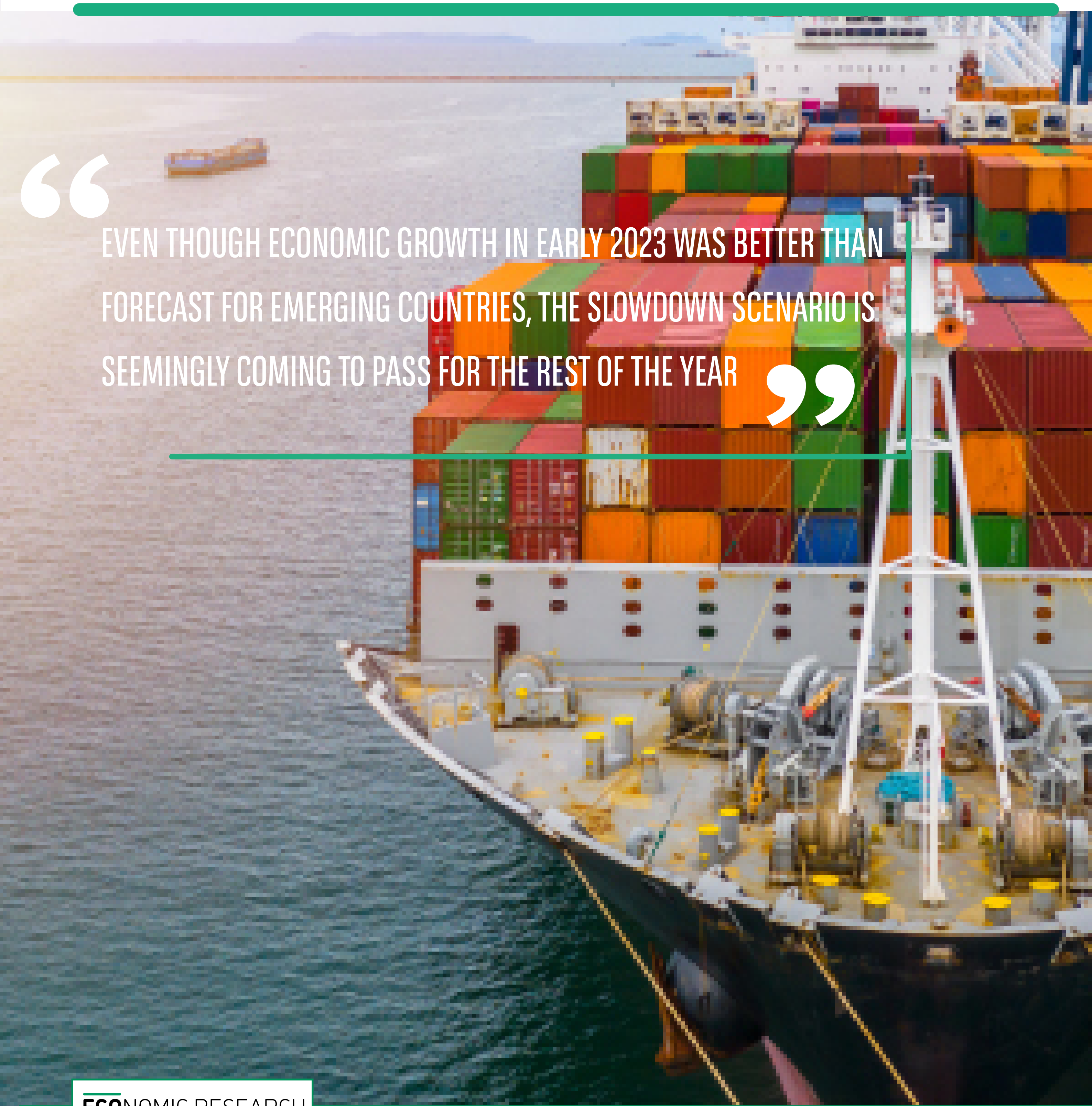
ECOEMERGING

3rd Quarter 2023
July 2023



"EVEN THOUGH ECONOMIC GROWTH IN EARLY 2023 WAS BETTER THAN FORECAST FOR EMERGING COUNTRIES, THE SLOWDOWN SCENARIO IS SEEMINGLY COMING TO PASS FOR THE REST OF THE YEAR"

ECONOMIC RESEARCH

BNP PARIBAS

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SOMMAIRE

INVESTMENT-DRIVEN RECOVERY: GROUNDS FOR OPTIMISM

Even though economic growth in early 2023 was better than forecast for emerging countries, the slowdown scenario is seemingly coming to pass for the rest of the year. In 2024, the strength of the recovery will hinge on the geopolitical climate and on how far monetary policy is eased in the US and the euro zone. It will also hinge on the investment outlook for emerging countries. The UNCTAD's annual report gives cause for optimism around the investment outlook, except for low-income economies.

During the first few months of the year, economic growth in emerging countries held up well (up 1.7% q/q in Q1 2023) thanks to the rebound in activity in some regional heavyweights (China, Brazil and Poland). Our central scenario for the months ahead still points to a slowdown. This is based on the many constraints on Chinese growth (see Focus on China) and the slowdown in global trade. This slowdown, already seen in Q1, was confirmed in Q2 by the worsening of new export orders indexes in PMI business surveys, particularly in industrialised Asian countries that have been facing the downturn in the global electronic cycle. Moreover, our slowdown scenario takes into account the delayed effect of monetary tightening, even though policy interest rates are no longer rising in the vast majority of countries.

In the short term, the world is seemingly no longer heading for a recession, thanks to disinflation fuelled by falling oil prices and the return of portfolio investments, which have contributed to the easing in domestic and foreign financing conditions since end-2022.

In 2024, the strength of the recovery will hinge on the geopolitical climate (the war in Ukraine and the ramifications of the trade and technology conflict between the USA and China) and on how far monetary policy is eased in the US and the euro zone. However, real GDP growth will also hinge on how well countries can adapt to climate change and, therefore, on their investments to help to generate sustainable growth. These transition and adaptation investments cannot solely come from governments, which will be working to or will have to limit or reduce their debt levels, or which simply have very little to no leeway in their financing capacity (see Focus on Egypt). Therefore, transition and adaptation investments will need to be largely covered by the private sector.

SIGNIFICANT FDI RECOVERY IN EMERGING COUNTRIES…

UNCTAD's World Investment Report 2023 paints a rather positive picture here. In China, foreign direct investment (FDI) has stood firm at 1% of GDP since 2018. If China is excluded, for emerging and developing countries within UNCTAD's amended scope[1] , FDI has recovered sharply, up 8% on average over 2020-2022 compared to the average for the previous three years. 2022 was a record year, with FDI standing at 2.4% of GDP, the highest level since 2012. Taking a regional-specific view, major Latin American countries have enjoyed a sizeable upswing in FDI over this period (3.8% of GDP, with a significant upturn in Brazil in 2021-2022), as well as major Central European countries and Turkey (3.2% of GDP). Foreign investment in the Middle East was also very strong, standing at 2.2% of GDP on average over 2020-2022 (compared to 1.3% over the previous three years). Africa continues to receive the lowest amount of FDI, but the picture is far from uniform here. On the one hand, non-hydrocarbon-producing countries have enjoyed stable levels of FDI (it even recovered in some countries in 2022, such as in Egypt and Morocco, where FDI respectively rose to 2.4% and 1.6% of GDP). On the other hand, hydrocarbon-producing countries faced stagnating FDI in 2022 due to repayments of loans linked to investments (in Angola since 2016 and in Nigeria in 2022) and investments nearly drying up altogether in Algeria.

It should be noted that industrialised Asian countries excluding China (Korea, Hong Kong, Singapore and Taiwan) have continued to attract the most FDI, in absolute terms, but also in relative terms. Collectively, FDI in the four countries accounted for almost 9% of GDP, which was slightly below the record level hit in 2015.

… SHOULD BE CONFIRMED BY GREENFIELD INVESTMENT PROJECTS

UNCTAD's report also takes the highly original approach of setting out information about greenfield investment projects[2] and financing for international projects (in numerical and value terms). Greenfield investment projects are broken down by country, helping readers to distinguish between developed and developing countries. As was the case with FDI, based on the UNCTAD sample and excluding China, greenfield projects amounted to the equivalent of 2.5% of GDP in 2022, thereby bringing them back to their pre-Covid levels. India boasts more projects than any other country, and the second highest in cumulative project valuation. However, if we look at this by major region, unlike with FDI, during 2022, the Middle East and non-hydrocarbon-producing African countries enjoyed the largest growth in the number and value of the projects announced. On the other hand, the broken-down figures for low-income countries suggest a gloomy outlook on the horizon.

Even more so than FDI, which cannot be compared to new investments as a whole (half at best), greenfield investment projects and their impact on economic growth should be taken with a pinch of salt, as announcements or pledges around these projects may not be followed up, particularly if financial costs threaten the viability of financing plans. In addition, for most projects, implementation times can be very long. It is the case in some Gulf countries (Qatar and Oman), and especially in Egypt where announced projects total a large USD 107 billion, which amounts to 23% of GDP.

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1 The distinction between developed and developing countries is not completely identical for UNCTAD, IMF and World Bank. UNCTAD views every EU country, as well as all Balkan countries and other European countries (Russia, Ukraine, Belarus and Moldova), as developed countries. On the other hand, Hong Kong, Singapore and Taiwan are classified as developing Asian countries. The figures in this Editorial have been recalculated in order to make it easier to compare these UNCTAD figures with the data from the IMF and World Bank. They do not include South Korea, Hong Kong, Singapore or Taiwan. On the other hand, they do include Central and Eastern European countries and Balkan countries that are EU members. We have also excluded Russia and Ukraine. The figures by region only take into account the major emerging countries (except for low-income countries which are part of UNCTAD).
2 Greenfield project data is from the Financial Times FDI Markets database. This source contains investment projects or joint ventures of all sizes that create jobs and obtain capital injections. These do not just cover cross-border investments, unlike FDI

CONFIDENCE ISSUES

The economic rebound that has followed the abandonment of the zero-Covid policy is quickly losing momentum. Domestic demand is held back by a significant fall in consumer and investor confidence, and export momentum is stalling. The authorities are cautiously easing monetary policy, but this may end up having limited effects on credit activity. Further stimulus measures are expected in the short term. They should, among other things, aim to encourage youth employment.

THE POST-COVID REBOUND IS ALREADY LOSING STEAM

Household consumption and activity in the service sectors recovered rapidly following the abandonment of the zero-Covid policy in December 2022 and after a few weeks of disruption caused by an upsurge of the epidemic. However, this recovery already lost momentum in Q2 2023.

Growth in the services sector accelerated to +9.1% year-on-year in the first five months of 2023, after a slight contraction in 2022. However, on the one hand, this figure is inflated by favourable base effects resulting from the very strict lockdowns imposed in the Shanghai region in spring 2022; on the other hand, activity in services showed first signs of weakening in May. The same applies to retail sales volumes, which rebounded by almost 9% y/y over the first five months of 2023, but whose growth slowed in May. Households are limiting their spending. They remain cautious in the face of the severe crisis in the real estate sector and the uncertainties weighing on their income and employment prospects.

LABOUR MARKET CONDITIONS ARE STILL WEAK

The labour market has not recovered its pre-pandemic situation. In particular, while the unemployment rate in all urban areas fell to 5.2% in May (compared to 5.5% at the end of 2022) and is approaching its pre-Covid level, unemployment among young people aged 16–24 has increased since the beginning of the year. It reached a record high of 20.8% in May, compared to 16.7% at the end of 2022 and 12% in 2019. This development can be notably explained by a mismatch between supply and demand that has appeared on the labour market since the regulatory tightening imposed in 2021 in various service sectors.

On the supply side, the number of young graduates entering the labour market has increased gradually over the past few years, and their level of education has risen. The number of young graduates leaving university reached 10.5 mn in 2022, up from 7.9 mn in 2017. Meanwhile, the total number of migrant workers from rural areas increased by only 3.1 mn in 2022 (to 295.6 mn), down from 4.8 mn in 2017.

On the demand side, total employment in the services sector stabilised in 2021 and then contracted in 2022 for the first time (with job losses totalling 12.9 mn). Total employment in industry also decreased in 2022 (resuming the trend followed from 2015 to 2019) while employment in the primary sector rose for the first time in twenty years (Chart 1).

In the tertiary sector, job losses in 2022 were mainly concentrated in services affected by the health restrictions (such as retail and leisure), real estate, and high-end services that have been targeted by regulatory tightening (education, Internet and tech, in particular). The former have benefited from the post-Covid rebound since the beginning of 2023, which should translate into new job creation. On the other hand, the regulatory framework is still uncertain for sectors considered sensitive by Beijing, which weighs on their investment and employment. However, these sectors specifically recruit young graduates and the most qualified workers.

THE REAL ESTATE CRISIS LINGERS ON, EXPORTS STALL

The ongoing crisis in the real estate and construction sectors and the slowdown in the manufacturing sector could also lead to further job losses.

