hostility between new parties looking to reform the country (mainly supported by younger voters) and parties who want to maintain the status quo.

The results of the general election, which was held as planned last May, are a good illustration of this. The opposition parties won a majority in the House of Representatives (with more than 300 seats out of 500) and the two main opposition parties alone won nearly all of these seats.

Move Forward, the party offering the greatest societal transformation (including an amendment to the country's lèse-majesté laws and a reform of the military) won 151 seats, while the Pheu Thai Party (PTP) won 141 seats.

Although it had formed a coalition of eight parties (representing more than 70% of the votes), Move Forward was not able to form a government. After several weeks of discussions, at the start of July, party leader Pita Limjareonrat's bid to become Prime Minister failed, as he failed to get votes from the Senate. According to the constitution in force since 2017, a Prime Ministerial candidate needs to win a majority of votes in the National Assembly, made up of the House of Representatives (500 seats) and the Senate (250 seats), whose members are all appointed by the King, in consultation with the military. Therefore, in order to get the 376 votes required to obtain a majority, alliances needed to be formed with the conservative parties and, in particular, the approval of the outgoing military government had to be won. At the end of August, Sretta Thavisin, the candidate from the PTP, was appointed Prime Minister, heading up a large coalition (made up of eleven parties, including two pro-military parties), after the National Assembly and the King gave their approval.

The political climate is expected to remain tense in the months ahead, as the Move Forward party was ultimately left out in the cold and the party has had to respond to a number of accusations that it is looking to ultimately overturn the monarchy, using its proposal to amend the country's lèse-majesté laws as an initial step on this journey. If the party were to be dissolved, large numbers of mass demonstrations would likely follow. In addition, when it comes down to it, the coalition government is made up of the PTP and ten other parties (including conservative parties), who all have greatly conflicting economic and political agendas, meaning that delivering policy embraced by all of these parties could be tricky. On the other hand, on a positive note, the need for consensus in order to implement reforms should prevent fiscal slippages.

However, in the medium term, the PTP and all of the coalition parties have declared that they intend to honour the previous government's commitments, in particular by introducing measures aimed at making the country more competitive. The «Thailand 4.0» industrial strategy and investment incentives (both domestic and foreign, thanks to the Investment Promotion Strategy, which is planned to run from 2023 to 2027) are therefore expected to continue. All of the parties also supported measures to accelerate the energy transition.

THAILAND: THE CENTRAL BANK PAUSES MONETARY TIGHTENING

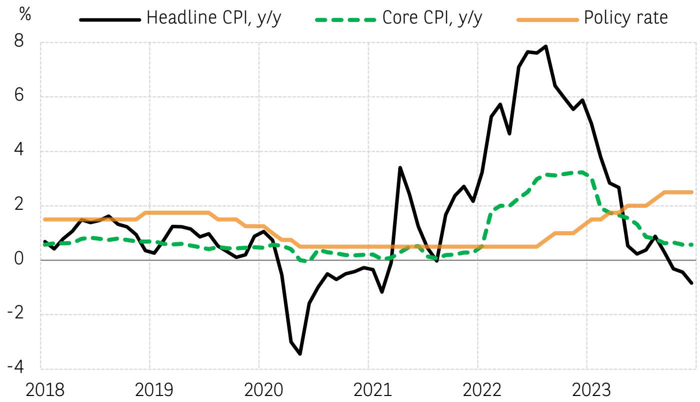

CHART 2 SOURCE: CENTRAL BANK, BNP PARIBAS

EXTRA-BUDGETARY SPENDING IN 2024

As part of this process, Thailand's lawmakers started to scrutinise the proposed budget for the 2024 fiscal year (which started in October 2023) during the first few days of January. As was the case in the previous election in 2019, the process of scrutinising the budget was delayed as a result of the protracted negotiations prior to a government being formed. The government proposes to increase spending by nearly 10% compared to the 2023 budget, with a number of measures aimed at boosting household consumption and investment, getting the country in a position to tackle population ageing, and fighting corruption put forward. Revenues are only expected to increase by 4.5% (the government assumes that GDP will grow between 2.7% and 3.7% in 2024). According to estimates, the deficit should stand at 3.7% of GDP in 2024 (up from 3% in 2023) and debt should remain stable at around 62% of GDP. The debates were fierce, as, on the one hand, opposition parties (primarily Move Forward) heavily criticised the proposed budget (a lack of clear objectives, and reforms modelled on reforms introduced by the previous government) and, on the other hand, because the proposed budget does not include the flagship economic measure, the «digital wallet», announced last November. This measure will set out to distribute 10,000 baht (around 280 euros) to over 56 million people, based on a number of criteria (such as age and income). This measure would cost the equivalent of at least 2.7% of GDP. The government recently secured the Privy Council of Thailand's approval to finance the project through a special loan, meaning that the deficit (and debt) related to implementing this project will fall outside the budget.

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VIETNAM

THE WIND IS IN ITS SAILS

Vietnam went through a number of difficulties in 2022 and 2023, related to the deterioration of the international environment, the severe correction in the property sector, the crisis of confidence and liquidity tensions in the banking sector. Economic growth stalled in early 2023, but then quickly accelerated again. Most notably, activity in the manufacturing export sector has been recovering for a few months, buoyed by healthy foreign direct investment inflows. These trends are expected to continue in the short term, with Vietnam being one of the major beneficiaries of the ongoing adjustments to global value chains.

In the last months of 2022 and in early 2023, the Vietnamese economy went through a number of difficulties that resulted in a brief yet significant slowdown in growth. In 2022, real GDP growth rebounded strongly (+8%) after the country's health restrictions were lifted. But then real GDP growth abruptly slowed to +3.3% y/y in Q1 2023. The accumulation of external shocks (declining global demand and US monetary tightening) and internal shocks (the property sector crisis and the confidence shock in the financial sector) shone a light on macro-financial vulnerabilities in the country, most notably, the low level of its foreign exchange reserves, the excessively high levels of domestic debt in some sectors and the lingering weaknesses of the banking system.

Despite these vulnerabilities, Vietnam's economic growth prospects are still solid, buoyed in particular by the development of the export manufacturing sector and foreign direct investment (FDI) inflows. Real GDP growth in fact quickly accelerated again last year, hitting +6.7% in Q4 2023. It is expected to remain comfortably above 6% year-on-year in the coming quarters.

FORECASTS

	2021	2022	2023e	2024e	2025e
Real GDP growth (%)	2.6	8.0	5.0	6.2	6.6
Inflation (CPI, year average, %)	1.8	3.2	3.3	3.4	3.5
Budget balance / GDP (%)	-1.4	0.3	-1.3	-1.8	-2.1
General government debt / GDP (%)	39.1	35.3	34.1	32.9	32.0
Current account balance / GDP (%)	-2.2	-0.3	5.3	4.7	4.4
External debt / GDP (%)	37.8	36.1	36.0	34.9	32.7
Forex reserves (USD bn)	109.4	86.5	91.0	100.2	115.3
Forex reserves, in months of imports	3.8	2.8	3.2	3.3	3.5

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

EXPORTS ARE READY TO TAKE OFF RAPIDLY AGAIN

The export sector has been hit hard by the recent weakening global demand. Over the period from Q4 2022 to Q3 2023, goods exports (measured in current dollars) decreased by 7.4% year-on-year (Chart 1). However, exports hit a trough last summer and started to increase again in year-on-year terms in Q4 2023 (+6.9%). At the same time, industrial production growth rebounded from -2% y/y in Q1 2023 to +5.3% in Q4 2023. The export sector in particular benefited from the green shoots of recovery in the global electronic cycle (and from shipments of new products from Samsung, which manufactures more than half of its phones in Vietnam) and from the continued expansion of the country's manufacturing production capacities. Vietnam appears to be very well positioned to benefit from the improvement (even if limited) in global demand in 2024 (according to the most recent IMF forecasts, world trade volumes of goods and services should increase by +3.3% in 2024, up from +0.4% in 2023).

VIETNAM: EXTERNAL TRADE

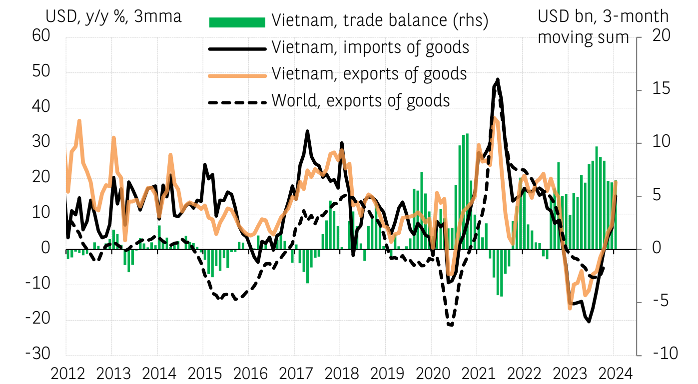

CHART 1

SOURCE: GENERAL STATISTICS OFFICE, IMF, BNP PARIBAS

FDI CONTINUES TO TRANSFORM THE ECONOMY

Vietnam has benefited from significant FDI inflows since it joined the World Trade Organisation in 2007, which has supported the continued and rapid expansion of its export manufacturing sector. Goods exports accounted for 91% of GDP in 2022, compared to 57% in 2011. Over the same period, Vietnam's global market share increased from 0.5% of total world exports of goods to 1.5%; the share of exports by the foreign-invested sector (with investors mainly from South Korea, Singapore, Japan and China/Hong Kong) increased from 48% to 73% of Vietnam's total exports; and the share of sales of telephones, computers and other electronic goods increased from 18% to 32% of total exports.

Net FDI inflows into Vietnam fell slightly during the Covid pandemic in 2020-2022, standing at USD 15.3 billion per year on average, which is still a high level, equivalent to 4.1% of GDP (compared to 4.7% of GDP on average in 2015-2019). In 2023, FDI inflows started to rise again in Vietnam (Chart 2), while FDI inflows into ASEAN countries and Asia in general declined, constrained by deteriorating global economic growth prospects and higher financing costs. In Vietnam, the net FDI inflows recorded in the balance of payments stood at USD 13.7 billion over the first three quarters of 2023, up 40% on the same period in 2022.

In the short term, all ASEAN countries are expected to attract further investment in the manufacturing sector (announcements of new projects are on the rise), but Vietnam is expected to remain one of the main beneficiaries of adjustments to global value chains. These adjustments stem in particular from corporate de-risking strategies in response to geopolitical turmoil, trade tensions and the US-China tech war. Multinational companies are looking to secure their value chains, safeguard their supplies of raw materials and strategic goods, diversify their production locations and reduce their dependency on China. Against this backdrop, Vietnam is continuing to attract investors and stand out thanks to its strong comparative advantages, such as the good level of education and the relatively low cost of its labour force, its geographic location, and the proactive policies of its authorities to create a favourable regulatory environment for FDI and to sign free trade agreements (such as the Comprehensive and Progressive Agreement for Trans-Pacific Partnership and the trade deal with the European Union). In addition, Vietnam is keeping a cautious foreign policy aimed at avoiding tensions with its various economic and trade partners (the United States, China and the EU absorbed 29%, 16% and 13% of Vietnamese exports, respectively, in 2022).