Admittedly, the number of completed construction sites has recovered over the first five months of 2023 (+19% y/y) thanks to support

FORECASTS

	2020	2021	2022	2023e	2024e
Real GDP growth, %	2.2	8.4	3.0	5.6	4.5
Inflation, CPI, year average, %	2.5	0.9	2.0	1.1	2.5
Official budget balance / GDP, %	-3.7	-3.1	-2.8	-3.0	-3.2
Official general government debt / GDP, %	45.9	46.8	50.4	52.2	53.5
Current account balance / GDP, %	1.7	2.0	2.2	1.7	1.2
External debt / GDP, %	16.3	15.4	13.7	14.0	14.0
Forex reserves, USD bn	3 217	3 250	3 128	3 100	3 050
Forex reserves, in months of imports	16.2	12.6	11.9	11.1	10.1

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

CHINA: JOB LOSSES IN THE SERVICES SECTOR

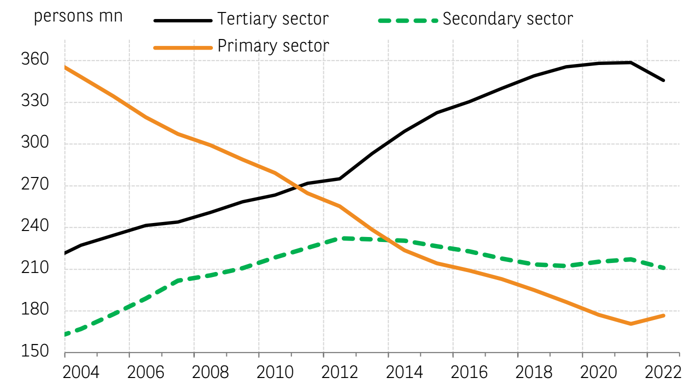

CHART 1 SOURCE: MINISTRY OF HUMAN RESOURCES AND SOCIAL SECURITY, BNP PARIBAS

policy measures. In particular, the authorities have encouraged short-term financing to developers who are able to complete the projects under way. They are aiming, firstly, to deliver prepaid housing in order to restore consumer confidence in the housing market. Secondly, the authorities are aiming to reduce the risks of both buyers defaulting on their mortgages and developers defaulting on their bank and bond loans (these defaults can result in even greater losses for lenders, as the recovery rate is very low if the real estate project is not completed). Nevertheless, potential buyers' sentiment still appears depressed and many developers continue to face cash flow issues and insolvency risks. This is preventing activity from recovering. Housing sales have continued to fall since the start of the year (-8% y/y) and the decline in real estate investment worsened in May (falling -6% y/y in value terms over the first five months of 2023).

The manufacturing sector is bearing the brunt of the slowdown in global demand and tensions with the United States. Industrial production only increased by +3.6% y/y over the first five months of 2023, which is unchanged compared to growth in 2022. Goods exports have barely increased since the beginning of the year (+1.1% y/y in current USD terms); they fell again in May following an upturn in March-April. Meanwhile, the decline in imports continued (-4.4% y/y over the first five months of 2023). Growth in manufacturing investment has slowed (+6% y/y in value terms over the first five months of 2023), constrained by sluggish demand, the production capacity utilisation rate hitting rock bottom (it fell to 74.3% in Q1 2023, which was its lowest level since 2016), and falling profits.

Overall, private investment has stagnated in recent months, and this situation could go on for some time: the uncertain outlook for exports and household consumption, the real estate crisis, domestic regulatory risks and geopolitical tensions are lingering on, and are all factors contributing to the pessimism among Chinese and foreign investors.

The public sector has partially offset the anaemic private investment since the start of 2022. The authorities now need to take further measures to support demand and try to build confidence among Chinese investors and consumers.

MONETARY AND FISCAL POLICY EASING IS CONSTRAINED

In mid-June, the central bank cut its policy rates for the first time since summer 2022 (Chart 2). The one-year MLF rate fell from 2.75% to 2.65%, followed by the one-year loan prime rate (from 3.65% to 3.55%) and the five-year loan prime rate (from 4.3% to 4.2%) – which is used as the reference rate for mortgages.

Further monetary easing measures are expected in the short term. Even though consumer price inflation is low (+0.2% y/y in May 2023), the authorities are expected to continue taking a cautious approach, as they are constrained by their long-term objective (i.e. reducing the debt excess of the corporate sector) and by depreciation pressures on the RMB. The Chinese currency fell a further 3.5% against the US dollar during H1 2023, after depreciating by 8.5% over 2022, largely due to the deterioration in capital flows[1].

Moreover, the effect of lower interest rates on credit activity could be limited due to the low demand for loans. Banks are also expected to take a cautious approach, given that their net interest margins are being squeezed, their profits are weakening and their asset quality is deteriorating. The average non-performing loan ratio (including special-mention loans) posted by commercial banks gradually improved from 4.8% of total loans at the end of 2019 to 3.9% at the end of 2022.

CHINA: MONETARY POLICY LOOSENING

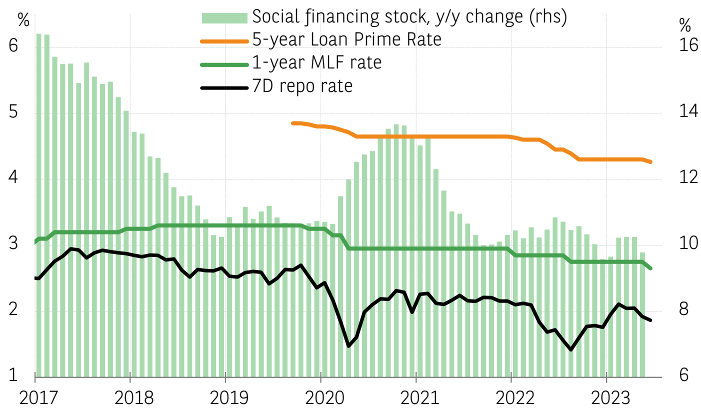

CHART 2 SOURCE: PBOC, NIFC, BNP PARIBAS

However, this decline is due to the widespread use of loan write-offs, which are offsetting the rise in new NPLs but are also contributing to a decline in profits. Loan quality is expected to deteriorate in the short term, due to the real estate crisis and the industrial slowdown. Large commercial banks are considered to have sufficient capital to absorb further losses, while, by contrast, smaller institutions are seen as much more fragile.

Since the start of the year, growth in total social financing has barely recovered despite the rebound in economic activity (Chart 2). Bank loans in local currency (which make up 64% of the social financing stock) rose by 11.7% y/y in May 2023, compared to 10.9% in December 2022. Regarding loans to the real estate sector (25% of total bank lending in 2022, compared to 29% in 2019), the measures taken by the authorities led loans to developers to recover (+5.9% y/y in Q1 2023 vs. +0.8% at the end of 2021), but they have not succeeded in reinvigorating housing loans to households (-0.2% y/y in Q1 2023).

Bond financing has slowed since mid-2022, given the sluggishness of the corporate securities market. Bond issues by the central government and local governments have been more dynamic. They slowed during the spring, but they are expected to increase again in the coming months as fiscal policy should become more supportive.

Indeed, monetary policy easing is likely to precede other stimulus measures on the fiscal front. Given the fragility of local government finances[2], further support could come from the central government. Measures to tackle youth unemployment are also expected to become a priority for the authorities. Public-sector job creation programmes and support programmes for companies to hire young graduates have been launched since last year. However, they are still small-scale programmes and will need to be reinforced and expanded.

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1See BNP Paribas, EcoEmerging, China: Further turmoil, Q1 2023.
2See BNP Paribas, EcoEmerging, China: Moving Off Uphill, Q2 2023.

INDIA

A BALANCING ACT

In India, economic growth is holding up thanks in particular to slowing inflation and early signs of an improvement in the labour market. Public finances, which consolidated slightly during the fiscal year 2022/2023, remain much more fragile than five years ago. The government is favouring growth over fiscal consolidation. Capital expenditure continues to increase, even though room for manoeuvre is shrinking due to the high and rising interest payments on government debt. The sharp rise in public investment has improved the quality of infrastructure, which should attract a little more foreign investment. Despite its non-involvement in the conflict in Ukraine, but primarily concerned with its own interests, India is seeking to move closer to the United States and Europe in order to counterbalance China, while maintaining its relations with Russia, its main energy and arms supplier.

ACTIVITY SLOWING BUT RESILIENT

India once again held up well to the global economic slowdown. Over fiscal year (FY) 2022/2023 as a whole, which ended on 31 March, economic growth reached 7.2%. In Q4 of the fiscal year (January-March 2023), it slowed to 6% y/y, which was much faster than expected. The outlook for FY2023/2024 is less favourable. According to the central bank (Reserve Bank of India, RBI), real GDP growth is expected to stand at 6.5%. These forecasts seem optimistic because the risks to growth are significant.

Over the first two months of the current fiscal year, economic activity continued to slow, both for companies and rural households. Industrial production slowed to 3.9% in April y/y compared to 5.4% in Q1 2023, and electricity demand has contracted over the last three months. Although domestic demand (60% of GDP) remains solid, it is weakening, as evidenced by the drop in tractor purchases by rural households and the slowdown in loans to households. Besides, although vehicle sales increased significantly in May, this can mainly be explained by the expected end of subsidies on 1st June; sales should then fall in the very short term.

However, it is worth mentioning two favourable developments, although they are yet to be confirmed: first, the slowdown in inflationary pressure and second, the rise in the employment rate.

In May 2023, the rise in prices stood at 4.3% y/y, close to the RBI's target of 2% +/- 2 percentage points (pp). At the same time, core inflation (excluding energy and food) was moderate at 5% y/y (a level not seen since mid-2020), leading the RBI to leave its key policy rates unchanged at 6.5% in June, a new status quo for the Monetary Policy Committee. The RBI is expected to reduce rates by Q1 2024 at the latest. However, inflationary risks remain high, particularly due to the *El Niño* meteorological phenomenon. At the end of June, total rainfall was 19% less than normal seasonal rainfall. It is estimated that a potential drought may have an impact of 25 to 30 basis points on economic growth (downwards) and on inflation (upwards).

The labour market is showing some signs of improvement. Up slightly since June 2022, the employment rate rose significantly in May (+2 pp to 38.6%), returning to levels prevailing before the Covid-19 pandemic. Admittedly, the unemployment rate remains high (7.7% in May), but this reflects the return of workers who had been forced to leave their jobs following the Covid-19 crisis. In the absence of any clear resumption of employment, the rise in the employment rate shows at least an uptick in confidence among the working-age population.

FORECASTS

	2020	2021	2022	2023e	2024e
Real GDP growth, % (1)	-6.6	8.7	7.2	6.1	6.5
Inflation, CPI, year average, % (1)	6.1	5.5	6.7	5.5	4.4
General Gov. Balance / GDP, % (1)	-13.9	-10.4	-9.9	-8.9	-8.1
General Gov. Debt / GDP, % (1)	89.4	84.1	83.4	83.5	83.4
Current account balance / GDP, % (1)	0.9	-1.2	-2.3	-2.0	-1.8
External debt / GDP, % (1)	21.5	19.5	19.6	19.8	19.9
Forex reserves, USD bn	579	618	562	550	570
Forex reserves, in months of imports	9.0	7.9	6.7	6.2	6.1

(1) FISCAL YEAR FROM APRIL 1ST OF YEAR N TO MARCH 31ST OF YEAR N+1
e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

INDIA: CPI AND INTEREST RATES

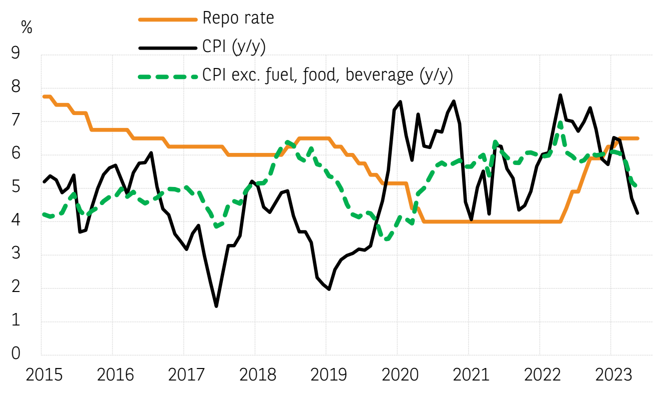

CHART 1 SOURCE: CEIC, RBI

PUBLIC FINANCES: FRAGILE CONSOLIDATION

Public finances in India are structurally fragile. Fiscal revenues are still extremely low (9% of GDP in FY2022/2023). Compared to GDP, they have not increased since the implementation of the Goods and Services Tax (GST) in July 2017. Moreover, the high burden of interest payments on government debt, which have risen sharply since the Covid-19 pandemic, constitutes a major constraint. However, the debt refinancing risk remains moderate, because government debt is denominated in rupees and held primarily by domestic creditors.

Over FY2022/2023, in line with the Ministry of Finance target, the government's fiscal deficit fell by 0.4 pp to 6.4% of GDP. This slight consolidation was made possible by the general decline in spending, which offset the contraction in revenues caused by the drop in customs duties on oil products (adopted to contain inflation) and the reduction in dividends received (caused by the drop in profits in line with the increase in production costs).

However, the fiscal deficit remained well above the level prevailing before the Covid-19 pandemic (3.8% of GDP on average over the 2015/16 and 2019/20 fiscal years). This slow consolidation reflects the government's new strategy, which aims to stimulate economic activity while also containing the fiscal deficit slippage. As a result, despite the high level of subsidies (which increased sharply with the Covid-19 pandemic) and the increase in interest payments (which reached 37.8% of government revenues over FY2022/2023), the government increased its capital expenditures, which reached 2.7% of GDP over the past year (+180% in five years).

According to the preliminary estimates of the Ministry of Finance, the consolidated public deficit (central government and States) should reach 9.9% of GDP, i.e., a 0.5-point reduction over a year. Central government debt should be slightly down, at 83.4% of GDP.

For FY2023/2024 the government forecasts a fall in the fiscal deficit by 0.5 pp to 5.9% of GDP. This consolidation should be made possible by the drop in subsidies (-0.8 points of GDP), in particular on food products (these subsidies were increased during the Covid-19 pandemic) and on fertilisers (subsidies were implemented as a result of the conflict in Ukraine). By doing this, subsidies should return to levels seen before the 2019/2020 pandemic crisis. Funds released would be used to further increase capital expenditure (+0.6 bp to 3.3% of GDP) and cover the expected increase in interest charges on debt (+0.3 points of GDP), which should reach 3.6% of GDP. By FY2025/2026, the government aims to reduce the fiscal deficit to 4.5% of GDP (a level still higher than that seen before the crisis).

INDIA ON THE INTERNATIONAL STAGE: BETWEEN STRATEGY AND OPPORTUNISM

India has always sought to adopt a neutral stance on the international scene. Its strategy is guided solely by the defence of its economic, social and cultural interests. This is particularly the case since Narendra Modi came to power in 2014; his governments have built on their political, economic and military relationships, to strengthen the country's autonomy, particularly in terms of defence. The country has been part of the Quadrilateral Security Dialogue (The Quad) with the US, Japan and Australia since 2020.

China remains its primary trading partner (13.8% of imports in 2022). This trade dependence on the Asian giant is common to most Asian countries. Unlike other South Asian countries, Chinese investment in India is extremely low. Meanwhile, India also boosted trade agreements in Asia in 2022 and resumed its trade negotiations with the European Union in summer 2022.

Beyond trade, in recent years India has wanted to strengthen its role as a major powerhouse in Asia, so as to counterbalance the growing influence of China. We should reiterate that cross-border tensions between the two countries remain marked, as evidenced by the confrontations in December 2022. Not having the financial and technological capabilities of its big neighbour, India has gradually moved closer to the United States.

Due to its neutrality but also its historical dependence on Russian military equipment and technology, India (like China and Pakistan) has not condemned Russia's invasion of Ukraine. On the contrary, it is seeking to take advantage of sanctions against Russia to import oil at a discount price. By doing this, Russia has become its primary oil supplier, ahead of countries in the Middle East. Furthermore, even though India has sought to diversify its arms supply sources, Russia was still its primary supplier in 2022 (45% of arms purchased abroad over the period 2018-2022), well ahead of the United States (11%).

INDIA: SLOW CONSOLIDATION OF PUBLIC FINANCES

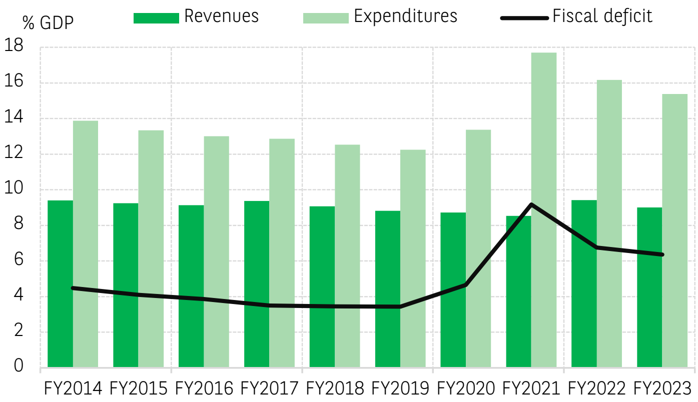

CHART 2 SOURCE: CEIC, MOF

THE BUSINESS ENVIRONMENT IS IMPROVING BUT GOVERNANCE IS NOT

Since 2019, an increasing number of reforms have been adopted to promote investment. In addition to lower corporate income tax rates in 2019 and the adoption, from 2020, of financial incentive programmes (Production Linked Incentive Scheme, PLI) for companies in labour-intensive sectors, the government has significantly increased investment in infrastructure. As a result, total miles of motorway and electricity production capacity increased by 27% and 22% respectively in five years. In addition, digitisation of the economy has thrived. In 2021, 46.3% of the population had access to the Internet, i.e., almost 17 pp more than before the Covid-19 pandemic. At the same time, administrative constraints on companies have been eased. Although still significant, the time taken to start a business, carry out real estate construction and the costs incurred by administrative procedures have decreased.

Conversely, the quality of governance has not improved in the last five years. India was ranked 112th out of 213 countries in 2022 according to the World Bank (i.e., 5 places lower than in 2017). Despite the government's attempts at prevention, corruption remains prevalent, as evidenced by India's downgrading from 80th in 2019 to 85th in 2022 by Transparency International. In terms of the rule of law, India's ranking has also fallen since 2019. The country was ranked 102nd in 2022 compared to 95th in 2018. Growing impairments of freedom of expression and worship are regularly reported by international non-governmental organisations. According to the latest report on democracy in the world published by the University of Gothenburg, democracy has deteriorated in the country and India is considered an "electoral autocracy".

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ECONOMIC AND STRATEGIC STRENGTH

Taiwanese economic activity has slowed sharply since spring 2022. The island is particularly vulnerable to weakening global demand and the downturn in the electronics cycle due to its dependence on semiconductor exports. At the same time, its position as a quasi-monopoly on the most sophisticated microprocessor market probably protects it against the threat of Chinese aggression, at least in the short term. From a strictly macroeconomic point of view, Taiwan has solid fundamentals – and in particular a very comfortable external financial position – that strengthen its ability to withstand external shocks.

DEPENDENCE ON THE GLOBAL ELECTRONICS CYCLE

Taiwan was one of the few countries in the world not to record any major deterioration in its macroeconomic performance in 2020-2021 despite the Covid-19 pandemic. Its economic growth even strengthened from an average of 2.8% per year in 2016-2018 to 4.5% in 2019-2021. It was supported by the sharp rise in production and exports in the manufacturing sector, by accommodative monetary and fiscal policies, and by the continued increase in the investment rate (from 21.6% of GDP on average in 2016-2018 to 25% in 2019-2021). Neither public finances nor external accounts deteriorated. The island's high-tech industry has benefited greatly from rising global demand and strengthened its leading position in the production of highly sophisticated microchips[1]. Semiconductor exports, which almost doubled between 2019 and 2022, accounted for 39% of total exports in 2022 (compared to 28% in 2019).

The economic situation has turned around since 2022. In spring 2022, an epidemic wave accompanied the gradual abandonment of the zero-Covid policy in Taiwan and led to a further (moderate and temporary) drop in mobility and retail sales indicators. At the same time, the strict lockdowns imposed in Shanghai caused supply-chain disruptions and a drop in Chinese demand that penalised Taiwan's economic activity.

Above all, the international environment deteriorated abruptly following Russia's invasion of Ukraine. On the economic front, the widespread rise in inflation has led to a tightening of domestic and international monetary conditions since March 2022. The subsequent weakening of global demand and the reversal of the global electronics cycle have increasingly weighed on Taiwanese exports of goods. After a rapid rise in 2021 (+29% in current US dollars) and in H1 2022 (+20% year-on-year), exports have fallen since last September. Their drop reached -3% year-on-year in H2 2022 and -18% in H1 2023, in particular driven by the contraction in sales to China and Hong Kong (which absorbed 42% of Taiwanese exports in 2022).

Furthermore, in a geopolitical context that has become more difficult, tensions in the Taiwan Strait have increased sharply since summer 2022, causing concern for foreign investors.

FORECASTS

	2020	2021	2022	2023e	2024e
Real GDP growth, %	3.4	6.5	2.4	0.6	2.9
Inflation, CPI, year average, %	-0.2	2.0	3.0	2.2	1.5
General government balance / GDP (%)	-1.0	-0.2	-1.5	-2.8	-2.0
General government debt / GDP (%)	32.1	30.1	30.1	32.1	32.7
Current account balance / GDP, %	14.3	15.2	13.2	11.3	12.0
External debt / GDP, %	28.2	27.5	26.5	26.1	25.0
Forex reserves, USD bn	529.9	548.4	554.9	560.0	565.0
Forex reserves, in months of imports	20.9	16.2	15.0	17.5	16.3

TABLE 1

e: ESTIMATES & FORECASTS

SOURCE: BNP PARIBAS ECONOMIC RESEARCH

TAIWAN: ADJUSTMENTS IN THE MANUFACTURING SECTOR

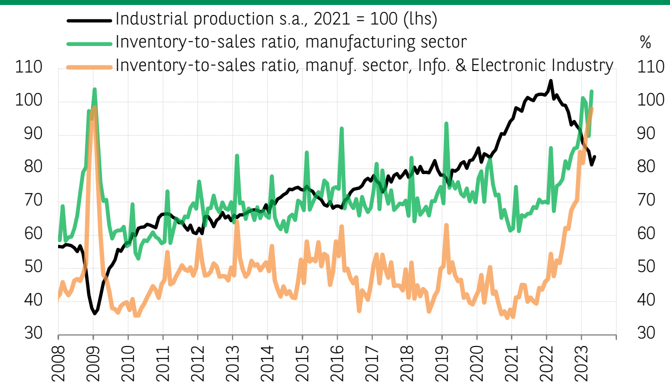

CHART 1

SOURCE: MINISTRY OF ECONOMIC AFFAIRS, BNP PARIBAS

THE ISLAND STARTED 2023 WITH A RECESSION

As a result, economic growth fell to +2.4% in 2022, then to -2.9% year-on-year in Q1 2023. Taiwan even recently entered a technical recession as activity contracted from one quarter to the next in Q4 2022 (-0.5%) and Q1 2023 (-0.6%).

Industrial production, after having risen by 15% in 2021 and peaked in February 2022, fell steadily until April 2023. It suffered from lower demand and significant stock adjustments, particularly in the technology sector. The slight improvement in industrial production in May (+3% month-on-month but still -16% year-on-year) could be short-lived. PMI indices in the manufacturing sector remained weak in May and June 2023 (at less than 45). On the one hand, inventories in the electronics industry remain at historically very high levels (Figure 1). On the other hand, global semiconductor demand is unlikely to recover significantly before Q4 2023. However, the outlook is seen as a little more favourable for the most sophisticated chips, used for high-performance computers and artificial intelligence devices, unlike consumer

1 Taiwan has 20% of the world's semiconductor production capacity (2019 data), but its share is much higher for the most sophisticated chips. In particular, it has a quasi-monopoly for logic chips of under 10 nm, with more than 90% of the production capacity.

electronics demand, which is expected to remain depressed until the end of the year.

Investment fell in Q1 2023 (-0.8% year-on-year) for the first time since 2017. This contraction stems from the deterioration in corporate revenue in the manufacturing sector[2], the weak export outlook in the short term, tighter monetary policy and credit conditions, and the start of a downward correction in the real estate sector. Added to this are investors' uncertainties linked to geopolitical tensions.

Private consumption remained dynamic (+6.5% year-on-year Q1 2023) and retail sales growth accelerated further in May. After a long period of health constraints, household spending has rebounded more strongly since the summer of 2022 and is still benefiting from post-Covid catch-up effects. In addition, it was encouraged by government stimulus measures, the recovery of tourism and the recovery of the labour market. This was driven by employment in services, and it led to a reacceleration in income growth and a drop in the unemployment rate (to 3.5% in May 2023). Consumer confidence has also improved since the beginning of the year (the index rose from a low point of 59.1 in December 2022 to 66.7 in June), but remains below the levels that prevailed over the 2010-2019 decade (during which the index averaged 81.2).

These private consumption dynamics are expected to lose steam in the second half of 2023. In particular, the recovery of the labour market could be interrupted due to the economic slowdown in the manufacturing sector.

MONETARY TIGHTENING ON PAUSE

Domestic demand should also remain held back by the effects of tighter credit conditions. In response to rising inflationary pressures in 2021 and 2022, the central bank raised its main policy rate from 1.125% in early 2022 to 1.875% in March 2023, the highest level since 2015. The latest quarterly monetary policy committee meeting held in mid-June kept policy rates unchanged. The status quo should be maintained for the remainder of the year due to moderation in inflation and downside risks to growth. Consumer price inflation (CPI) gradually fell by +3.6% year-on-year in July 2022 to 2% in June 2023, and should continue to slow down slowly in H2 2023. At the same time, the very low interest rates in Taiwan compared to the United States should prevent a new cycle of monetary policy easing in the short term.

The rise in nominal borrowing rates, linked to the decisions of the central bank, has added to the effects of disinflation on real rates since summer 2022. In addition, the authorities introduced macro-prudential measures in 2022, and again recently, in order to moderate the rise in housing loans and limit property speculation (the last measure taken in mid-June caps the loan-to-value ratio at 70% for the purchase of second homes in certain regions). Growth in domestic credit to the private sector has thus lost momentum in recent months (Figure 2). The slowdown in bank mortgages has been particularly marked (mortgages rose +3.9% year-on-year in nominal terms in May 2023, compared to +9% at the end of 2021). These trends will continue in the short term.