CURRENT ACCOUNT: RETURNING TO SURPLUSES

In 2023, Vietnam's trade surpluses increased substantially as imports of goods fell more sharply than exports over the entire year (Chart 1). In addition, the deficits in the balances of services and income decreased, thanks to, on the one hand, the recovery in tourism revenues and, on the other hand, the increase in remittances. The current account balance went from a slight deficit in 2021 and 2022 to an estimated surplus of more than USD 22 billion in 2023, or more than 5% of GDP, which is a record level for Vietnam (Chart 2).

In 2024, the trade surplus is expected to adjust slightly downwards and the deficit in the balance of services is expected to continue to decline thanks to the recovery in the tourism sector. The current account surplus should fall slightly and the surplus in the basic balance (current account + net FDI) should remain at a very comfortable level (estimated to stand at 9.5% of GDP in 2023, compared to 3.5% in 2022).

Thanks to these surpluses, Vietnam appears to be able to strengthen its external solvency and liquidity position. Its external debt is already moderate, estimated to stand at 36% of GDP and 44% of goods export receipts in 2023. However, Vietnam's foreign exchange reserves are not comfortable, covering just over three months of imports of goods and services at the end of 2023. They fell from USD 109.4 billion at the end of 2021 to USD 86.5 billion at the end of 2022, after gradually increasing for six years. Then, foreign exchange reserves barely recovered in 2023, despite the improvement in the current account balance and FDI inflows. As a matter of fact, Vietnam has faced significant capital outflows over the past two years, observed in the deposits and loans transactions of the "other investments" item of the balance of payments, and above all in "errors and omissions" (Chart 2).

VIETNAM: BALANCE OF PAYMENTS

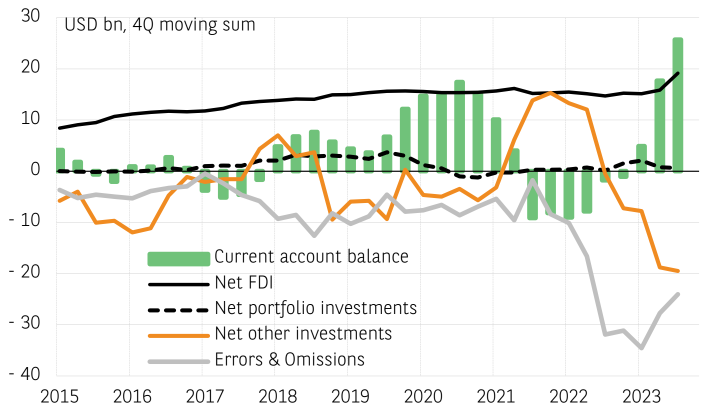

CHART 2

SOURCE: STATE BANK OF VIETNAM, BNP PARIBAS

LINGERING WEAKNESSES

Capital flight has mainly come from residents, whose confidence in the dong (VND) and local banks was rattled in 2022 by the rise in inflation, by the dong's depreciation against the USD after several years of relative exchange rate stability, and by the property sector crisis. In 2023, the various sources of pressure gradually faded away, thanks to the improvement in the current account, the slight decline in inflation up until the summer, monetary policy easing (the refinancing rate was cut from 6% to 4.5%), lower pressure on the dong, and improved domestic liquidity conditions (the overnight interbank rate fell from an average of 4.8% in Q1 2023 to 0.6% in Q4). However, the property sector crisis has lingered on and banks remain fragile as a result of weak capitalisation ratios and high credit risks – and this is continuing to weigh on residents' confidence.

In 2024, the situation in the property sector is expected to improve slowly (thanks to government support measures, in particular) and pressures in the financial sector are likely to continue to ease. Solid growth in activity and export revenues should help to gradually reduce the vulnerabilities of the Vietnamese economy in the short and medium term, but this will need to go hand in hand with structural reforms aimed at strengthening the financial sector and improving corporate governance.

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BRAZIL

SOME CAUSE FOR SATISFACTION...AMIDST A FEW GREY AREAS

For his return at the helm of Brazil, Lula can look at his first year back in office with some contentment: macro-financial indicators boasted solid prints, social programs were given a new impetus, an ambitious change in direction was initiated on the environment and the government's capacity to reform ended up being much stronger than anticipated by most observers. This picture, nonetheless, conceals some imbalances most apparent in Brazil's growth profile, the dynamics of unemployment and the structure of its trade balance. The markets' renewed skepticism relative to the government's ability to balance its books (despite the new fiscal framework) constitutes another grey area. In 2024, economic growth, inflation and interest rates will be lower than in 2023. The refinement in recent months of the government's policy direction combined with the increased provision of financing for the green economy should help support a reprisal of investment.

2023 : A TRACK RECORD THAT EXCEEDED EXPECTATIONS...

Lula tallied a very respectable track record for the first year of his third term back in office. Yet this scenario seemed far from self-evident considering the government coalition's lack of majority in the lower house (fewer than 200 seats out of 513 representatives), and Lula's tumultuous inauguration and first few weeks in office (attacks against executive and legislative institutions in Brasilia, prosecutions against Bolsonaro, tensions with the Central Bank, market concerns following the sharp rise in social spending[1] , etc.).

But in the end, macro-financial results surprised positively with some honourable mentions: real GDP growth exceeded expectations by more than 2.5 points. In December, the unemployment rate (7.4%) fell to its lowest level since 2015 and disinflation was more pronounced than expected, with the annual change in the IPCA Index falling back into the Central Bank's tolerance band for the first time since 2020. The trade balance posted a record surplus (flirting with the USD 100 bn mark), allowing the current account deficit to shrink by a little more than one point of GDP. Portfolio investments by non-residents experienced a trend reversal, driven in part by attractive bond yields (net inflows of USD 19.7 bn in 2023 vs. net outflows of USD 4.7 bn in 2022 according to IIF data.) Solvency and external liquidity indicators remained satisfactory - bolstered by a USD 30 bn increase in foreign exchange reserves and a moderate increase in external debt.

On the market front, the B3-Ibovespa stock market index reached an all-time high (132,000 points in December) and registered a 34% increase in dollar terms – outperforming the MSCI Emerging market index by some 24 points. Meanwhile, the real – bolstered by carry trade flows – posted gains of almost 10% against the dollar. The disruptive shock to the corporate debt market caused by the default in Q1 of a systemic player (the retailer Americana) was, in the end, relatively short-lived – with issuances normalizing in Q2. Improvements in the perception of sovereign risk (embodied in the narrowing of the EMBI+ Brazil spread by 62 basis points and rating upgrades from BB- to BB by both S&P and Fitch) also enabled the government to issue its first ESG bond in November (USD 2 bn over 7 years) under relatively favourable terms (6.5% yield with a 182 basis points spread over the US Treasury, a 10-year record).

In addition, the government succeeded in approving a tax reform (30 years in the making) and a new fiscal framework while managing to maintain its social commitments (restart housing and 'fight against hunger' programmes, increase benefits under *Bolsa Familia*). The deployment of a household debt restructuring programme (*Desenrola Brasil*) and the renewal of programmes to support businesses (*Pronampe*) have also helped contain the rise in credit risk.

FORECASTS

	2021	2022	2023e	2024e	2025e
Real GDP growth, %	5.0	2.9	3.1	1.7	1.9
Inflation, CPI, year average, %	8.3	9.3	4.6	4.2	3.7
Fiscal balance / GDP, %	-4.3	-4.6	-7.9	-7.3	-6.9
Gross public debt / GDP, %	78.3	72.9	75.6	78.7	81.1
Current account balance / GDP, %	-2.8	-2.9	-1.3	-1.1	-1.5
External debt / GDP, %	42.0	35.8	36.7	38.0	39.0
Forex reserves, USD bn	362.0	324.0	355.0	342.0	350.0
Forex reserves, in months of imports	14.2	11.0	12.4	12.7	12.2

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

BRAZIL: NET NON-RESIDENT PURCHASES OF STOCKS AND BONDS

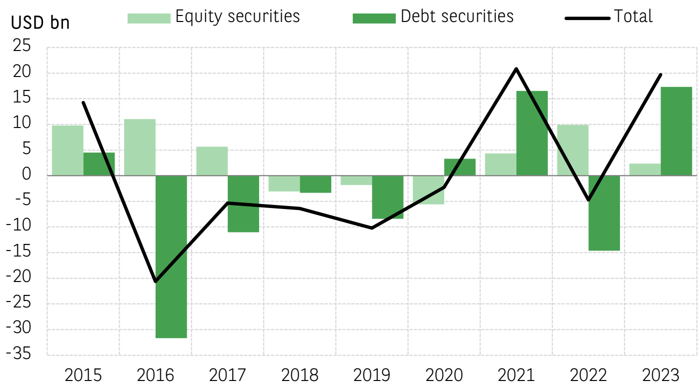

CHART 1

SOURCE: IIF, BNP PARIBAS

... WHICH NONETHELESS MASKS SOME IMBALANCES

The country's overall good performance, however, masks some areas of fragility: i/ the details of the national accounts show for instance a growth profile that is strongly unbalanced making the economy more

1 The cost of the social welfare programme, Bolsa Familia, was multiplied by 3 compared to the pre-pandemic period, i.e., almost 1.7% of GDP.

structurally vulnerable. Of the 3% growth expected in 2023, more than half has come from the agro-industry and extractive sectors with a contribution of around 0.8pp for the oil industry alone. ii/ We can, moreover, doubt the structural nature of the improvements in the labour market. Indeed, despite a very tight labour market, average real wages remained at their pre-pandemic level. The decline in the unemployment rate is largely attributable to the decline in the labour market participation rate. At a constant participation rate (end of 2019), the unemployment rate would have increased by a little over 2 points from its current level. iii/ The trade balance is less diversified than in the past (in terms of both partners and products), making the external accounts somewhat more fragile in the event of shocks. In 2023, agricultural products represented a significantly larger share of total exports (49% compared to 38% over the 2020-22 period), while China further strengthened its position as the country's leading trading partner (absorbing 31% of exports in 2023 compared to 26% over the 2016-22 period with a concentration in soya, crude oil, meat, iron ores and paper pulp). The dependence is reciprocal: 20% of China's agricultural imports today come from Brazil. Russia, and its cheap refined oil, has also become the country's second largest fuel supplier, meeting 50% of its diesel needs - highly sought after in the transport and agro-business sectors.