ECONOMIC SHIELDS

Finally, uncertainty among investors and consumers could increase and weigh more on activity in the run-up to the presidential and legislative elections, which will take place in January 2024. The most likely scenario at present is the continuation in power of the DPP (Democratic Progressive Party, the party of Tsai Ing-wen, the president since 2016), as well as the preservation of its majority at the legislative assembly. The preparation and holding of the elections will certainly increase nervousness in the Taiwan Strait. Tensions between China and Taiwan have worsened since the summer of 2022 and have reached a level unprecedented in more than twenty years. Chinese military exercises in the strait are increasing, maintaining the risk of more severe incidents at all times. The risk of escalation is high in the medium term. However, the risk of an island invasion seems to be contained in the short term: there are many reasons of a military, geopolitical and economic nature. In particular, Taiwan Semiconductor Manufacturing Co. (TSMC), state-of-the-art semiconductor production plants and Taiwan's position as a quasi-monopoly in the most sophisticated chip market constitute a «silicon shield» that protects the island, at least in the short term. A Chinese military operation would put China's and the rest of the world's semiconductor supply at risk. The crucial role of the Taiwan Strait in shipping (about half of all container ships in operation sailed through the strait in 2022), especially for trade in goods departing from Chinese factories to European and US markets, probably also mitigates the risk of escalation of military manoeuvres or a blockade of strait waters.

Faced with the slowdown in global trade and tensions with China, Taiwan has financial shields that limit its purely macroeconomic vulnerability. Taiwan mainly holds a very solid external financial position, which is based on large current account surpluses (between 10% and 15% of GDP over the last ten years), very comfortable foreign exchange reserves (USD 565 billion at the end of June 2023, i.e. more than 15 months of imports of goods and services), moderate public debt, and limited external debt reflecting a very low dependence on non-resident financing.

TAIWAN: MONETARY CONDITIONS TIGHTENING

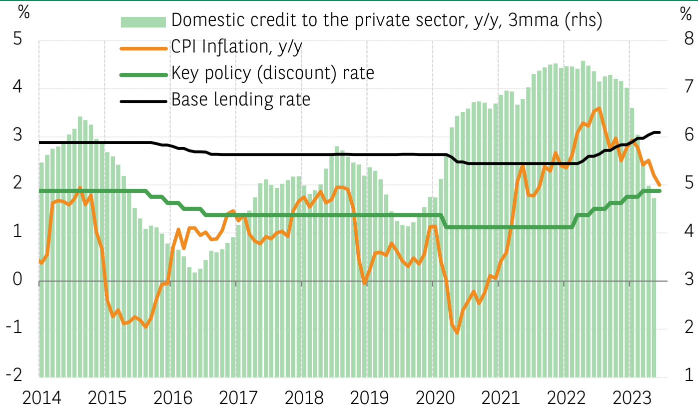

CHART 2 SOURCE: CBRC, DGBAS, BNP PARIBAS

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2 In particular, revenue from the semiconductor industry fell by -13% year-on-year in Q1 2023. After an average increase of 22% per year in 2020-2022, it is expected to fall by -12% over 2023 as a whole, according to the Taiwanese Semiconductor Industry Association (TSIA).

CHANGE OF DIRECTION

Since the presidential and legislative elections in May, the Turkish lira has fallen sharply again and domestic interest rates have increased. Calm has returned in recent weeks with the monetary turnaround of the central bank (CBRT), now led by Hafize Gaye Erkan, and the return of Mehmet Simsek, who in the past has been the AKP government's guarantor to foreign markets and investors, at the head of the Ministry of Treasury and Finance. But their task of rebalancing a real economy in a state of overheating and faced with stubbornly high inflation is a challenge. More than the recent slowdown in growth, the likely risk of worsening twin deficits must be closely monitored. However, the alarmist analyses that conclude that there is a risk of a balance-of-payments crisis are exaggerated.

Since the presidential and legislative elections in May, financial tensions in Türkiye have renewed. A much-anticipated start to monetary normalisation took place in the weeks following President Erdogan's re-election and the better-than-expected score of the AKP in parliament. Under the aegis of a new governor, Hafize Gaye Erkan, the central bank's key rate (the two-week repo rate) was raised from 8.5% to 15%.

President Erdogan also called on one of his former finance ministers, Mehmet Simsek, to reassure the financial community about the government's economic strategy.[1] Mr Simsek stressed the need for rational economic policy, i.e. budgetary policy and monetary policy based on clear rules (particularly monetary policy, the objective of which must remain price stability) and predictable rules (particularly budgetary policy, the objectives of which must be the control and stability of deficits and their financing). Mr Simsek advocates a policy based on the principles of market economics, open to the outside world with a free exchange system, the final objectives being (financial) stability, confidence and sustainability of growth.

THE CHALLENGES FACING THE NEW ECONOMIC TEAM

Some calm has returned with the actions of the central bank (CBRT) and the statements of Mr Simsek. But yields on 10-year government bonds in local currency, which moved below 10% before the elections, have just stabilised at around 16% since mid-June. Above all, the Turkish lira, which lost just over 20% compared to its pre-election level (compared to 6.5% between the end of 2022 and the day before the elections), has not re-appreciated. In fact, the markets were expecting a more severe monetary tightening (the average forecast for the repo rate was 20%).

Against a backdrop of still significant economic growth until Q1 2023, monetary tightening is deemed insufficient to curb inflation (for the overall index and measured year-on-year, inflation slowed significantly from 85.5% in October 2022 to 39.6% in May; however, core inflation continued to rise sharply, standing at 2.9% month-on-month on average between February and May, and has even accelerated again since April, reaching 4.3% in May)[2], and to reduce the current account deficit. The markets are concerned about the recurrence of twin deficits (current and budgetary), which are to be monitored (i.e. above 5% of GDP each). A rebalancing of growth is indeed necessary.

FORECASTS

	2020	2021	2022	2023e	2024e
Real GDP growth, %	1.8	11.4	5.0	2.6	3.5
Inflation, CPI, year average, %	12.1	19.6	72.3	48.1	45.3
Gen. Gov. balance / GDP, %	-3.5	-2.8	-1.9	-6.0	-2.5
Gen. Gov. debt / GDP, %	35.9	37.9	26.9	29.9	24.3
Current account balance / GDP, %	-4.4	-0.9	-5.3	-4.5	-3.6
External debt / GDP, %	59.9	53.4	57.4	48.0	44.0
Forex reserves, USD bn	49.0	72.5	83.0	65.0	70.0
Forex reserves, in months of imports	2.6	3.1	2.6	2.0	2.1

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

TURKIYE: RENEWED FINANCIAL TENSIONS

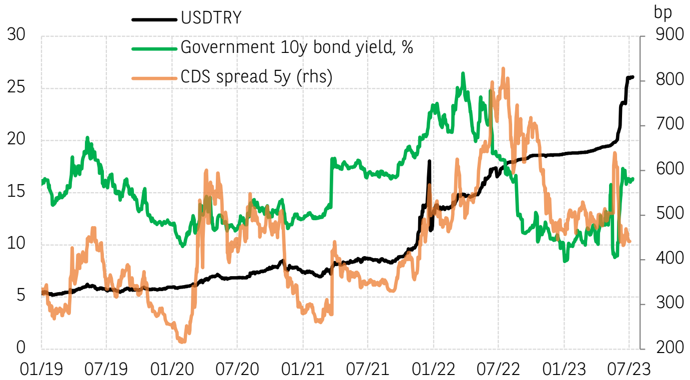

CHART 1 SOURCES : MACROBOND, BNP PARIBAS

1 Together with Ali Babacan, Mehmet Simsek was the guarantor of the Erdogan government for the conduct of economic policy and public finances for many years : Mr Simsek, as Minister for Treasury and Finance between 2009 and 2015, then Deputy Prime Minister for the Economy from 2015 to 2018, Ali Babacan, as Minister for the Economy from 2002 to 2007, then Deputy Prime Minister for the Economy between 2009 and 2015.

2 According to ENAG, a collective of economists, mainly academics, who collect daily or even intraday data, mainly online, inflation was 8.5% month-on-month between 30/05 and 30/06 and 108.6% year-on-year (NB: inflation measured by ENAG has always been at least double the official inflation published by Turkstat, notably because it does not take into account administered prices).

FROM OVERHEATING TO SLOWING DOWN

Despite inflation and the depreciation/volatility of the lira, the economy has remained dynamic, even though activity slowed in Q1 2023 (+0.3% q/q after +0.9% in Q4 2022). Real GDP is 20% higher than at the end of 2019, the strongest performance amongst the main developed and emerging countries, including China. Business confidence has been eroded since mid-2022, but not more so than in other countries. The confidence of households, which had fallen from mid-2018 to mid-2022 when it reached a low, has rallied and returned to its average level for 2015-2017.

Household consumption has been particularly dynamic thanks to the catch-up of wages on inflation from H2 2022 (the minimum wage has multiplied by 3.9 since the end of 2019, including +55% in early March 2023, compared to x2.9 for the official consumer price index). The increase in employment (+11% at the end of March 2023 compared to the end of 2019) and the use of credit, particularly by cards, also supported household purchases. The number of people actively using credit cards increased from 20.7 million in December 2019 to 25.5 in March 2023. Faced with rapid inflation, this payment method, whose interest rates have been capped, has been as much an opportunity as a last-resort financing solution for households. Admittedly, the rate of payment incidents on cards to private individuals is relatively high (between 6.5% and 12%), but has fallen since 2021. Overall, Turkish households are not over-indebted. At the end of March, total outstanding bank loans represented 10% of GDP and 45% of the wage bill compared to 13% and 42% respectively at the end of 2019.

Corporate investment has been even more dynamic than private consumption. Investment in equipment is 40% higher than its previous high point in mid-2018. The increase in imports of capital goods (in dollars) is just as impressive. In particular, corporate investment has been boosted by the dynamism of exports. Furthermore, net external trade (exports minus imports) only contributed negatively to growth from Q3 2022. Contrary to households, companies as a whole have used much less credit; total outstanding commercial bank loans represented 37% of GDP and 56% of gross macroeconomic operating surplus[3] in March compared to 50% and 85% respectively at the end of 2019.

Before monetary tightening and the depreciation of the lira in recent weeks, a slowdown in growth was anticipated due to the recessive impact (at least in the short term) of the February earthquake and the economic turnaround of the main European trading partners, with Germany leading the way. Recent financial tensions can only exacerbate this, despite the a priori positive effect of the depreciation of the exchange rate on net external demand.

Households will be subject to both a further acceleration in inflation and higher credit rates (already, banks had raised the consumer credit rate sharply from 25% at the beginning of March to 41% in mid-June). However, the pre-election announcements made by President Erdogan should result in a sharp increase in public spending and transfers and prevent the economy from falling into recession.

THE SPECTRE OF TWIN DEFICITS

Much more than the slowdown in growth, the risk of worsening twin deficits must be closely monitored. In April, the 12-month rolling sum of the current account deficit reached USD 57.8 billion, representing just over 6% of GDP. However, the drop in oil prices would save almost USD 20 billion on the energy bill (based on a price of USD 75 per barrel for Brent). In addition, tourism revenues should reach a record (of at least USD 45 billion). In our scenario of a moderate growth slowdown, the current account deficit would fall over the second half of the year so that it would come out at between USD 35 and 40 billion for 2023 as a whole, i.e. between 4% and 4.5% of GDP.

There is more uncertainty about the budget deficit. Between January and May, the general government budget balance posted an annualised deficit of 3.6% of GDP while, over the same period in 2022, this balance was positive. With the slowdown in activity, announcements during the campaign and the cost of the bank deposit protection scheme for households and companies having agreed to convert their deposits in foreign currency into lira (cost estimated at 1.5% of GDP since its implementation at the end of 2021 if the exchange rate against the dollar stabilises in the 25–27 range), the deficit could reach 10% of GDP according to the Economic Policy Research Foundation of Türkiye (TEPAV). Corrective action will probably be taken to prevent such slippage.

But if this is not the case, the current account deficit would most likely exceed 5% of GDP by a large margin and tensions on interest rates and the lira would reappear even if monetary tightening continued. In this scenario, some analyses are considering the eventuality of a balance-of-payments crisis given the erosion of foreign exchange reserves. The BoP crisis could even escalate into a financial crisis due to a significant and unprecedented central bank balance sheet imbalance and the exposure of companies to foreign exchange risk[4]. Foreign exchange reserves actually fell by USD 25.6 billion between the end of 2022 and mid-June to USD 102.8 billion (including gold stock) and USD 60.8 billion for foreign currency reserves. In net terms, they have become negative again. But net reserves show a biased picture of the country's available external liquidity in our view. Above all, let the new Minister for the Economy and Finance and the Governor of the Central Bank take the time to rebalance the economy and do not underestimate the resilience that the Turkish economy has demonstrated over the past few years.