A BALANCING ACT BETWEEN ENVIRONMENTAL PRESERVATION AND ECONOMIC DEVELOPMENT

Brazil - currently the world's 7th largest emitter of greenhouse gases[2] - has been, throughout the year, put to the test of its contradictions on the environment: on the one hand, deforestation of the Amazon has fallen by half and Lula has made, both domestically and internationally, some ambitious pledges on the environment[3]. The country is also in the process of finalizing the launch of a national carbon market which intends - in addition to regulating carbon credits - to establish an emissions cap for around 4,000 companies emitting more than 25,000 tons of CO2 equivalent each year. On the other hand, to give himself additional room to maneuver with the agricultural lobby – very influential with elected representatives – Lula promulgated at the end of 2023, a law speeding up the process authorizing new pesticides (of which the country is already the world's leading consumer absorbing 1/5th of global stocks, according to the FAO.) In contrast to the Amazon, deforestation in the Cerrado savannah (which is home to 5% of global biodiversity and where 45% of Brazilian agriculture and livestock farming takes place) has become more pronounced this past year. Oil exploration projects in the Amazon basin have also not been called into question. An investment plan in fossil fuels (BRL 335 bn) is expected to allow the country to increase its production to 5.4 mn barrels/day by 2030 compared to 3 mn currently. Brazil is expected to become one of the countries experiencing the strongest growth in oil production over the coming years, along with Guyana and the US according to the IEA.

BRAZIL: LOANS FOR INFRASTRUCTURE PROJECTS BY TYPE OF LENDER

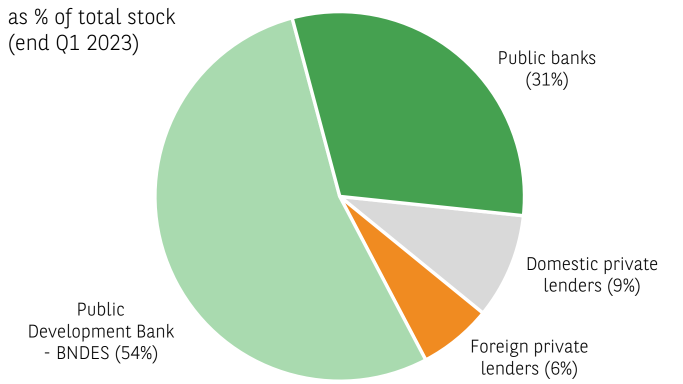

CHART 2 SOURCE: BCB, OECD, BNP PARIBAS

2024 OUTLOOK: STIMULUS OR RESTRAINT?

In 2024, economic growth should be close to its potential (between 1.5% and 2%). The statistical carry-over from 2023 growth will be low, at around 0.3 pp, on the back of a moderating economy in H2-2003. Due to climate events and large base effects, the contribution of agriculture to growth is expected to be negative after an exceptional year in 2023. Interest rate cuts are expected to carry on. Since August 2023, the BCB has made 5 cuts to the SELIC rate accumulating 250 basis points of adjustment (to 11.25% at the end of January). The further easing of monetary conditions should benefit sectors that are most sensitive to the credit cycle, including many which have had a harder time in 2023 (e.g., manufacturing sector, construction). The fall in rates should encourage local investors to return to the equity market and support the resumption of IPOs (3 to 5 anticipated) after a 2-year hiatus.

The authorities could be tempted to further stimulate economic growth. The market expects a revision of the primary deficit objective[4] in March/April (a move which risks undermining the credibility of the new fiscal framework). The authorities are expected to further lean on the public Development Bank (BNDES), already the largest provider of funds for infrastructure projects (54%). The latter plans to increase disbursements to around 2% of GDP by 2026 compared to 1.2% currently. The government also hopes to encourage more private sector investment following the recent adoption of the tax reform and the announcements in recent months of the new growth acceleration program and reindustrialization plan (August 2023 and January 2024, respectively). The green economy will benefit from preferential financing conditions and new hedging mechanisms to protect investors against currency risk – considered an important barrier to foreign direct investment.

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2 According to the World Resource Institute, Brazil is responsible for 3% of greenhouse gas emissions. Around 40% of these emissions are linked to deforestation.
3 Within the framework of the Nationally Determined Contributions (NDCs) - in September revision of the targets for reducing greenhouse gas emissions (from 37% to 48% by 2025 and from 50% to 53% by 2030); a pledge to deliver zero deforestation by 2030 ; in his plan to reindustrialize the country, announced in January 2024 (USD 61 bn over 2024-2026, focusing on health, defence, agribusiness, transport and digital technology), Lula aims to reduce the carbon dioxide produced by industry by 30%, in particular by stimulating the production of biofuels and renewable energy.
4 Market participants are expecting the primary balance (excluding interest payments on public debt) to deviate by 0.8 points of GDP in 2024 from the government's 'zero deficit' target. Markets don't buy a large reduction in spending and/or a sufficient rationalization of revenues (through better collection, end of exemptions, reform of tax loopholes, etc.).

ARGENTINA

SHOCK THERAPY

Following his clear victory in the presidential election, the new president, Javier Milei, intends to push ahead with the liberalisation and deregulation of the economy. A decree and an omnibus bill containing just over 1,000 measures, including some very radical ones, are already being scrutinised in the National Congress of Argentina. These measures have been received rather favourably by the markets and the IMF. However, against a very tense political and social backdrop, the economy is plunging into stagflation and the country's financial situation is still very precarious. The government has already discussed a reprofiling of domestic public debt repayments with the banks. A default on external debt could still be avoided with support from the IMF. However, if the recession continues beyond 2024, it is difficult to imagine Argentina emerging from the crisis without debt restructuring.

Javier Milei's victory in the presidential election last October and the announcements of very radical economic policy measures since he took office on 10 December suggest a particularly difficult 2024 for the Argentine economy.

SHOCK THERAPY

Just a few days after he was sworn into office, the president signed a decree containing 366 changes aiming to stabilise the economy (the so-called "Necessity and Urgency Decree", DNU), which has been in force since 29 December[1]. The stabilisation plan is mainly built around: 1) balancing the budget from 2024 through spending cuts of 2.9% and an increase in revenue of 2.2% of GDP and 2) devaluing the official exchange rate against the dollar from 376 to 800 pesos, combined with temporarily hiking import taxes (from 7.5% to 17.5%) and export taxes (with the introduction of a minimum rate of 15%).

On 20 December, President Milei tabled an «omnibus» bill containing 664 articles to the National Congress. These articles supplement the DNU, but are not urgent measures and instead have a much broader aim, focusing on mass privatisation, deregulating a number of sectors and easing labour market rules. Javier Milei has sought to delegate legislative powers to the executive for a renewable 2-year period, so that he could pass his measures without Congress' approval.

The latest IMF review viewed the fiscal measures favourably, even though the devaluation of the peso will be accompanied by accelerating inflation. The country is expected to receive an additional USD 4.7 billion from the Fund before the end of January. The Argentine financial markets also reacted positively, as the spread between the official exchange rate and parallel exchange rates (blue-chip swap rate, MEP), which came down from 170% to 50% with the devaluation, has stabilised since the announcements. The Central Bank of Argentina's foreign exchange reserves have increased by USD 4.8 billion since Milei took office.

STAGFLATION INTENSIFIES

However, the DNU has already been challenged on a number of occasions before the courts, with unions arguing that the measures are unconstitutional (particularly the labour market reform measures). At the same time, Milei would like to see the bill passed quickly by the National Congress, but his party does not have a majority in either the Chamber of Deputies or the Senate, and the support of small right-wing parties is not enough. Milei is locked in a very unpredictable stand-off with the deputies.

FORECASTS

	2021	2022	2023e	2024e	2025e
Real GDP growth, %	10.4	5.2	-1.1	-3.0	2.5
Inflation, CPI, year average, %	48.4	72.4	133.5	331.0	67.0
General gov. balance / GDP, %	-4.5	-3.8	-5.2	-3.0	-2.0
General gov. debt / GDP, %	80.0	85.5	154.5	90.0	82.0
Current account balance / GDP, %	1.4	-0.7	-3.5	1.5	1.0
External debt / GDP, %	55.0	58.8	113.7	56.8	57.3
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

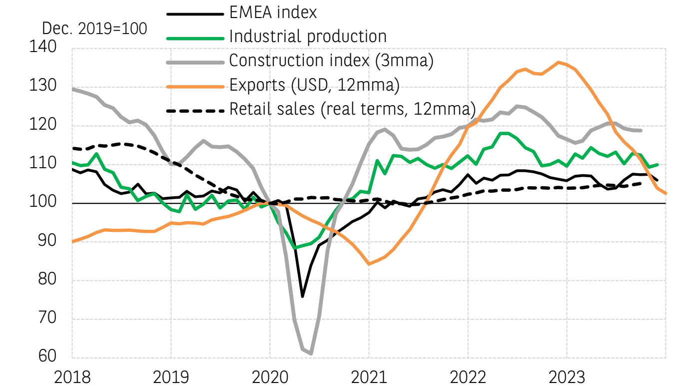

CHART 1

ARGENTINA: ACTIVITY INDICATORS

Public hostility was also expressed through a general strike on 24 January. The political and social risk has therefore skyrocketed and is likely to reignite financial instability.

In the short term, the measures will lead to more severe stagflation than was anticipated before the elections. Industrial production and construction activity have been declining since 2022 and exports have

1 Congress members (deputies and senators) can suspend the implementation of this decree if it is thrown out by both chambers. Conversely, bills must be adopted by the legislative and judicial branches before they are implemented.

been in freefall since 2023, as a result of the drought that has hit agricultural exports hard (see chart). Real GDP is expected to have fallen by an annual average of 2% in 2023.

Agricultural production should recover sharply in 2024, thanks to record harvests following several years of drought. However, in other sectors, the slump will simply deepen, following the inflationary shock of the devaluation of the peso.

Before the devaluation, inflation was already skyrocketing (+11% per month on average between August and November, compared to 7% between January and July), despite price-increase controls introduced by the previous government. In December, inflation came in at 25.5% over one month and 211.4% over one year, with the devaluation and the end of price controls triggering a catch-up wave, particularly around fuel prices (+47.7% over one month) and food prices (+29.7% over one month).

Inflation will remain very high during the first half of 2024 as the catch-up will continue (according to JP Morgan's calculations, so far only 30% of the monetary devaluation has been passed on) and regulated prices, which account for 16% of the consumer basket, will rise sharply as a result of the subsidy cuts. The monthly inflation rate is forecasted to average about 15%-20%. In the second half of 2024, if the depreciation of the exchange rate is contained at 2% per month (official target), inflation could fall below 10%. However, this can only happen if money-based inflation disappears. Therefore, much will depend on the credibility of the budgetary targets, on whether these targets are met and on the replenishment of foreign exchange reserves.

NEW PUBLIC DEBT RESTRUCTURING ON THE HORIZON ?

The government's financial situation is still precarious. For 2023 as a whole, the new administration is forecasting a primary deficit of 3% of GDP, which is a rise of 1 point of GDP compared to 2022. In view of the interest burden of 2.2%, the total deficit is expected to stand at 5.2% of GDP.

However, according to calculations by GlobalSource Partners, the Central Bank of Argentina (BCRA) saw its own interest burden double to almost 9% of GDP in 2023, pushing the public deficit up to 14% of GDP. As a matter of fact, the direct (advances to the Treasury) and indirect (purchases of government securities) monetary financing of the budget deficit forced the BCRA to issue sterilisation bonds (28-day LELIQ) amounting to up to an equivalent of 8% of GDP, at an interest rate that rose from 75% at the end of 2022 to 133% until 18 December[2] . Reducing the BCRA's liabilities is a government priority. Since November, LELIQS, whose stock only accounted for 1% of GDP at the end of December, have no longer been issued and have been replaced by reverse repos. At the same time, the key policy rate was lowered to 100%. Nevertheless, the interest burden for the BCRA will remain very high.

Even if the government manages to balance its books and contain the debt burden which has spilled over into the BCRA debt burden, it will face a liquidity problem on both domestic and external debt.

Repayments of domestic debt denominated in pesos (including debt indexed on inflation and the exchange rate) represent the equivalent of USD 35 billion. Fortunately, 65% of this debt is held by government-owned banks.

ARGENTINA: EXCHANGE RATE & OFFICIAL FX RESERVES

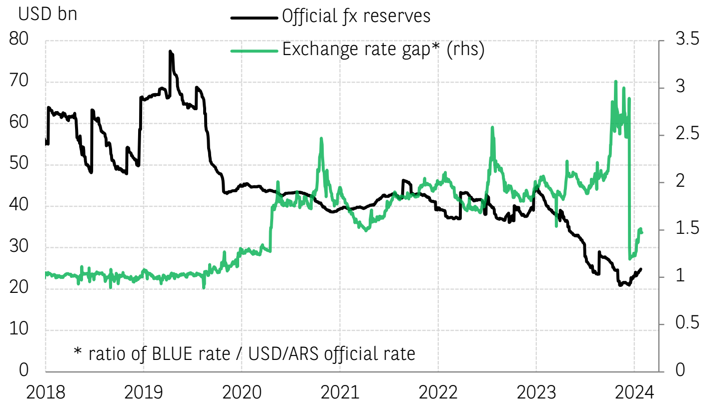

CHART 2 SOURCE: BCRA, BNP PARIBAS

Therefore, a meeting was organised at the start of January, at the behest of the Economy Minister and the Secretary of Finance, with representatives from the major banks to discuss postponing the 2024 repayment deadlines. It should be noted that the previous Economy Minister Sergio Massa had already imposed a postponement of the 2023 repayment deadlines on banks, at the end of 2022.

External debt repayments (interest and principal) amount to USD 16.8 billion for 2024 (USD 7.5 billion for the IMF, USD 5 billion for other official creditors and USD 4.3 billion for private creditors), with two significant falls in January and July. In addition to this, there is also the trade debt accumulated by importers to their suppliers in 2023 because they were unable to obtain dollars. This debt was valued at USD 21 billion at the end of 2023.

The payment of USD 4.3 billion by the IMF should cover the debts falling due in January 2024. However, foreign exchange reserves only amount to USD 24 billion and are even negative in net terms (i.e. minus the banks' reserve requirements and the swap line with the Central Bank of the People's Republic of China). In addition, the Argentine government has been ordered to pay compensation of USD 16.1 billion to creditors adversely affected during the nationalisation of the oil company YPF in 2012.

As things stand, international debt issuance is not an option. The government is being forced to issue domestic bonds denominated in dollars to settle importers' commercial debt[3] . However, demand is low as the interest rate offered (5%) does not remotely cover the risk.

At the end of December 2023, federal government debt stood at USD 368 billion, including USD 264 billion in foreign currency (mostly in dollars). Following the December devaluation, the debt ratio is equivalent to 154% of GDP[4] and foreign exchange reserves only cover one tenth of the foreign currency debt. It seems inevitable that domestic public debt repayments in 2024 will have to be reprofiled. With the support of the IMF, the government could still avoid defaulting on its external debt. However, if the recession continues beyond 2024, it is difficult to imagine Argentina emerging from the crisis without debt restructuring.

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2 The 28-day LELIQ rate was the benchmark rate up until this date. It is now the overnight reverse repo rate.
3 Bonds for the Rebuilding of a Free Argentina (Bopreal).
4 In % of GDP on year average. With GDP estimated at end-year, the ratio is much lower but still elevated (102%)

HUNGARY

CAUTIOUS OPTIMISM

After an expected recession in 2023, better growth prospects lie ahead in 2024. Economic activity is expected to be driven by both an improvement in domestic demand and a slight rebound in growth in the Eurozone. The monetary easing cycle initiated at the end of 2023 should continue, albeit cautiously, due to the persistence of strong wage pressure. External accounts remain strong, with foreign exchange reserves having increased for several years. Hungary is expected to post a current account surplus in 2023, after a deficit of -8.2% of GDP in 2022. As to public accounts, the budget deficit has continued to deteriorate, and is expected to exceed 5% of GDP in 2023. Like many European countries, Hungary may face an excessive deficit procedure in 2024.

RECESSION IN 2023 FOLLOWED BY MILD RECOVERY IN 2024

Hungary is one of the worst performing economies in the region, with negative growth expected for 2023. Over the first three quarters of 2023, real GDP fell by 1.2% y/y, primarily due to weak domestic demand (-6.0% y/y over the same period). The higher cost of credit and high inflation weighed in heavily. Net exports of goods and services, by contrast, contributed positively to growth and only partially offset the contraction in domestic demand.

In Q4 2023, economic activity was a mixed bag judging by economic indicators. On the one hand, industrial production fell below its pre-Covid-19 level in November and fell across all sectors. New car registrations, on the decline since last April, have continued their downward trend (-3.5% in 2023). On the other hand, household purchase intentions for durable goods in the coming months and the household confidence index have improved. The increase in real wages in the manufacturing sector, which has turned positive since last August (+1.3% y/y in August, +2.8% in September and +5.6% in October), argues in favour of a rebound in consumption.

Economic growth prospects are expected to improve in 2024, but should remain modest. Consumption will be buoyed by lower inflation, the upward revision of pensions (+6% in 2024 and payment of a premium in February), of the minimum wage (+15% in December 2023) and of wages for certain categories of civil servants (+32.2% for teachers in January 2024, +20% for nurses in March). Similarly, the expected easing of lending conditions, brought by recent central bank policy rate cuts and new support measures for first-time buyers (interest payment subsidies through the CSOK Plus programme), will revitalise the property sector and the credit market. Nevertheless, some caution remains necessary. The expected increase in public investment remains conditional on the release of European funds this year. Similarly, the outlook for private investment remains uncertain as the extension of windfall taxes in certain sectors (introduced in 2022) up to the end of 2024 could discourage the implementation of new projects. The expected recovery in Hungarian exports could be disappointing in the event of weaker growth prospects in the euro area.

MONETARY EASING

In 2023, Hungary recorded the highest inflation rate amongst European Union countries, at 17.5% on average. By way of comparison, inflation stood at 5.5% in the euro area over the same period. Inflation reached 11% in Poland, 9.8% in Romania, 12% in the Czech Republic and 8.7% in Bulgaria. A positive point is that inflation has fallen significantly from the peak of 26.2% seen in January 2023 and in particular, since September, so that Hungary is now posting a lower figure than Central European countries.

FORECASTS

	2021	2022	2023e	2024e	2025e
Real GDP growth, %	7.2	4.6	-0.5	3.3	3.2
Inflation, CPI, year average, %	5.2	15.3	17.5	4.8	3.6
General gov. balance / GDP (%)	-7.2	-6.2	-5.9	-3.8	-3.2
General gov. debt / GDP (%)	74.5	70.6	67.1	65.0	64.3
Current account balance / GDP, %	-4.1	-8.2	0.5	0.5	0.6
External debt / GDP, %	87.3	91.0	81.0	79.6	83.3
Forex reserves, EUR bn	38.4	38.7	41.4	43.0	46.0
Forex reserves, in months of imports	3.8	3.0	3.5	3.6	3.7

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

INFLATION IN CENTRAL EUROPE

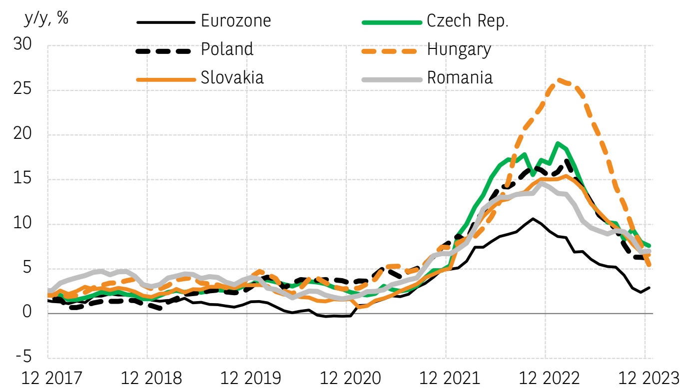

CHART 1

SOURCE: EUROSTAT, BNP PARIBAS

Last December, inflation stood at 5.5% y/y compared to 7.6% y/y in the Czech Republic, 6.6% in Poland and 7.0% in Romania. The rapid fall in inflation is attributed to a lower contribution from 'food' items to 1.3 percentage points in December, compared to 11.1 points in January 2023 and a negative contribution from the 'energy' item (-0.9 point).

Disinflation is expected to continue throughout 2024 without, however, reaching the Central Bank's inflation target of 3%. However, while prices on the international commodity markets may ease further, new taxes on fuel, toll and retail that came into force on 1st January 2024 will maintain upward pressure. Similarly, wages continued to grow steadily (+15.2% y/y in October 2023; +15.4% on average from July to September). The rise in the minimum wage of 15% for unskilled workers and 10% for skilled workers in December 2023, along with the expected impact on wage pressure in other professions, should keep core inflation at high levels. A return to the inflation target zone is not expected before 2025.

The slowdown in inflation has enabled an easing of monetary policy since the end of 2023. The monetary authorities cut their key rate by 300 basis points cumulatively to 10.00% in January 2024. Recent comments from the Central Bank suggest that monetary easing should continue in the coming months, but room for manoeuvre remains limited due to wage pressure.

HEADING FOR AN EXCESSIVE DEFICIT PROCEDURE IN 2024

With inflation, the public debt-to-GDP ratio is expected to improve further in 2023 and fall below the 70% mark, even though economic growth has weakened. That said, the budget deficit has remained elevated since 2020 (-7.6% of GDP, -7.2% in 2021 and -6.2% in 2022) due to the multiple shocks faced by the economy, which have in turn led to an increase in government spending.

The budget deficit would have been more pronounced without the fiscal consolidation efforts since summer 2022, which included the introduction of a tax on exceptional profits and the removal of price caps on fuel in 2022 and on foodstuffs in 2023. In 2023, the deficit is expected to reach 5.9% of GDP, compared to the 3.5% forecast pencilled in the budget. Government interest payments, estimated at 4.3% of GDP (2.8% in 2022), have increased significantly and are now among the highest in the EU. This surge is primarily attributable to interest paid on inflation-linked bonds. In addition, the extension of energy subsidies, pension hikes (+15% in 2023), plus the supplement paid to pensioners, have weighed on expenditure. The participation in certain companies has resulted in exceptional disbursements. And lastly, the authorities have funded some projects that were supposed to be financed by European funds, suspended by Brussels. For 2024, the authorities are predicting a less pronounced deficit than last year but higher than 3% of GDP. Interest costs will still be higher than 4% of GDP. To bring the budget deficit back below 3% of GDP, a large primary surplus will be necessary, and this is unlikely this year. Since 2020, the country has recorded a primary deficit (-5.2% in 2020, -4.9% in 2021 and -3.4% in 2022), and this will probably still be the case in 2024, even if a significant reduction is expected.