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3 GDP – payroll + taxes (net of subsidies)
4 Türkiye's increasing balance sheet risks» - Brad W. Setser – Council of foreign relations – June 2023

HUNGARY

SOFT DOMESTIC DEMAND

Economic activity has weakened significantly in the last three quarters. In Q1 2023, GDP contraction was largely attributed to the drop in domestic demand. For 2023, the scenario of a weak recession seems to be emerging, due to a strong negative carry-over effect. Moreover, prospects for a recovery are weak in the short term, as inflation remains very high and the real estate market is showing signs of weakness. In 2022, budget and current account deficits increased due to the energy shock. However, debt ratios (public and external) worsened slightly. In 2023, external accounts are expected to improve thanks to the easing of commodity and energy prices.

RECESSION CONTINUES

The Hungarian economy posted a negative growth in the last three quarters. Real GDP fell by 0.3% q/q in Q1, after -0.6% in Q4 2022 and -0.8% in Q3. Domestic demand is losing momentum and is mainly responsible for this. Household consumption and destocking contributed negatively to GDP growth. By contrast, net exports improved in Q1 but were not sufficient to offset weakening domestic demand.

This year, Hungary may underperform compared to its neighbours in Central and Eastern Europe. Several factors support this scenario. Firstly, the country has a negative carry-over effect of -1% for 2023 in Q1. Inflation, which is much higher in the region, will still impact negatively on growth, as wages have been rising more slowly than consumer prices since August 2022. Furthermore, the level of interest rates is not favourable to demand for new loans. Besides, fiscal policy will provide a relatively weak support to the economy given consolidation efforts introduced since summer 2022. The authorities' target is to reduce their budget deficit to 3.9% of GDP in 2023 and then to 2.9% in 2024, although, at first glance, this seems optimistic, particularly for 2023.

As a result, prospects for an improvement in economic activity are weak in the short term. High frequency indicators, such as industrial production, retail sales and households' major purchase intentions for the current and future period, have deteriorated in recent months. Production fell by 3.6% y/y in April, after reaching -2.9% and -1% in previous months. The drop in retail sales was more pronounced (-12.0% y/y in April; -12.7% in March; -8.4% in February). Importantly, industrial production and retail sales fell below their pre-Covid-19 level in April.

Investment has contracted in recent quarters (Q1:-6.7% y/y; Q4 2022: -6.9%; Q3: -0.9%), and is barely expected to improve in the coming months. In fact, public investment planned for this year will undoubtedly be postponed due to budgetary savings and the absence of European funds, suspended by the European Union since 2022. Private investment will be held back by the slowdown in industry. The deterioration of confidence in the manufacturing sector, reflected by the PMIs and European Commission indexes, do not bode well for a significant recovery in the industrial sector in the short term. Similarly, the increase in the funding cost of companies in the shape of bank loans or bond issues can only hinder new investment projects. External demand is likely to weaken in the coming quarters. The German economy has already entered recession in Q1, which will impact Hungarian exports, with Germany alone accounting for 25.2% of Hungarian exports in 2022. Furthermore, Hungary's export price competitiveness could deteriorate if the upward trajectory of its currency observed since January 2023 were to continue. The Hungarian forint appreciated against the euro and the dollar by 7.1% and 9.7% respectively in H1, after a year (2022) marked by strong downward pressure. For the time being, the nominal effective exchange rate is not overvalued as it is 10% below the trend over the past 10 years.

FORECASTS

	2020	2021	2022	2023e	2024e
Real GDP growth, %	-4.7	7.2	4.6	-0.2	3.1
Inflation, CPI, year average, %	3.4	5.2	15.3	18.7	7.6
Gen. Gov. balance / GDP (%)	-7.5	-7.1	-6.2	-4.3	-3.3
Gen. Gov. debt / GDP (%)	77.3	74.4	71.0	66.6	64.7
Current account balance / GDP, %	-1.1	-3.9	-8.2	-3.0	-2.6
External debt / GDP, %	81.0	84.7	88.3	85.0	80.9
Forex reserves, EUR bn	33.7	38.4	38.7	39.0	39.5
Forex reserves, in months of imports	4.0	3.8	3.0	3.9	4.1

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

HUNGARY: INDUSTRIAL PRODUCTION AND RETAIL SALES

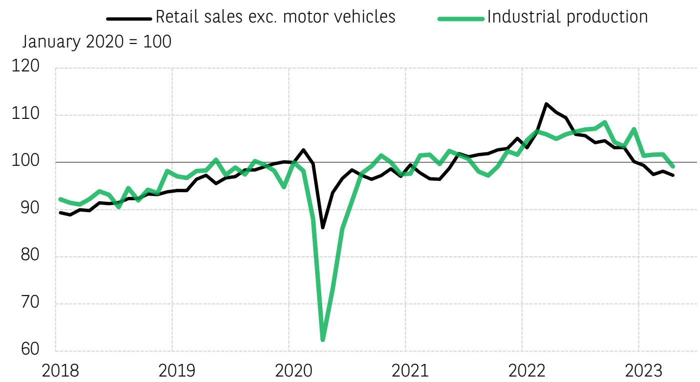

CHART 1

SOURCE: CENTRAL STATISTICAL OFFICE, BNP PARIBAS

In 2024 and 2025, economic activity should recover owing to the expected recovery in global demand and the drop in inflation. Similarly, the economy could benefit from the postponement of investment projects initially planned for 2023.

SLOW DISINFLATION

Hungary has by far the highest inflation rate among countries in the European Union. In May, it stood at 21.5% y/y compared with an average of 10-15% in the region. This gap with other Central European countries can be explained by the lifting of the price freeze on fuel last December. In addition, upward pressure on food prices is comparatively higher than in neighbouring countries. The reason for this lies in the price ceilings on certain food goods, which initially resulted in shortages. At the same time, the rise in uncapped prices has been reflected in other food products. Food price inflation was still 34.1% y/y in May, the historic high having been reached last December (47.9%).

Inflation reached a peak in January 2023. However, disinflation will be slow due to relatively strong wage pressure. Hungary will very probably continue to post the highest rate of inflation in the region in 2024. New tax measures (hikes in tax on fuel, alcohol and tobacco in 2024, tax on interest, etc.) announced by the government to consolidate public accounts should have an impact of around +0.7 to 1.0 point on inflation in 2024 according to central bank estimates.

Hence, monetary authorities will probably keep their key rate unchanged at 13% (after the strong increase of 1,010 bp in Q1-Q3 2022) for a certain period of time. The benchmark interest rate cut is not expected before 2024. Nevertheless, it should be noted that the Central Bank has lowered the overnight lending rate by 650 basis points cumulatively since April 2023 to 18.5%. But this rate represents the cap on the central bank's interest rate corridor ceiling, i.e., the highest refinancing rate for banks.

THE PROPERTY MARKET IS RUNNING OUT OF STEAM

The interest rate environment is not without its consequences on the real estate market. In all Central European countries, a reversal of the property market has been observed since April/May 2022. In response to the increase in the cost of mortgage loans, new home loans fell sharply (73.2% y/y in April 2023). Similarly, in Q1 2023, real estate transactions fell by 43% y/y, according to the latest report on the real estate sector by the Central Bank of Hungary. The drop in building permits for housing reflects, has translated into the loss of confidence amongst builders and developers who are currently facing a drop in demand for housing. At the same time, construction costs increased due to rising building material prices and wage pressure. For the time being, residential prices (in nominal terms) are still rising, but their increase has slowed very sharply, after several years of sustained rise. A decline in house prices seems inevitable in the short term, given the scale of the decline in property transactions.

It should be noted that, as seen in the Czech Republic and Slovakia, mortgage loans in Hungary are mainly taken out at a fixed rate. As a result, the increase in the cost of borrowing primarily affected new loans. So, in order to support households, the Hungarian authorities capped interest rates linked to new mortgage loans since the beginning of 2022.

CENTRAL EUROPE: HOUSE PRICE INDEX

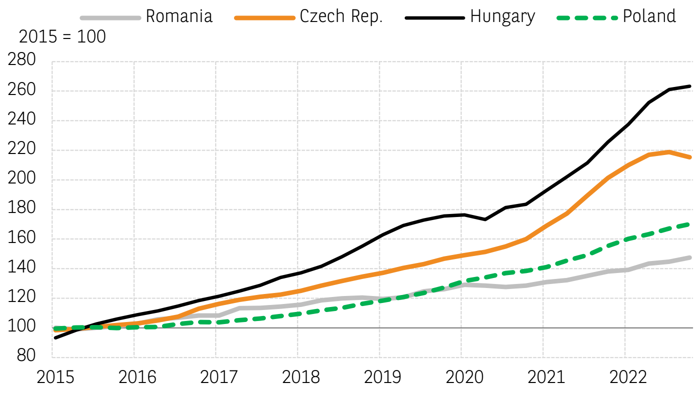

CHART 2 SOURCE: OECD, BNP PARIBAS

SMALLER DEFICITS IN 2023

The year 2022 was characterised by significant macroeconomic imbalances while the country was facing a suspension of European funds.

In 2022, the budget deficit reached 6.2% of GDP, well above the official target of 4.9%, due to supportive measures for households and businesses put in place following the energy price shock. Similarly, interest payments were up sharply, reaching 8.3% of tax revenue in Q4 in 2022. However, the deficit would have been more pronounced without the fiscal consolidation measures introduced in H2 2022.

The increase in energy prices also widened the current account deficit to -8.2% of GDP in 2022 after reaching -3.9% in 2021 and -1.1% in 2020. External debt increased 3.6 points to 88.3% of GDP. However, the Hungarian economy still benefited from significant capital flows despite uncertainties associated with the war in Ukraine. Portfolio and direct foreign investment flows contributed to the coverage of the current account deficit by 60%.

In 2023, the outlook is brighter for fiscal and external accounts. With inflation, the government's debt-to-GDP ratio should continue to fall even if growth slows. And the ratio is expected to improve over the next three years even if deficit reduction targets are not fully met. The current account balance should benefit from the easing of commodity prices on international markets. And the trade balance posted a surplus in Q1. The current account deficit stood at EUR -0.8 billion in Q1 2023 compared to EUR -2.1 billion in Q1 2022. Net capital flows remained positive in Q1 2023.

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ROMANIA

FISCAL CONSOLIDATION IS THE PRIORITY

Very dynamic to date, economic growth is now expected to weaken, and the authorities will face several challenges in 2023. Consolidation of public accounts is a priority in the short term, failing which, Romania could be subject to further disciplinary measures by the European Union. Inflation remains high although it has fallen since the end of 2022, which should encourage monetary authorities to favour a status quo. The current account deficit widened to nearly 10% of GDP in 2022, but should ease in the short term due to the drop in energy prices. Despite the size of current account and budget deficits, Romania continues to attract foreign capital flows.

SLUGGISH ECONOMIC ACTIVITY IN H1 2023

Real GDP growth slowed significantly in Q1 2023, standing at +0.2% q/q after reaching +1.0% q/q in the previous two quarters. The economy weakened further in Q2, judging by the economic indicators published recently. Retail sales fell -1.5% y/y in April, even though they had held up well until then. The country has been seeing a downward trend in industrial production for several months now. At the same time, the decline in volumes of imports of consumer goods and intermediate goods indicates that the slowdown is not just affecting exports. The real estate market is also losing momentum. The demand for new home loans has declined due to the increased cost of borrowing. Mortgage rates stood at 8.3% in April 2023, compared to 4.3% on average in 2021. In addition, households have faced an increase in their monthly debt repayments, as mortgages are primarily granted at variable rates. In H2, consumption should nevertheless continue to prove resilient. Once more in positive territory since April, real wages will be a factor supporting household purchasing power, as long as the drop in inflation continues.

Among Central European countries, Romania will probably see the strongest growth in 2023, even if this growth slows. Hungary, the Czech Republic and Slovakia are more exposed to fluctuations in external demand. Usually holding up better than its neighbours, the Polish economy is expected to see a more significant slowdown this time, due to the downturn in the real estate sector. In addition, investment projects are likely to be postponed after the general election next autumn.

In 2024 and 2025, the Romanian economy should recover and then gradually converge towards its estimated potential growth of around 3.5% in the medium term. However, the likely move towards greater fiscal discipline over the next two years suggests limited support for investment and household consumption.

GRADUAL DROP IN INFLATION

Based on the harmonised price index, inflation reached a high in November, then gradually fell to 9.6% y/y in May. This figure is comparable to figures seen in Central European countries, with the exception of Hungary, which is still struggling with very high inflationary pressures (+21.9% y/y in May).

In Romania, the decline was mainly due to a lower contribution from the "food" and "energy" items. However, disinflation will be slow, due to relatively strong wage pressure. Furthermore, core inflation slightly accelerated to 8.7% y/y in May.

The Central Bank is unlikely to move towards monetary easing any time soon. It will undoubtedly favour a monetary status quo this year, after having increased the key policy rate by 475 basis points cumulatively to 7% until January 2023.