As a result of an expected deficit exceeding 3% of GDP in 2024, Hungary, like many EU countries, will have difficulty avoiding an excessive deficit procedure. In fact, the escape clause concerning the Stability and Growth Pact, temporarily introduced during the Covid-19 pandemic, came to an end on 31st December 2023.

HUNGARY: GOVERNMENT'S INTEREST PAYMENTS

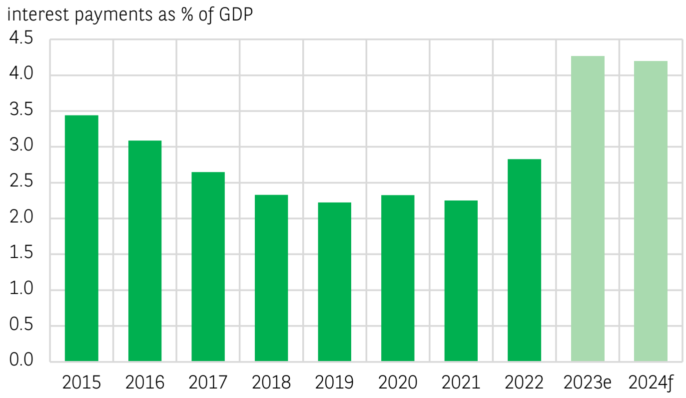

CHART 2

SOURCE: CENTRAL STATISTICAL OFFICE, BNPPARIBAS

Nevertheless, public debt remains sustainable. The temporary suspension of the issuance of inflation-linked bonds (13% of public debt) and lower inflation should ease the burden of interest payments. Moreover, fiscal consolidation efforts and the gradual withdrawal of support measures related to the energy shock suggest that Hungary should return to a primary surplus by 2025/2026. In addition, the debt profile has improved since 2011. The share of government debt denominated in foreign currency (mainly in euros) fell sharply (26.9% of the total in 2023 according to the Hungarian debt management agency (AKK) compared to 50% in 2011). The share of fixed-rate debt is in the order of 68.6% of the total. However, financing needs remain high and are unlikely to improve significantly in the medium term. Gross government bond issuances are estimated at HUF 10,273 billion in 2024 (around 12% of GDP), including HUF 2,515 billion to cover the financing needs of the government budget.

SOME IMPROVEMENTS

External accounts have improved. After a deficit of 8.2% of GDP in 2022, the current account is expected to once again generate a surplus in 2023 (EUR 0.5 billion over the first nine months cumulatively) owing to a reduction in the energy bill. Similarly, net capital flows were resilient over the first three quarters overall, at EUR 3.5 billion. Foreign exchange reserves increased to EUR 41.4 billion in 2023, with an import cover ratio of 3.5 months.

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WESTERN BALKANS

MACROECONOMIC STABILITY DESPITE EXTERNAL SHOCKS

Despite their many vulnerabilities, including a high dependency on the European market and a complex political environment, the economies of the Western Balkans have held up remarkably well against two external shocks since 2022: the war in Ukraine and Europe's economic slowdown. The foreign exchange risk has been contained thanks to the support of foreign direct investment and external financing. Buoyant domestic demand has helped to offset the effects of the slowdown in Europe on exports. Inflationary pressures, which were still substantial in 2023, are expected to ease this year. In Croatia, macroeconomic risks will be reduced significantly thanks to the eurozone accession. However, its high dependency on tourism activity is still a factor of vulnerability. While Serbia's admission to the EU is still being hindered by predominantly political factors, its economic performance has been strong, both in terms of external accounts and public finances.

LIMITED IMPACT OF THE WAR IN UKRAINE

The gradual severing of ties between Europe and Russia has not led to any major economic difficulties in the Western Balkans, in particular thanks to a limited dependency on gas imports (Slovenia and Montenegro) and diversified energy-supply sources (development of LNG terminals in Croatia and low dependency on Russian gas in North Macedonia). In theory, the country most exposed to the supply risk is still Serbia, due to its dependency on Russian gas imports, which account for 90% of its gas imports. In June 2022, the Serbian government secured its imports on favourable terms by renewing its supply contract with Russia for three years.

Beyond energy issues, the war in Ukraine has severely disrupted commodity markets and capital flows. Part of the Balkans is particularly sensitive to any shortfall in its balance of payments, given that most local currencies are pegged to the euro (Croatia and Slovenia are members of the euro area) and public debt and bank balance sheets are being significantly euroised. Even though the link with the single currency can take various forms (from a managed exchange rate policy in Serbia to a de facto euroisation of the economy in Kosovo), in order to ensure that the foreign exchange regime remains credible, countries must hold sufficient foreign-currency liquidity to be able to cope with any deterioration in the balance of payments. Unsurprisingly, the current account deficit increased in 2022, rising on average from 5.5% to 8.2% of GDP. While the Western Balkan countries came into the crisis with satisfactory levels of foreign-currency liquidity, their financing needs have been covered by buoyant foreign direct investment (as is the case in Serbia, Montenegro and North Macedonia), as well as by the support of multilateral lenders (Serbia and North Macedonia).

IMPACT OF EUROPE'S ECONOMIC SLOWDOWN OFFSET BY DOMESTIC DEMAND

The vulnerability to Europe's economy can take various forms, as the European Union is the largest export market for goods, the main source of tourists and the main destination for expatriates who contribute significantly to local activity through remittances. In 2023, the economic slowdown in Europe (0.5% in the euro area and -0.1% in Germany) had contrasting effects on activity. On average, exports of goods and services slowed sharply during the first three quarters.

However, household consumption remained sustained, thanks in particular to real wage growth in Slovenia, Serbia and Croatia against a backdrop of receding inflationary pressures. For all of the countries, inflation is expected to fall from 12% on average in 2022 to 4.2% in 2024, according to European Commission forecasts. Investment was the other main growth driver in 2023, buoyed in particular by foreign direct investment and EU funding.

According to European Commission forecasts, growth should reach 2.5% on average across the entire area. In Slovenia, activity is expected to be slower (+1.3% expected), due to the floods that hit the country

SERBIA

	2021	2022	2023e	2024e	2025e
Real GDP growth, %	7.5	2.5	2.2	3.1	3.5
Inflation, CPI, year average, %	4.1	11.9	12.7	5.5	3.5
Central gov. balance / GDP, %	-4.3	-3.2	-2.6	-2.3	-1.9
Central gov. debt / GDP, %	57	56	52	49	45
Current account balance / GDP, %	-4.3	-6.9	-2.3	-3.8	-4.1
External debt / GDP, %	71	68	65	62	59
Forex reserves, EUR bn	16.5	19.4	25.0	27.0	30.0
Forex reserves, in months of imports	5.9	5.2	6.6	6.7	6.9

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

REAL GDP GROWTH

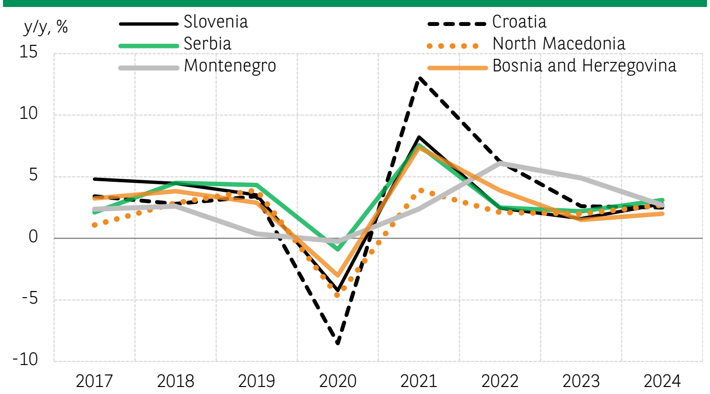

CHART 1 SOURCE: EUROPEAN COMMISSION, BNP PARIBAS

hard during summer 2023. About 80% of the country's municipalities were affected by this climatic event and the direct damage is estimated at around 5% of GDP, according to the European Commission. In 2024, average growth is expected to barely accelerate at all, rising to just 2.6% against a backdrop of a fragile economic recovery in the euro area (+1.6% expected).

CROATIA: EUROZONE ACCESSION

2023 saw Croatia join the euro area. By removing the foreign exchange risk, Croatia's eurozone membership significantly reduces specific risks associated with the high share of government debt denominated in foreign currencies (70% of the total, mostly in euros) and the euroisation of around 70% of bank balance sheets.

In addition, both adopting the euro and joining the Schengen Area is expected to benefit the tourism accommodation sector. Tourism is a key sector of the Croatian economy, as it contributes to around a quarter of its GDP (compared to less than 10% on average in the European Union). In 2023, annual tourist numbers were almost back at their pre-pandemic levels. The size of the tourism sector within the economy reduces some risks, in particular, the risk of energy-price volatility on activity, but increases others, including the risk of dependency on the European economy. In the longer term, the rising temperatures and drought risk expected to affect the entire Mediterranean region will adversely impact tourist numbers and the availability of some resources, such as water.

Public finances are sound, and with accounts being kept practically balanced in 2022 and 2023, this will help to reduce the government debt ratio, which is expected to be below 60% of GDP in 2024.

Significant financial support is being provided by the European Union and this should help the country to gradually catch up with the European standard. In 2022, Croatia's GDP per capita was 73% of the European Union average (60% in 2013). By 2030, it is estimated that Croatia (which has a high capacity to absorb European funding) could receive European support funds equivalent to a quarter of its current GDP.

SERBIA: SOUND ECONOMIC FUNDAMENTALS

Over the past two years, Serbia has been evolving in a complex political environment. This is because, on top of the recurring regional tensions, there have also been the consequences of its close partnership with Russia, which have damaged its relations with the European Union. These factors may hinder the country's integration into the European Union. However, from an economic perspective, its fundamentals are still sound and will help it to cope with any external shocks.

Given the significant euroisation of bank balance sheets and government debt, the Serbian economy's ability to generate sufficient foreign currency is a key factor in the country's macroeconomic stability. In practice, the foreign exchange policy focuses on keeping the dinar stable against the euro and has resulted in interventions in the foreign exchange market by the National Bank of Serbia.

SERBIA: FISCAL BALANCE AND INTEREST PAYMENT

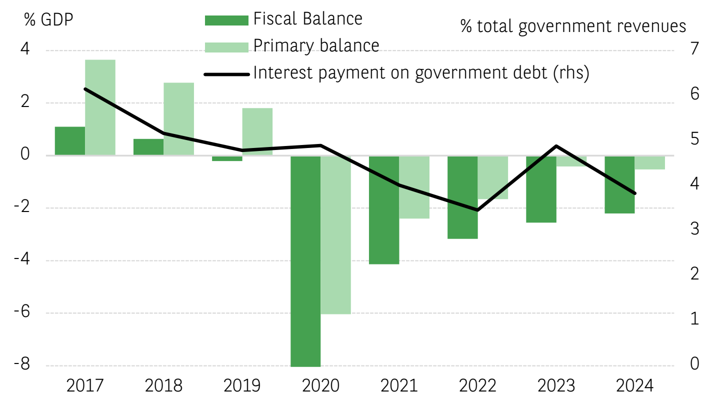

CHART 2

SOURCE: MINISTRY OF FINANCE, BNP PARIBAS

Due to a recurring and rather high current account deficit (5.4% of GDP on average over the 2018-22 period) and a large external debt amortisation (10.4% of GDP on average over the 2018-22 period), the country has a substantial financing need. This is being covered by net foreign direct investment (which has covered an average of 140% of the current account deficit since 2015) and by external debt flows. Despite a much higher risk premium than before the war in Ukraine broke out (193 bps currently compared to less than 100 bps before March 2022), Serbia is still issuing sovereign bonds on international markets (USD 1.75 bn issued in 2023). In addition, the Serbian government's compliance with the IMF's requirements has resulted in financing tranches under a Stand-By Arrangement worth a total of EUR 2.4 billion (3.5% of GDP) being regularly disbursed. The National Bank of Serbia has enough foreign exchange reserves to limit the foreign exchange volatility and fulfil the IMF's prudential criteria.

Public accounts have improved significantly since 2016, particularly under the IMF's supervision. While IMF support is not crucial from a financing perspective, it does help to anchor the country's macroeconomic policy. After the significant deterioration in the fiscal balance as a result of the pandemic (-8.0% of GDP in 2020), followed by the need to increase wages and social spending against a backdrop of persistent inflation (+7.6% y/y in December 2023), the budget deficit is expected to gradually fall thanks to spending control (2.2% of GDP, according to the European Commission forecast). Public debt is at a moderate level (56% of GDP in 2022), and the government has liquid deposits equivalent to around 5% of GDP, according to IMF estimates. Debt interest payment accounts for around 4.5% of budget revenues (2023 estimate), and allows for some fiscal policy flexibility.

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EGYPT

RISING PRESSURE ON PUBLIC FINANCES

Against a backdrop of rising regional geopolitical pressures, the economic crisis is deepening further in Egypt and now poses a threat to public finances. With no agreement reached with the IMF, the balance of payments crisis is continuing to unfold, and the adjustments needed are being postponed. As a result of the exchange rate depreciating and interest rates rocketing, this crisis has pushed the interest burden on government debt to a level that could quickly become unsustainable. As a matter of fact, it could hit 70% of government revenue this year and remain very high next year. While reaching an agreement with the IMF should provide a solution for the balance of payments crisis, at least in the short term, the government restructuring domestic debt is becoming an increasingly likely scenario.

SLOWING ACTIVITY AND MODERATING INFLATION

Economic activity has slowed sharply since 2022. Real GDP rose 3.8% during the 2023 fiscal year (FY) (compared to 6.6% in 2022), and only increased by 2.7% y/y in Q1 FY2024, continuing a downturn that began in Q1 FY2023. The main factors driving this slowdown are the balance of payments crisis and its ramifications on foreign currency availability and cost, as well as inflation.

The resurging geopolitical risk in the region should reinforce this negative trend in the short term. The recent threats to safe maritime transportation in the Red Sea have reduced traffic on the Suez Canal (around 2% of GDP) by more than 40% since the start of this year. In addition, this deteriorating political environment in the region could negatively impact tourist numbers. In the energy sector, gas production was down for a second year in 2023 (-11%) and this fall in production is expected to continue in 2024.

More broadly, high inflation and interest rates, as well as the short-term uncertainties around the exchange rate, will continue to constrain household consumption and corporate investment. In total, we are anticipating 3% growth in real GDP in FY2024. A potential rebound next year still depends above all on the geopolitical risk in the region, and particularly on the beginning of the stabilisation of the macroeconomic situation under the IMF's supervision. At this stage, the visibility on each of these two factors is very limited.

The fall in inflation (in year-on-year terms), which began last September, is not expected to continue this year. In December 2023, prices were up 34% in year-on-year terms, down from the high of 38% in September. However, a number of price hikes (electricity, urban transport and internet) are coming into force at the start of this year and will fuel service price rises. In addition, an agreement with the IMF will very likely result in a significant downward adjustment of the exchange rate, and therefore in additional inflationary pressures. On average, inflation is expected to hit 32% in FY2024 before falling to around 20% in FY2025.

PERSISTING PRESSURES ON THE POUND

According to the most recent figures available, the current account deficit continued to decrease in Q1 FY2024. Over a rolling year, this deficit is equivalent to around 1.1% of GDP. Positive developments concern exports of non-hydrocarbon goods, high tourism revenues (in 2023, tourist numbers hit an all-time high of 14.9 million visitors) and revenues from the Suez Canal. By contrast, the fall in private transfers (linked to the widening gap between the official exchange rate and the parallel exchange rate) and the decline in hydrocarbon exports hit foreign exchange revenue hard. In addition, it should be noted that the improvement in the current account is strongly linked to the decline in goods imports due to the constraints on access to foreign currency.

FORECASTS

	2021	2022	2023e	2024e	2025e
Real GDP growth, %	3.3	6.6	3.8	3.0	4.0
Inflation, CPI, year average, %	4.5	8.5	24.0	32.0	20.0
Central gov. balance / GDP (%)	-7.0	-6.5	-7.3	-10.1	-8.6
Central gov. debt / GDP (%)	91	89	93	85	83
Current account balance / GDP (%)	-4.4	-3.5	-1.2	-2.4	-2.7
External debt / GDP (%)	35	33	41	49	48
Forex reserves (USD bn)	41	33	35	43	46
Forex reserves, in months of imports	6.0	3.9	4.9	5.5	5.5

TABLE 1

Fiscal year from July 1st of year n to June 30 of year n+1
e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

EGYPT: ECONOMIC GROWTH AND INFLATION

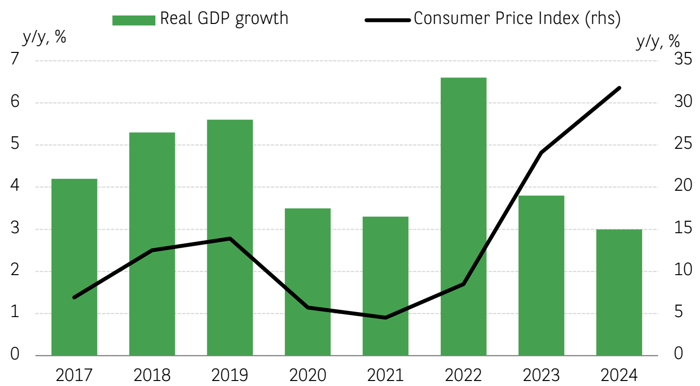

CHART 1

SOURCE: CENTRAL BANK OF EGYPT, BNP PARIBAS

In the short term, geopolitical factors will hurt tourism and revenue from the Suez Canal, which account for 14% and 9% of foreign exchange revenue, respectively. In addition, the persisting wide gap between the official and parallel exchange rates will continue to adversely affect remittances, which, in a normal year, account for more than a third of foreign exchange revenue. Finally, hydrocarbon export revenues are not expected to improve.

This is because, on the one hand, Egypt is increasingly struggling to generate an exportable gas surplus as a result of sustained consumption and lower production. On the other hand, according to our central scenario, oil and LNG prices in Europe should not rise significantly during the first half of 2024.

For several months, the issue of covering the external financing need (current deficit plus amortisation of foreign currency debt) has been relying on the resumption of the IMF financial support (and the bilateral and multilateral financing that rely on it), which was suspended at the start of 2023 and is subject to the implementation of specific economic reforms. Throughout 2024, Egypt faces a huge debt wall in foreign currency. This is because, according to the Central Bank of Egypt, the amortisation of external debt (mainly due from public creditors, and excluding deposits from the Gulf states in the Central Bank of Egypt) amounts to USD 10.1 billion in H1 2024 and USD 12.8 billion in H2 2024. The total external debt service (amortisation and interest) amounts to around USD 31 billion for 2024 as a whole.

According to our estimates, the combination of international support (the amount of support from the IMF will very likely be higher than the USD 3 billion originally planned), FDI flows, including revenue from privatisations, and an additional increase in the net external liabilities of commercial banks, should help Egypt to cover its foreign currency financing need and fuel an increase in the Central Bank of Egypt's foreign exchange reserves. In FY2025, whether the external financing need can be covered will depend on Egypt's capacity to tap the international bond market and on the return of portfolio investments. Portfolio investments are relying on the restoration of foreign currency liquidity and on the effectiveness of the policy to curb inflation. However, the recent exclusion of Egypt from an international benchmark bond index will negatively impact foreign investment inflows into the local debt market. In the medium term, a persistent sizeable current account deficit and dependence on volatile sources of financing will keep the pressure on the pound and foreign currency liquidity.

AN INCREASINGLY UNSUSTAINABLE DEBT SERVICE

While we believe that the foreign currency liquidity crisis can be managed in the short term, the public finance situation is seemingly becoming increasingly unsustainable, due to the alarming levels of some indicators. Despite the persistent high budget deficits, up until now, the government's financing needs have been covered thanks to the high level of local bank liquidity (around 80% of the government's outstanding debt is in local currency) and greater access to external financing sources. The lingering balance of payments crisis has led to a sharp depreciation of the pound (by around 50% against the USD in 2023) and a huge rise in central bank interest rates (+1,200 bp since March 2022) in response to the surge in inflation. Public finances are very sensitive to these two variables, due to, in particular, the steady rise in foreign currency public debt, which increased from 7.4% of GDP in FY2016 to 21% in FY2023, and the short maturities of domestic debt. During the first five months of FY2024, 85% of local debt issues had a maturity of less than one year. And for the time being, as long as inflationary pressures remain high and foreign currency liquidity remains tight, there is very little scope for exploring extending the maturity on local government debt issues.

EGYPT: FISCAL BALANCE AND INTEREST PAYMENT

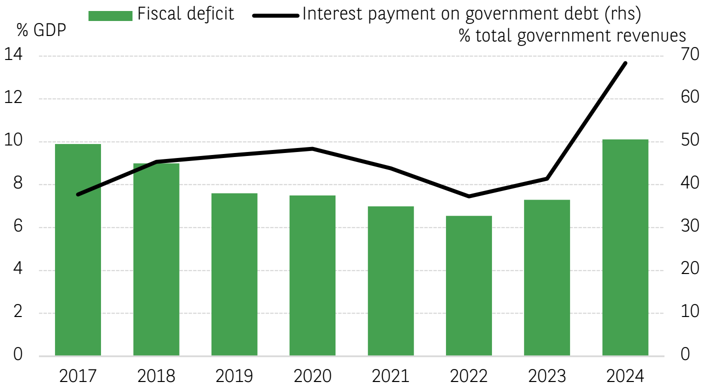

CHART 2

SOURCE: MINISTRY OF FINANCE, BNP PARIBAS

With this in mind, the ratio of government debt interest payments to total government revenue is expected to reach an all-time high in FY2024. This ratio, which measures the affordability of debt for the government, hit 43% in FY2023, which was already one of the highest among emerging economies. According to the budgetary figures for the first half of FY2024, debt interest payments hit 6.2% of GDP. Over the entire year, they are expected to increase to around 12-15% of GDP. According to our estimates, the debt interest payments-to-revenue ratio could rise to 70% in FY2024 and is expected to remain very high in FY2025. This is because the macroeconomic adjustment that will be attached to the IMF support is expected to result in further exchange rate depreciation and domestic interest rates increase, therefore causing a further rise in debt service. The monetary policy committee rose its benchmark interest rate by 200 bps on 1st February. The difference between the official exchange rate and the exchange rate on derivative market (NDF 12m) is 50% against the USD.