FORECASTS

	2020	2021	2022	2023e	2024e
Real GDP growth, %	-3.2	5.9	4.2	2.5	4.0
Inflation, CPI, year average, %	2.3	4.1	12.0	9.6	5.5
Gen. Gov. balance / GDP, %	-9.2	-7.1	-6.2	-4.7	-3.7
Gen. Gov. debt / GDP, %	46.9	48.6	47.2	46.8	46.3
Current account balance / GDP, %	-4.9	-7.2	-9.3	-6.7	-4.4
External debt / GDP, %	57.5	56.7	50.5	48.5	45.5
Forex reserves, EUR bn	42.5	45.8	52.3	54.0	57.0
Forex reserves, in months of imports	6.7	5.9	5.3	4.9	5.2

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

ROMANIA: GOODS IMPORTS IN VOLUME

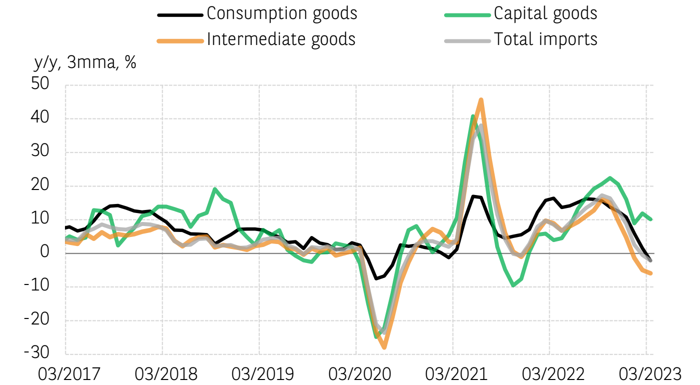

CHART 1 SOURCE: EUROSTAT, BNP PARIBAS

BUDGET RECALIBRATION REQUIRED

Despite the improvement in the debt-to-GDP ratio in 2022, public accounts are showing some fragility. In fact, the budget deficit has remained high as a result of successive shocks to the economy since 2020. This deficit was -6.2% of GDP in 2022, after reaching -7.4% in 2021 and -9.2% in 2020. In the short term, the debt burden in the government's budget will increase, although it remains relatively low for the time being, at 7.3% of tax revenues (4.7% in 2021 and 6.3% in 2022).

In 2023 and 2024, the budget deficit will be reduced, but it should remain above the EU's target of 3% of GDP.

As a result, significant consolidation efforts will be needed in the short term to comply with EU budgetary rules. Failing this, Romania may be subject to further disciplinary measures. On 30 June, the country received a warning from the European Commission of a possible suspension of European funds if public accounts were not quickly put back on track. We should remember that European funds represent a significant source of financing for the country, estimated at around EUR 10 billion per year (3% of GDP). In addition, Romania has already been the subject of an excessive deficit procedure since 2020, due to new expenditure (increases in pensions, wages, etc.) deemed unsustainable by the EU.

At the end of May, measures were adopted by the government to reduce public spending, but they are marginal (0.3% of GDP). More radical measures will be required to significantly contain the budget deficit, which already reached 2.7% of GDP over the first five months of the year. However, fiscal consolidation will prove difficult in the short term, with several elections (presidential, legislative and local) due to take place in 2024, which should be accompanied by an increase in spending.

SLIGHT DECLINE IN THE CURRENT ACCOUNT DEFICIT

Romania has posted a structural current account deficit for several years. The persistence of deficits stems from strong domestic demand, itself generated by the succession of expansionary budgetary policies implemented in recent years. In 2022, the current account deficit widened further to 9.3% of GDP. The increase in the energy bill alone represented 30% of the deficit. The income balance remained in the red. The services balance surplus only marginally offset the deterioration in the trade balance.

Financing the current account deficit did not pose a major problem. In 2022, the current account deficit was broadly covered by non-debt flows, including foreign direct investment (FDI) and European funds. These two sources of financing combined represented EUR 21 billion in 2022 and reached 78.3% of the deficit.

External liquidity is at comfortable levels thanks to the accumulation of foreign exchange reserves covering more than five months of imports. Furthermore, the ratio of external debt to GDP has not deteriorated; it even fell slightly by 2.1 points to 48.4% in 2022.

In the short term, external accounts should benefit from lower energy prices, but the current account deficit will remain relatively high due to the structural deficit in the trade balance, even excluding energy.

AN ATTRACTIVE DESTINATION FOR FOREIGN INVESTMENT

The persistence of twin deficits in 2022 did not damage the perception of risk, judging by the slight appreciation of the Romanian leu against the euro over the period. The prospects for high yields on the bond markets favoured net inflows of capital. Portfolio investment flows saw a strong rise to EUR 9.7 billion in Q1 2023, after reaching EUR 0.3 billion and EUR 1.4 billion in the two previous quarters. Over 2022 as a whole, these investment flows amounted to around EUR 5 billion despite the uncertainties linked to the war in Ukraine. Furthermore, Romania remains an attractive destination for FDI, which stood at EUR 2.3 billion in Q1 2023 after reaching EUR 9.6 billion in 2022 (i.e., 3.4% of GDP). As a comparison, this ratio was 2% on average over the period 2010-2020.

FDI and European funds have helped Romania catch up with developed countries since it joined the European Union in 2007. The gap between

ROMANIA: CAPITAL FLOWS AND CURRENT ACCOUNT BALANCE

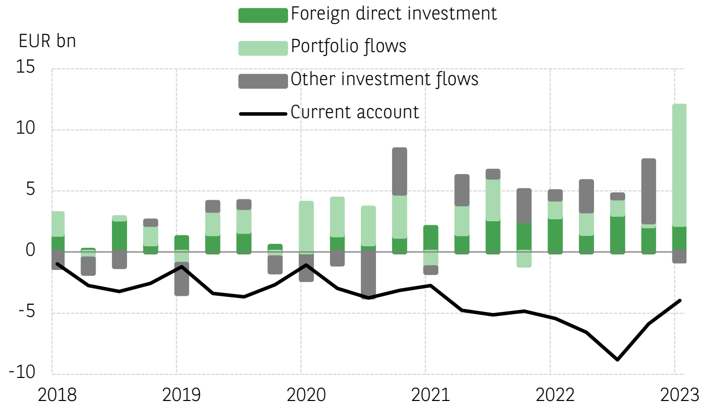

CHART 2 SOURCE: NATIONAL BANK OF ROMANIA, BNP PARIBAS

Romanian GDP per capita and EU GDP has narrowed considerably since then (70% in 2022, compared to 49% in 2007). A continued catch-up will remain on track in the coming years. Like its neighbours in Central Europe, Romania could benefit from the reorganisation of production in the euro area, as a result of the large supply shocks caused by the Covid-19 crisis and, more recently, by the war in Ukraine. Furthermore, sanctions against Russia and Belarus, which led to industrial site closures, could benefit all Central European countries. According to the Romanian authorities, several projects are under consideration to relocate these sites.

Romania's many plus points are its geographical proximity to the euro area, a developed infrastructure network and a diversified industrial base. In addition, the relative stability of the leu against the euro, observed in recent years, mitigates currency risk. The managed exchange rate mechanism has resulted in a very small deviation of the nominal effective exchange rate from its long-term trend. The prospects for joining the euro, within (at least) 5-10 years, will result in a total removal of this currency risk for manufacturers based in the euro area.

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BRAZIL

A WIND OF OPTIMISM

A wind of optimism is currently blowing over Brazil. Brazilian assets recovered strongly in Q2 2023 on the back of reform progress and positive surprises from growth, inflation, the labour market and external accounts. The short-term outlook has also improved. New fiscal measures combined with a softening of energy prices and the prospects of monetary easing in H2 has helped mitigate the expected economic slowdown this year. However, flashing green lights conceal the underlying weaknesses of internal demand as well as differentiated performances across sectors. In the absence of higher revenues, the primary result targets defined by the new fiscal framework is expected to be difficult to achieve.

THE UPTURN IN FINANCIAL MARKETS ....

Since the end of March, Brazilian assets have experienced a notable upturn. The stock market posted a 16% gain while the real appreciated some 10% against the dollar at the end of June. The yield curve also fell. The yield on two-year sovereign bonds fell from 14.2% at the end of December 2022 to 10.5% in June. Real interest rates on long-term inflation-linked government bonds have also eased by almost 100 basis points since the announcement of the new fiscal rules in April. Foreign investors' appetite for Brazilian debt securities has also firmed up (between January and May, non-residents have been net buyers to the tune of USD 4 bn, according to the IIF data).

... REFLECTS POSITIVE SURPRISES ON THE MACROECONOMIC FRONT...

In addition to the role played by exogenous factors (falling dollar, Chinese recovery, easing of financial stability risks, decoupling of emerging markets with advanced economies), the wave of optimism across Brazilian markets reflects above all the good performance of growth and prospective rate cuts anticipated some time towards the end of the summer (the policy rate, the SELIC, has been kept at 13.75% since August 2022). Growth surprised strongly to the upside in Q1 (+1.9% q/q and 4% y/y after a 0.1% q/q decline in Q4 2022) on the back of exceptional harvests of soybeans, corn and other grains (agricultural output jumped 21.9% in the quarter, a record). Economic activity continued to show signs of resilience early in Q2 amidst continued strength in the labour market. At the same time, inflation has continued to slow down helped by still large base effects resulting from the war in Ukraine as well as the real appreciation. In May, the IPCA price index fell to its lowest level since October 2020 (3.94% y/y vs. a 3.25% target); the diffusion index also declined (the share of items whose price rose during the month dropped to 56% from 66%). Core inflation also retreated (6.19% versus 9.12% at end-2022). On the external front, the trade balance logged a record surplus in the first five months of the year (USD 35 bn, a 37% increase y/y) despite retreating commodity prices. The result was driven by strong volume growth on the back of higher oil production and an exceptional harvest as well as lower imports. Meanwhile, the current account deficit continued to decline (-2.5% of GDP in May compared to -3% at end-2022) remaining fully covered by net FDI flows (+2.8% of GDP).

Such flashing green lights, on an aggregate level, nevertheless hide the underlying weaknesses of domestic demand as well as widely differentiated performances across sectors. National accounts show indeed a weakening of domestic consumption and investment over the last four quarters. Also, had it not been for strong inventory accumulation, the contribution of domestic demand to GDP growth in Q1 would have been negative. Moreover, the strong performance in agriculture and livestock year to date conceals declining outputs in most sectors of industry as well as the strong retreat in service activity in April (transport and storage services remain outliers boosted by bumper harvests since the start of the year). Activity in manufacturing / processing industries as well as civil construction have meanwhile continued to suffer from high interest rates.

In the short term, the easing of energy prices and new fiscal measures should support activity and thus help mitigate the economic slowdown expected this year.

FORECASTS

	2020	2021	2022	2023e	2024e
Real GDP growth, %	-3.3	5.0	2.9	2.5	0.5
Inflation, CPI, year average, %	3.2	8.3	9.3	4.7	4.0
Fiscal balance / GDP, %	-13.3	-4.3	-5.3	-8.9	-8.2
Gross public debt / GDP, %	87	78	73	77	80
Current account balance / GDP, %	-1.9	-2.8	-2.9	-2.3	-2.0
External debt / GDP, %	44	42	39	41	43
Forex reserves, USD bn	356	362	324	341	338
Forex reserves, in months of imports	19	14	10	16	15

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

BRAZIL: CONTRIBUTIONS OF THE COMPONENTS OF GDP TO QUARTERLY GROWTH

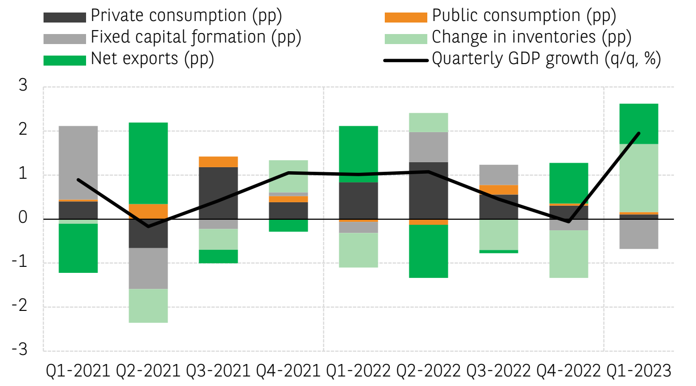

CHART 1 SOURCE: IBGE, BNP PARIBAS

The government has announced tax breaks to support the automotive industry ("popular car" program) and a 27% increase in funding for the agricultural sector for 2023/2024. The development bank, BNDES, has also announced increased financing to support industry over the next four years. On the demand side, in addition to the social transfers approved in the 2023 budget, the poorest households will benefit from the increase in the minimum wage (which came into force in May), the widening of the tax exemption brackets, as well as falling prices resulting from Petrobras' new fuel pricing policy (which henceforth will also better insulate the domestic market against volatility in international markets). The implementation of the new debt restructuring program ("Desenrola Brasil"), aimed at countering the rise in households' defaults, should, meanwhile, benefit a larger number of recipients than initially expected (nearly 70 million Brazilians).