The debt burden is clearly unsustainable and is drastically reducing the budgetary leeway.

Although fiscal performance in the first half of the year was relatively good (tax revenues were up 43% y/y), this is partly due to an expansion of the tax base, but certainly also to the automatic effect of rising inflation on budgetary revenues. The prospects of slowing growth and a struggle to find further budget revenue streams, set against a backdrop of falling household disposable income, may further reduce the government's budgetary leeway. On the expenditure side, there is not much scope for cuts. Social welfare expenditure and wages account for approximately 61% of total primary expenditure.

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TUNISIA

WALKING A TIGHTROPE

Hard hit by the Covid crisis and the consequences of the war in Ukraine, the Tunisian economy is now facing significant financing constraints. External accounts held up fairly well in 2023, but the macroeconomic situation remains very fragile. Debt repayments for this year are significant, and the country is not immune from another shock. In particular, the prospect of rapprochement with the IMF seems less and less likely, fuelling fears about the government's ability to cover all its financing needs. A debt crisis cannot be ruled out.

IMF AGREEMENT IN 2024 SEEMS UNLIKELY

Tunisia is walking a tightrope without a real safety net. This is expected to be the case once again in 2024. The presidential elections held in the autumn have reduced the prospect of an agreement with the IMF; reaching this agreement would however help unblock most bilateral and multilateral assistance programmes. The IMF's assistance remains conditional on implementation of reforms that President Saïed has largely rejected, due to a social cost considered too high (restructuring of public companies, overhaul of the subsidy system). Officially, discussions have not broken off and new terms, taking into account the concerns of the Tunisian authorities, could contribute to reconciling positions. But this scenario seems unlikely. Any agreement with the IMF will require budgetary efforts, which are all the more difficult to implement since the very low participation rate in the local elections in December is evidence of latent grass-roots dissatisfaction. The stability of the foreign exchange reserves of the central bank (BCT) in 2023 probably also reinforced the authorities' idea that the economy could do without financial support from the IMF. Considering this year's significant financing needs, this strategy is nevertheless risky.

FORECASTS

	2021	2022	2023e	2024e	2025e
Real GDP growth (%)	4.6	2.6	0.6	2.2	2.0
Inflation (CPI, year average, %)	5.7	8.3	9.3	8.0	7.0
Central gov. balance / GDP (%)	-7.9	-7.7	-7.7	-6.6	-6.1
Central gov. debt / GDP (%)	79.9	79.8	79.7	80.7	81.6
Current account balance / GDP (%)	-6.0	-8.6	-3.8	-4.4	-4.7
External debt / GDP (%)	91.6	90.8	86.4	86.3	86.5
Forex reserves (USD bn)	8.4	7.7	8.3	8.0	7.9
Forex reserves, in months of imports	4.2	3.2	3.5	3.2	3.1

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

PUBLIC FINANCE: VERY HIGH FINANCING RISK

Despite the dissipation of the terms-of-trade shock linked to the conflict in Ukraine, and the moderation of civil servants' wage bill growth, the budget deficit barely stabilised in 2023, at 7.7% of GDP. This is 2.5 points higher than in the initial Finance Bill. For 2024, the adjustment should remain modest, with a budget deficit of 6.6% of GDP expected by the government.

Subsidies on energy and base products will remain a heavy burden on the budget. After doubling in 2022 to reach a record level of 8.3% of GDP, subsidies only fell very slightly in 2023 to 7.2% of GDP, compared to 5.5% budgeted. According to government forecasts, they are still expected to reach 6.5% of GDP this year, i.e. almost 20% of spending. By way of comparison, this item represented 12% of spending on average between 2015 and 2021. Further slippages should not be precluded, bearing in mind the volatility of global commodity prices. Added to this is the increase in interest costs, which have exceeded 10% of budget expenditure for the first time since early 2010. The debt burden is the result of an accumulation of high budget deficits and increased recourse to domestic financing on terms less favourable than those granted by official external creditors. However, this trend is not set to reverse.

Unless the budget deficit narrows more than expected, the Tunisian government's financing needs will exceed 17% of GDP this year (see Chart 1). Debt amortization will count for two-thirds of this amount. This is huge and incommensurate with the pre-pandemic situation, when financing needs were around 8-9% of GDP. The authorities' ability to cope with this remains very uncertain. In fact, 57% of the financing plan included in the budget is based on external resources, of which only one-third have been identified.

TUNISIA: GOVERNMENT FINANCING NEEDS

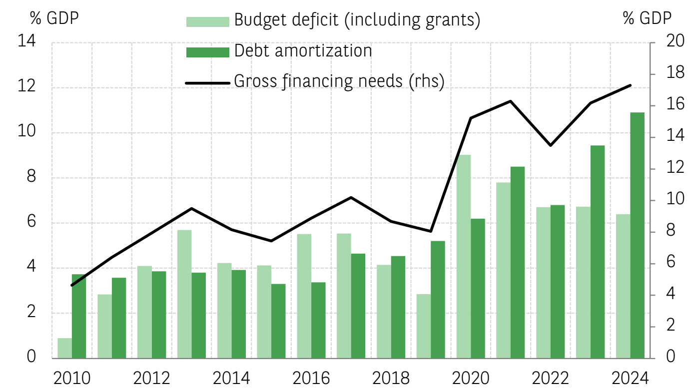

CHART 1

SOURCE: MINISTRY OF FINANCE, BNP PARIBAS

The government is counting on official external financial support, but the repeated budgetary underperformances of recent years call for caution. At the end of September 2023, the government had succeeded in mobilising only 28% of the external resources planned in the initial budget. Without an agreement with the IMF, such a scenario is therefore likely to recur, leaving a gap of 12-13% of GDP to be covered in a shallow domestic bond market. Standing at 15% at the end of 2019, banks' exposure to the public sector, in the broad sense (corporates and government), rose at the end of 2019 to 20% of the assets of the entire system.

Moreover, the overall volume of bank refinancing with the Central Bank increased by 43% in 2023, of which more than one-third in the form of open market operations compared to less than 20% in 2022. However, a minority of these open market operations are used for monetary policy purposes. In other words, the monetary authorities are indirectly refinancing the government by buying back treasury bills on the interbank market. Measures to allow the Central Bank to directly finance the government are even being developed, which could potentially have a significant impact on inflation or exchange rates.

Liquidity risk is not the only source of concern. With debt now reaching 80% of GDP and an inexorably increasing interest burden (14% of income in 2024 compared to 10% in 2020), the government's solvency is also deteriorating dangerously. The country is now considered as just one step away from payment default by Fitch and Moody's rating agencies.

FRAGILE IMPROVEMENT IN EXTERNAL ACCOUNTS

After a difficult 2022, pressure on foreign exchange reserves has eased considerably thanks to very good tourism activity, high remittances from the Tunisian diaspora, and the fall in prices of the main commodities imported. From USD 3.1 billion over the first nine months of 2022, the current account deficit narrowed to USD 1.1 billion in 2023. According to our estimates, it is not expected to exceed 4% of GDP over the whole year, compared to 8.6% in 2022. The BCT has been able to build up some of its foreign exchange reserves (+USD 600 million). At USD 8.3 billion, they now cover 3.5 months of imports of goods and services (G&S).

External accounts remain fragile. The outlook is for a moderate deterioration of the current account deficit to 4.4% of GDP in 2024. But the significant weight of the energy imbalance in the trade balance (more than half of the deficit in 2023), or the dependence on Europe for exports, exposes the economy to a number of economic uncertainties. In addition, the country will also have to cover significant external debt amortization (USD 3.6 billion compared to USD 2.8 billion in 2023). However, funding sources outside official assistance are largely insufficient. Net FDI flows are low, around USD 500-600 million for the last four years, i.e. less than 1.5% of GDP, and they will probably stay low in the coming months due to the country's macroeconomic difficulties. With five-year sovereign risk premiums still exceeding 1,000 bps, Tunisia will not be able to turn to the international financial markets either to issue debt. Should downside risks (increase in the current deficit, insufficient financing) materialise, foreign exchange reserves could, as a result, fall below the three-month alert threshold for G&S imports with, as a corollary, strong pressure on the dinar.

Another factor illustrates the current vulnerabilities: the emergence of shortages of subsidised base products since 2022, the import and marketing of which are handled by increasingly indebted public companies. The result is a compression of imports, which may ease pressure on foreign exchange reserves for some time, but this situation cannot last in the long term.

TUNISIA: SECTOR CONTRIBUTION TO GDP GROWTH

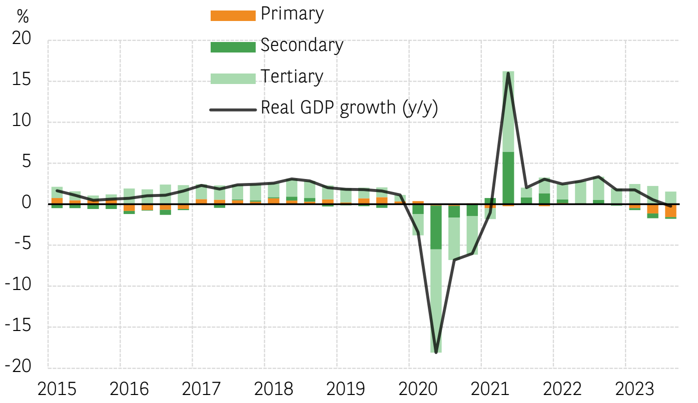

CHART 2

SOURCE: INS, BNP PARIBAS

ECONOMIC GROWTH: NO RECOVERY IN SIGHT

Against this backdrop, it is difficult to imagine how economic activity could really recover. Over the first nine months of 2023, economic growth only reached 0.7% on average (see Chart 2), its lowest level since 2011, excluding the Covid crisis. The contraction of more than 10% in agricultural value added due to severe drought, explains a large part of this underperformance. But outside the agricultural sector, growth has also stagnated. Despite the good performance of exports of manufactured products and tourism, growth stood at 1.9% on average compared to 3.1% the previous year. However, without a relaxation of financing constraints, most of the factors that weighed on the economy in 2023 are expected to persist or even worsen: crowding-out effect of bank credit in the economy due to the government's extensive use of the local market, high inflation (8.1% at the end of 2023, 12.3% on food), almost no budgetary leeway (current expenditure now above revenue). Even with an upturn in agricultural production, growth is expected to barely exceed 2% in 2024, which is too low to push down an unemployment rate of nearly 16%. Unlike almost all countries in the region, Tunisia will therefore not return to its pre-pandemic GDP until next year. This reflects the depth of a crisis in which the fall in investment by more than 10 GDP points since 2010 is one of the most striking elements. Beyond the necessary macroeconomic stabilisation, the Tunisian economy therefore needs extensive work on reforms to restore its growth potential. This will be a lengthy and risky process, especially if a debt crisis were to add to current difficulties.

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ETHIOPIA

DIFFICULT COMPROMISES

A breakthrough has recently been made in the process of restructuring the Ethiopian government's external debt. The peace agreement between the federal authorities and the Tigray rebel forces, signed in November 2022, ended two years of civil war and cleared the way for negotiations with international institutions to resume. Consequently, almost three years after requesting a debt restructuring under the G20 Common Framework, Ethiopia reached an agreement on an interim suspension of its bilateral debt service. However, this is only the first step on its journey, as the Ethiopian government must now reach agreements with all of its external creditors in order to fully restructure its debt. Before this, it must negotiate with the IMF in order to obtain its financial support, in exchange for undertaking tough reforms which will primarily set out to strengthen the country's external accounts. This is all happening against the backdrop of ongoing conflicts in the region, which are jeopardising the country's relations with its international partners.

A SLOW RESTRUCTURING PROCESS...

In February 2021, staring down the barrel of an increasingly likely default, the Ethiopian government requested a debt restructuring under the G20 Common Framework. At that time, external liquidity was falling to critically low levels. On top of the falling coffee prices (a third of Ethiopia's exports) over the past decade, the country had also been hit by the Covid-19 pandemic and the ongoing historic drought in the Horn of Africa since 2020.

However, the civil war that broke out in the country in November 2020 derailed the negotiation process and led to its relations with foreign donors being cut off. Official development assistance (ODA), on which the country has been historically dependent, shrank by 40% between 2020 and 2022, plummeting to USD 2.7 bn, a decade low. As a result, the foreign exchange shortage intensified and foreign exchange reserves gradually fell to USD 1 bn in June 2023, covering less than one month of imports.

The signing of the peace agreements between the federal government and the Tigray People's Liberation Front (TPLF) in November 2022 was a breakthrough moment in this situation. Ethiopia reached interim agreements on suspending its bilateral debt service for the 2023 and 2024 fiscal years, first in August 2023 with China, which holds 75% of its bilateral debt, and then last November with all of its other bilateral creditors. As a result, interest payments will be deferred until 2025, with the payment of the principal postponed until 2027, coming to a combined total of USD 2.5 bn.

Beyond the short-term external liquidity relief, these agreements enabled the Common Framework to be relaunched after a long spell of inactivity. In order to comply with this mechanism, two weeks after it signed the bilateral agreements, the Ethiopian government did not pay a USD 33 mn coupon owed on its outstanding Eurobond debt, in order to uphold the principle of comparability of treatment between creditors. As a result, S&P and Fitch downgraded the government rating to «default» last month. The country is the latest in a line of African governments that have defaulted on their external commercial debt since the Covid-19 pandemic, following in the footsteps of Zambia and Ghana.

However, unlike these other two countries, Ethiopia's default is the culmination of a temporary external liquidity crisis rather than a long-term insolvency issue. According to the Ethiopian Ministry of Finance, in September 2023, public debt was contained at 39% of GDP, compared to 88% in Ghana and 140% in Zambia when they defaulted, respectively. Furthermore, less than a quarter of the external debt was owed to private creditors. Therefore, the negotiations could be faster.

FORECASTS

	2021	2022	2023e	2024e	2025e
Real GDP growth (%)	6.3	6.3	6.1	6.2	6.4
Inflation (CPI, year average, %)	26.8	33.9	29.1	20.7	16.5
Government balance / GDP (%)	-2.8	-4.1	-2.7	-2.0	-2.5
Government debt / GDP (%)	53.8	46.4	37.9	31.2	28.9
Current account balance / GDP (%)	-3.2	-4.3	-2.4	-2.0	-1.2
External debt / GDP (%)	27.0	22.5	20.3	16.6	14.4
Forex reserves (USD bn)	2.9	1.5	1.1	1.3	1.5
Forex reserves, in months of imports	4.1	1.6	1.4	1.6	1.8

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

ETHIOPIA: EXTERNAL PUBLIC DEBT BY CREDITOR AS OF SEPTEMBER 2023

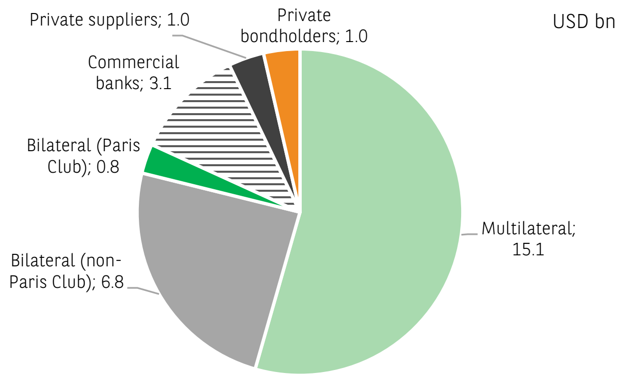

CHART 1

SOURCE: ETHIOPIAN MINISTRY OF FINANCE, BNP PARIBAS

Firstly, the scope of the restructuring will not include domestic debt, as was the case in Ghana. In addition, the restructuring is expected to be limited to extending maturities, with the aim of spreading repayments better over time and therefore reducing periods of liquidity pressure.

Any such agreement should be relatively easier to negotiate with bilateral creditors, especially with China, which has traditionally been reluctant to accept debt write-offs. However, as is often the case, Eurobond debt will be more difficult to restructure, as evidenced by the failure by the government and private bondholders to reach an initial agreement at the end of October. Fortunately, Ethiopia has issued only one Eurobond for an amount of USD 1 bn, i.e., only 11% of the scope of the debt to be restructured.

... WHICH WILL HINGE ON TOUGH REFORMS...

Nevertheless, any further progress under the G20 Common Framework is still dependent on securing a USD 3.5 bn IMF funding programme, which would unlock a similar amount from the World Bank. The Ethiopian government does not have much room for manoeuvre in negotiating the conditions for this funding: without an agreement with the IMF by the end of the first quarter of 2024, bilateral creditors reserve the right to cancel their debt service suspension. Yet, the IMF will demand tough reforms from the Ethiopian authorities, which the government has delayed for many years.

The main sticking point in the negotiations is the gradual devaluation of the exchange rate, a reform launched under the previous IMF programme in 2019, but ultimately abandoned in 2021. For decades, the National Bank of Ethiopia (NBE) has been managing the exchange rate and the Birr has been largely overvalued. Due to the foreign exchange shortage, the disparity between the official rate and the parallel market rate has gradually widened to nearly 100% at present.

Devaluation with the aim of bringing the official and parallel rates back together will be needed for the NBE to end the restricted access to the dollar (at least 35% of currency transactions are thought to be carried out on the parallel market) and liberalise the foreign exchange regime. The scale of the devaluation is being discussed by the Ethiopian government and the IMF, as a full correction of the overvaluation would obviously have a significant impact on inflation, which is already very high, with the year-on-year rise in consumer prices exceeding 25% since June 2021.

Therefore, if the foreign exchange market were to be liberalised, this would need to go hand in hand with a reform of monetary policy in order to better control inflation via the interest rate channel. At the present time, the NBE's main measures to tackle inflation involve capping bank credit growth at 14% for the current fiscal year and reducing the NBE's direct advances to the government, i.e. reducing the monetisation of the fiscal deficit. However, the end of direct advances will be difficult, in view of the government's substantial short-term financing needs and its struggles to find revenue. According to the IMF, the Ethiopian government's fiscal revenue gradually declined from 15.6% of GDP in 2016 to 8.5% in 2022, one of the lowest ratios in sub-Saharan Africa. Over the same period, spending contracted at a slower pace, so much so that the budget deficit widened to 4.1% of GDP in 2022. In order to get public finances on a more sustainable footing and show goodwill to the IMF, the government will therefore have to propose fiscal reforms aiming to structurally increase revenue while drastically reducing subsidies and social transfers, which accounted for more than half of budgetary expenditure in 2020.

Further reforms will be needed in order to durably attract foreign investment and strengthen external accounts. Other actions that may be required to secure the IMF financing include developing and liberalising the financial sector, continuing the programme to privatise public companies and improving the business environment.

ETHIOPIA: STRONG INFLATIONARY PRESSURES

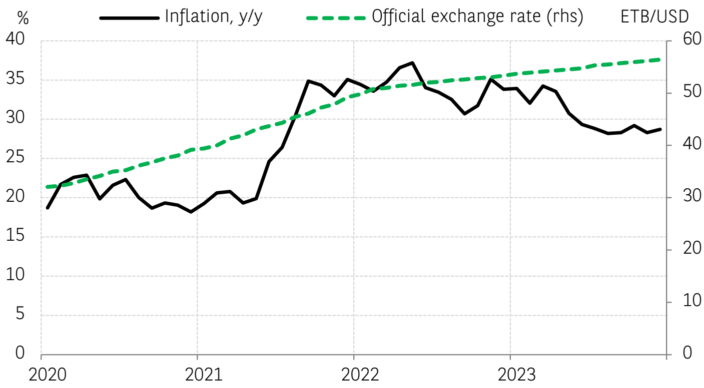

CHART 2

SOURCE: NBE, COMMERCIAL BANK OF ETHIOPIA, BNP PARIBAS

... AND BE THREATENED BY ONGOING CONFLICTS IN THE REGION

Despite its estimated death toll of 600,000 people, which has made the Ethiopian civil war the deadliest conflict in the last twenty years, the signing of the peace agreements between the federal government and the TPLF has not halted the ethno-political conflicts that are tearing the country apart. While the situation is still tense in Tigray, the insurgent movements in the neighbouring regions of Oromia and Amhara have grown in recent months, against the backdrop of territorial disputes and calls for self-determination. The United States and the European Union, which announced the resumption of ODA to Ethiopia in H2 2023, expressed their concern about the escalation of violence and reiterated that their financial assistance programmes remained conditional on the peace agreements being honoured. The resurgence of conflicts could also hold up the debt restructuring process.

On the external side, tensions between Ethiopia and its neighbours have also intensified in recent months. In December 2023, the trilateral negotiations with Egypt and Sudan around the Grand Ethiopian Renaissance Dam once again failed. Ethiopia, which expects the dam to produce 6,000 MW of electricity in the future, has refused to negotiate an agreement on sharing water resources, which Egypt has described as a violation of the 2015 Declaration of Principles. In addition, at the start of January, the Ethiopian government signed an agreement with the self-declared Republic of Somaliland to recognise its sovereignty in exchange for a port access on the Red Sea and a military base on the coast. Ethiopia, which has been a landlocked country since the secession of Eritrea in 1993, sees 95% of its trade transit through Djibouti for an annual payment of USD 1.5 bn. Somalia, supported by Egypt, immediately denounced the violation of its sovereignty, as Somaliland's sovereignty claim has no international recognition. There is no certainty as to whether anything concrete will come from this arrangement with Somaliland, but if it does, it will add fuel to the fire in an already fragile region.

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