... AS WELL AS PROGRESS ON THE REFORM FRONT

The approval, at the end of June, of a more restrictive version of the new fiscal framework [1], combined with the presentation of the long-awaited tax reform[2] as well as the easing of tensions between the government and the Central Bank have contributed to lower both medium-term inflation expectations as well as risk premia (75 bp drop in Brazilian 5-year CDS since March). Other initiatives were also well received by the markets: i/ new cooperation agreements with China[3] , ii/ decision to change the time frame when assessing inflation against the target (starting in 2025[4]), iii/ advances (despite some negative developments[5]) on the energy transition and environmental protection fronts. In addition to the presentation of a BRL 56 bn investment plan to further develop electric transmission lines, the government announced the forthcoming creation of a carbon market, as well as its intention to extend the protected area in the Amazon region by some 30,000 km², i.e. the equivalent to the size of Belgium. Farmers who adopt more sustainable practices will meanwhile have access to financing at preferential rates. Other actors are also involved: BNDES, the development bank, has reinforced its consideration for key environmental performance indicators (KPIs) in allocating its loans; Petrobras has committed to ensuring that 100% of the electricity used in its activities – whether industrial or administrative – will be produced from renewable sources. Finally, Brazilian banks have adopted a new protocol to combat deforestation in the beef industry. Brazil has, meanwhile, experienced a 31% drop in deforestation over the first five months of the year compared to the same period in 2022.

Dissipating fears of witnessing a reversal in reforms undertaken since 2016 have also contributed to further investors' optimism. Lula, whose popularity has stagnated since the beginning of the year, has faced difficulties in countering the privatization of Electrobras; Congress also rejected a bill authorizing greater government control over the governance of state-owned enterprises (SOE law).

STRUCTURAL CHALLENGES AND BUDGET EXECUTION

Brazil's solid run so far – which culminated in June in S&P revising its rating outlook from stable to positive – should nonetheless not overshadow the many challenges still facing the country i/ on the social front (increasing polarization, rising hunger and poverty), ii/ on the demographic front (ageing population, declining birth rate), and above all, iii/ on the economic front – with low potential growth in large part due to a complex and costly business environment. According to a recent study carried out by the Movement for Competitiveness (MCB) in partnership with the think tank FGV, the additional cost borne by companies to produce in the country (Custo Brasil) compared to the average cost in the OECD is estimated to some BRL 1,500 bn, or approximately 20% of GDP. The cost of employment, logistics, financing, regulatory and tax requirements, as well as low integration into global supply chains are believed to be responsible for 80% of this additional cost. In an attempt to help remedy this, the MBC/FGV and the Ministry of Development, Industry, Trade and Services (MDIC) will launch, in the second half of 2023, the Custo Brasil Observatory which will monitor and update, on an ongoing basis, various projects to report on their impact on the Brazilian economy.

In the immediate future however, the more pressing challenge, arguably, will be to meet primary results targets set out in the new fiscal framework (0% in 2024, +0.5% in 2025 and +1% in 2026). Compliance with the targets will ultimately condition the leeway authorities have to lift structural obstacles to growth. Indeed, according to the new fiscal rules, the increase in spending will be capped each year at a minimum of 0.6% and a maximum of 2.5% in real terms depending on the primary result of the previous year. Given the economic scenario and the upward trajectory of spending, attaining the target appears, for the time being, highly unlikely in the absence of new sources of revenues. Increased receipts from the proposed tax reform appear to be the most likely avenue to sustainably generate higher revenues. However, it still needs to be approved by Congress - a challenge that spans 30 years.

BRAZIL: TRADE BALANCE (GOODS)

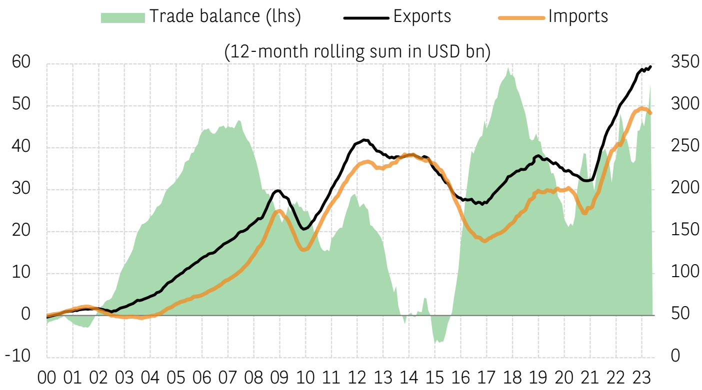

CHART 2 SOURCE: BCB, BNP PARIBAS

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1 Stricter sanctions are provided for in the event of non-compliance with the primary balance targets. The new fiscal rules excluded some social, health and educational spending and defined a floor for investment spending each year (around BRL 70 and 80 bn, i.e. approximately 0.6% of GDP per year until 2025).
2 In particular, it intends to replace indirect taxes on production and consumption (IPI, PIS, Cofins, ICMS and ISS, the levels of which can vary by state and municipality) with a dual value added tax.
3 Lula traveled with more than 200 business leaders, in April, concluding some about twenty commercial agreements with his Chinese counterpart (in mining, agriculture, energy, information and communication technologies). Chinese investment in Brazil, through agreements to construct bridges, railways, ports and car factories, among others, is expected to help boost Brazilian industrial production (which has fallen by around 6 points in 20 years).
4 The target was maintained at 3% but inflation will be evaluated on a 12-month rolling window rather than at the end of the calendar year as in the current format.
5 Driven by the agrobusiness and conservative interest groups, Congress passed Bill PL490 drastically limiting the recognition of land claims by indigenous groups made after 1988. Congress also stripped the Ministry of the Environment and the new Ministry of Indigenous Peoples of part of their powers. Lula has also showed little opposition to an oil exploration project at the gates of the Amazon.

AMBITIOUS GOALS FOR THE ENERGY TRANSITION

Chile seems to have made more progress with the energy transition than most Latin American countries. The combination of a favourable geography, significant resources, the aspirations of public opinion and political will has favoured implementation of a number of measures for almost 25 years. Since he came to power in 2022, Gabriel Boric has undertaken to exceed the goals set up to that point, on a country level, by achieving carbon neutrality before 2050, and on an international level, by developing lithium and green hydrogen production and export capacities.

STATE OF PLAY

Chile's contribution to greenhouse gases (GHG) is marginal in global terms (less than 0.25% of total in 2021). However, this contribution has grown over the past three decades (standing at just 0.15% of the total in 1990). Furthermore, although the impact of renewable energies has been steadily increasing since the early 2000s, the primary energy mix remains highly carbon-intensive: according to data from the International Energy Agency (IEA), in 2021, around 44% of the energy supply came from oil, 16% from coal, 14% from natural gas and only 6% from renewable energies.

The energy sector remains the largest contributor to greenhouse gas emissions (i.e., more than 75% of the country's total emissions), mainly due to the consumption of coal required for electricity generation, as well as the consumption of diesel fuel in transport. In terms of emissions caused by humans, these are slightly below the global average (4.4 and 4.7 tonnes of CO2 per capita respectively in 2021, according to data provided by the Global Carbon Project), but well below the OECD average (10.2 tonnes in 2021).

THE SHIFT SEEN IN THE 2010s

In the early 2010s, successive governments implemented increasingly demanding energy transition policies. The introduction of these policies followed several decades of policies aimed at reducing dependence on imported energy without any environmental considerations. As a result, while the country had focused its energy policy on hydroelectric power since the 1940s, several episodes of drought in the 1990s led to a very sharp increase in natural gas imports, mainly from Argentina. According to data from the World Bank, imported fossil fuels rose from 43% of total energy consumption in 1990 to almost 65% in 2000 (of which, more than half in oil and natural gas). In the 2000s, the sudden shutdown of the natural gas supply in Argentina (causing a number of power outages and penalising several major cities, and above all the mining industry) led the government to build five new coal-fired power plants, bringing their number to 28.

The trend was not reversed (again) until the early 2010s. Driven by broad public and political support, a national energy strategy set targets for 2012 and 2030. In the long term, the government is therefore planning to ultimately stop using conventional fossil fuels, to reduce dependence on imported energy and, to achieve this, to favour the use of renewable energy (geothermal energy, biomass, wind, solar, tidal energy). In 2015, as part of the Paris Agreement, Michelle Bachelet's government committed to defining and regularly updating long-term goals, known as Nationally Determined Contributions (NDCs).

Chile has therefore committed to achieving carbon neutrality by 2050. The strategy is detailed in a five-year plan entitled "Long-Term Energy Planning" (PELP, first published in 2015). Since 2017, the country has also had a single interconnected national electricity grid (previously, the Chilean electricity grid was operated exclusively by private operators, from production to distribution).

FORECASTS

	2020	2021	2022	2023e	2024e
Real GDP growth (%)	-6.0	11.7	2.7	-1.0	1.0
Inflation (CPI, year average, %)	3.0	4.5	11.6	8.3	4.1
Central Gov. balance / GDP (%)	-7.1	-7.5	1.3	-1.8	-2.1
Public debt / GDP (%)	32.5	36.3	37.9	39.6	41.1
Current account balance / GDP (%)	-1.4	-6.6	-8.7	-4.0	-4.1
External debt / GDP (%)	82.6	75.0	77.6	82.8	87.8
Forex reserves (USD bn)	39.2	51.3	39.1	44.7	44.1
Forex reserves, in months of imports	5.5	5.3	4.1	4.9	4.8

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

CHILE: ENERGY MIX

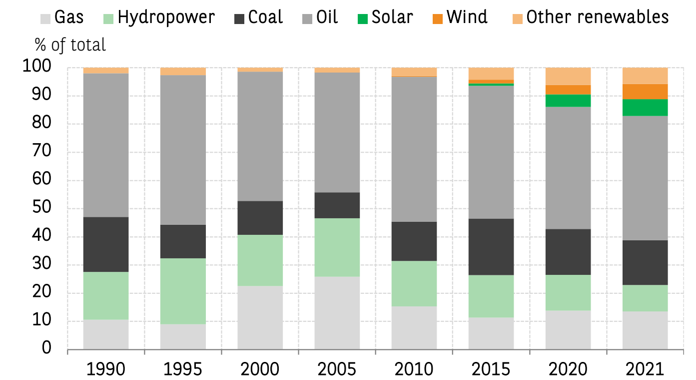

CHART 1

SOURCE: ENERGY INSTITUTE, STATISTICAL REVIEW OF WORLD ENERGY, BNP PARIBAS

NEW, MORE AMBITIOUS GOALS

Since taking up his position in March 2022, Gabriel Boric has undertaken to significantly accelerate the energy transition. In a new version of the PELP, the NDCs have been adjusted: Chile's target is now to achieve GHG emissions of 95 MtCO2eq in 2030 (with a peak in emissions in 2025), i.e., a 15% reduction from their 2018 level (112 MtCO2eq), and still achieving carbon neutrality by 2050.

Three scenarios are detailed in the new PELP, which can be summarised as follows[1]: 1/ exact repetition of the goals announced by the previous government; 2/ closure of two thirds of coal-fired power plants by 2025; and 3/ closure of all coal-fired power plants by 2030 and implementation of green[2] hydrogen production systems and incentives to promote the development of electric mobility. Favoured by the government, the last scenario is particularly ambitious since, on the one hand, the assumptions of GDP growth, and therefore energy consumption, are significantly higher and, on the other hand, the goal is to reach no less than 80% of renewable energies in electricity production by 2030 (while these represented less than 50% in 2020), a completely decarbonised electricity mix by 2050, and a share of 70% in zero-emission fuels in non-electric end uses. In addition, the government plans to use 45% renewable energy for heat and cooling by 2030 and 80% by 2050. And lastly, in its roadmap, the government also indicates that it wants to strengthen the electrification of uses and combat fuel poverty.

All these goals are included in a law passed in June 2022 (Framework Law for the Energy Transition). Beyond these goals, the Law proposes decentralisation of climate policy. Climate action no longer depends solely on the Ministry of the Environment, but also on other ministries, regional governments, several government "climate agencies" and also, to a large extent, on the private sector. The Law, in fact, sets out a financial framework for public-private partnerships for environmental projects and sector-based plans for adapting to energy transition strategies. Rather than setting a national cap on GHG emissions, caps on GHG emissions can be set per sector, for individual installations or groups of installations. The details are yet to be defined in an amendment to the Law which should be published in the coming months.

TWO-WAY OPPORTUNITIES, LITHIUM AND GREEN HYDROGEN

And lastly, the Law outlines a strategy for public-private partnerships in the field of green hydrogen operation and production, notably with funding of USD 50 million for six industrial projects in this sector, several agreements with international companies (including GNL Quintero, CAP and Air Liquide), bilateral partnerships, with Germany and the United States in particular (pooling of research programmes and production techniques). According to the latest PELP, the country intends to set up an electrolysis capacity of 5 GW (in operation or under development) by 2025, and become a major exporter by 2030 with a production capacity of 25 GW.

At the same time, and paradoxically, the Chilean government intends to position itself as a leader on the lithium market. Lithium extraction and refining, in fact, require a lot of water and polluting chemicals, and also weaken ecosystems around mines. According to figures provided by BP, Chilean production accounted for 26% of total global production in 2021 (just behind Australia), and the country had more than 45% of total known reserves.

In mid-June, President Boric clarified his "national lithium strategy". The details are yet to be determined, but the government wants to create a national lithium company and set up partnerships with private companies present throughout the ore production cycle. The Law also provides for an increase in the taxation of mining companies (implementation scheduled for early 2024).

GLOBAL PRODUCTION AND RESERVES OF LITHIUM

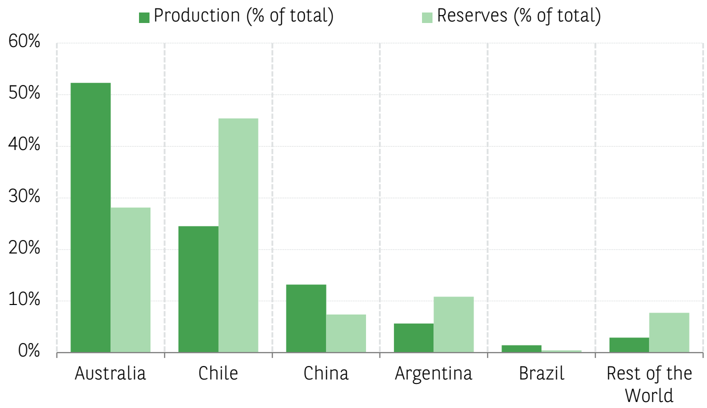

CHART 2 SOURCE: BP, BNP PARIBAS

Revenue should contribute to the financing of the ambitious energy transition programme (in addition to the tax reform proposed by the government, which was rejected by the National Congress last March). In this area too, a number of projects are under discussion (including trade agreements with the European Union and other countries in the region, including Argentina and Bolivia).

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1 The first two scenarios assume average GDP growth of 2.8% per year between 2021 and 2030, then 1.8% per year between 2031 and 2040, followed by 1.3% per year between 2041 and 2050. The latter scenario assumes more dynamic growth for the three periods, i.e., 3.2%, 2.3% and 1.9% per year, respectively.
2 To produce hydrogen, an electrolyser can be used to separate hydrogen and oxygen molecules from water. Green hydrogen refers to when the electrical energy used for this process comes from renewable energy, such as solar and wind.

NATURAL GAS: A REGIONAL OVERVIEW

For about a decade now, the exploitation of new natural gas reserves in the Eastern Mediterranean has had significant economic consequences for producing countries, and has been upgrading the region's position on the international gas market. Egypt still dominates the sector, with significant reserves and export infrastructure, but Israeli production is increasingly impacting the region's exports. 2022 was a very favourable year for the sector due to rising prices and European demand. Despite the current decline in prices on the European market, this trend should continue in the coming years. Beyond that, the outlook is more uncertain: while global gas production capacities are expected to increase significantly, the role of this hydrocarbon in the energy transition is likely to be challenged.

RESERVES AND PRODUCTION

Egypt and Israel are the two largest producers of natural gas in the Eastern Mediterranean. Egypt has the largest reserves (2.13 trillion m3), in particular thanks to the discovery of the Zohr gas field in the 2010s. More modest in size (0.59 trillion m3), Israel's reserves are distributed between several offshore fields; other relatively less significant reserves are located in Cypriot territorial waters (0.11 trillion m3) and in Lebanese territorial waters. Lebanese reserves are being estimated, after the border agreement entered into with Israel in October 2022. Although modest globally (around 3.5% of Middle East and North Africa natural gas reserves, and less than 2% of the world's reserves), the exploitation of these reserves has substantial consequences for the Egyptian economy (generating foreign currencies) and the Israeli economy (improving energy independence).

In Egypt, total natural gas production reached 67 billion m3 in 2022, according to data from the JODI (Joint Organisation Data Initiative). Thanks to new production capacities and the construction of gas-fired power stations, its share in the Egyptian energy mix has increased from 35% to 58% over the past twenty years. Exports of liquefied natural gas (LNG) to Europe, which were almost nil between 2014 and 2016, due to a lack of exportable quantities, resumed from 2017, thanks to the exploitation of the Zohr gas field. LNG exports reached 12 billion m3 in 2022.

In Israel, the production from offshore fields starting in 2013 has reduced the share of oil and, to a lesser extent, coal in the country's energy mix. The share of natural gas rose from 7% in 2005 to 38% in 2020. Natural gas production reached approximately 22 billion m3 in 2022, of which approximately 42% is exported by pipeline to Jordan and Egypt.

VARIOUS MACROECONOMIC CONSEQUENCES

In Israel and Egypt, the exploitation of new gas fields has had positive macroeconomic consequences, but varied in intensity, mainly due to the very different situation of the external accounts of the two countries.

Development of the Tamar and Leviathan fields has enabled the Israeli economy to significantly strengthen its energy sovereignty. Initially, production was mainly intended for domestic consumption and helped the country achieve total self-sufficiency and, therefore, reduce its vulnerability to the volatility of the market. In addition, export agreements to Jordan (2016) and Egypt (2019) have contributed to a significant improvement in investment profitability. While, in the case of Jordan, imports are meeting domestic demand, the gas exported to

NATURAL GAS PRODUCTION

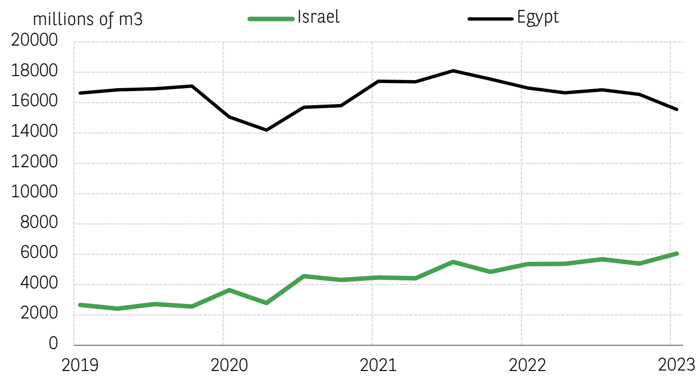

CHART 1

SOURCE: JODI, MEES, BNP PARIBAS

EGYPT: IMPORTS AND EXPORTS OF NATURAL GAS

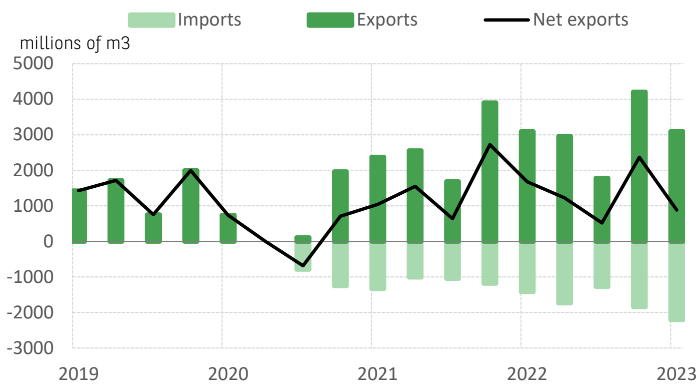

CHART 2

SOURCE: JODI, BNP PARIBAS

Egypt is liquefied at Egyptian terminals to be re-exported primarily to the European market. As a result, with the energy crisis in Europe, Israeli gas exports to Egypt increased by 49% in 2022.

The macroeconomic consequences of these exports are relatively minor for Israel. Between 2020 and 2022, they represented on average only 0.9% of total current account revenue. External accounts are one of the main strengths of the Israeli economy. They are dominated by exports of high-tech services, which have enabled almost structural current account surpluses.

In Egypt, gas exports are a substantial but volatile source of foreign currency. In June 2022, the agreement between the EU, Egypt and Israel led to a sharp increase in Egyptian total exports, whichincreased by 7% y/y in 2022. Sales to Europe jumped 177% in volume, reaching 47% of Egypt's total LNG exports (compared to 18% in 2021). Furthermore, with the sharp rise in spot prices of LNG on the European market in 2022, export revenue more than doubled, reaching USD 8.4 billion. Against a backdrop of a balance of payments crisis (from Q1 2022), LNG exports represented 8% of total current account receipts (3.8% in 2021).

We can therefore see that while gas exports significantly support Egyptian external accounts, which are structurally fragile, gas production in Israel is, above all, an element of energy sovereignty and its export, a means of regional influence.

SUPPORTING EUROPEAN DEMAND

The momentum of gas exports in 2022 is expected to continue in the coming years, but there are a number of uncertainties. The disruption of pipeline supply from Russia has made Europe highly dependent on LNG imports in the short term and has provided new opportunities for other producers. European LNG imports increased by 67% in 2022 y/y, primarily from North America.

Despite this positive outlook, Egyptian LNG export revenues are expected to decrease in 2023 due to less tension on European supply compared to 2022 (although some tension could resurface from the second half of the year) and lower prices in 2023. While data for Q1 2023 confirm Europe as the number one destination for Egyptian gas exports (76% of the total), export volumes and prices have fallen. During H1 2023, the spot price of LNG for the European market (TTF reference in Rotterdam) averaged EUR 44/mwh, compared to an average of EUR 132/mwh in 2022. In terms of volume, exports fell by 38% in Q1 2023. More generally, maintaining or even increasing exports will depend on the discovery of new reserves, given the maturity of existing fields and the technical difficulties constraining their production. As a result, total natural gas production in Egypt was down 5% in 2022, and the increase in exports was explained by a record level of imports from Israel (49% y/y).

Egypt's gas supply is not under threat, for the time being. In fact, 2022 saw a drop in gas consumption, thanks in particular to the transfer of a proportion of domestic demand for primary energy to oil. Over time, further declines in total production are likely to increase Egyptian dependence on imports from Israel. An additional constraint: the increase in the Egyptian government's dues to international energy companies (currently estimated at USD 3 billion according to the MEES) could hinder investment and therefore the increase in production capacity.

EGYPT: CURRENT ACCOUNT RECEIPTS

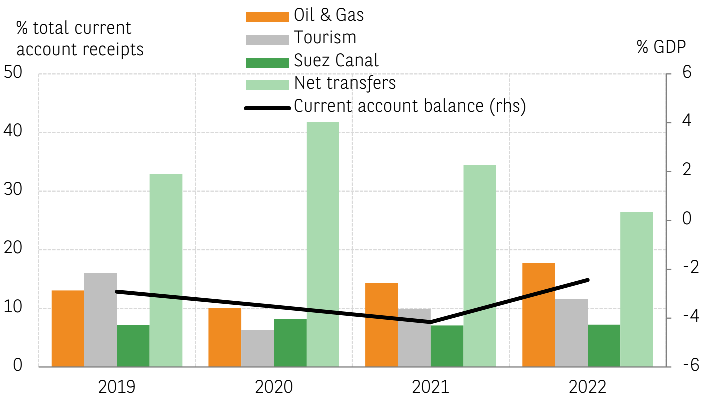

CHART 3 SOURCE: CBE, IMF, BNP PARIBAS

As for Israel, production could almost double by 2030, thanks to the exploitation of additional reserves in existing fields and of new smaller fields. Domestic gas consumption is expected to increase moderately with the increase in the share of gas in the energy mix, as the use of coal is expected to be phased out by 2025. However, part of the additional consumption should be met by renewable energy sources (mainly solar). These factors will increase Israeli export capacity.

UNCERTAIN PROSPECTS

In the medium term, European gas demand could slow, due to the uncertain future role of natural gas in the global energy mix. Disruptions in the gas market in 2022 could challenge its status as an energy of transition according to the International Energy Agency (IEA)[1]. Geopolitical events in 2022 have caused supply disruptions and very high price volatility.

This possible change in gas status could reduce European demand, along with an increase in renewable energy capacity. In its central scenario, the IEA expects a sharp slowdown in the growth in global gas demand. While this rose by 20% between 2010 and 2020, this increase would only be 5% in the following decade. On the supply side, the marketing of new production capacities in Qatar from 2025 will significantly increase the quantity of gas available on the market.

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1 World Energy Outlook - Topics - IE

TACKLING THE CLIMATE CHALLENGE

Egypt is heavily exposed to the consequences of global warming due to its Mediterranean geographical location, high population growth and the importance of the agricultural sector. Already deemed critical, water stress is likely to increase in the medium and long term. The deteriorating trend of various vulnerability and resilience indicators, currently at medium levels, is increasing climate risk in the long term. The financial resources of the Egyptian government are extremely constrained, given the deteriorating macroeconomic situation and the unfavourable outlook. Transformation of the energy mix may be partially funded by private capital. However, funding for climate change reduction and adaptation policies, by definition less profitable in the short term, remains problematic.

SIGNIFICANT EXPOSURE TO CLIMATE RISK

Climate change risk analysis is broken down into three categories of indicators: exposure to risks caused by rising temperatures (drought, rising water levels), vulnerability of the economy and inhabitants to these hazards, and lastly, the capacity to cope with these risks . We use the indicators and data from the INFORM[1] database, which makes a clear distinction between these indicators and provides projections according to the main climate scenarios.

The Mediterranean Basin is classified by the IPCC as a climate change hot spot due to very high exposure to the consequences of rising temperatures. Temperatures are expected to be 20% above the global average by 2100. Against this backdrop, Egypt is particularly vulnerable to the consequences of global warming due to the importance of agricultural activity in the economy (1/4 of employment and 20% of exports), strong population growth, high and difficult to control urbanisation of the population, and the concentration of the population in the Nile basin and in the coastal area.

The issue of water is key, with the population doubly at risk: the risk of drought and the risk of rising water levels. Water stress is considered critical by the Food and Agriculture Organisation (FAO), given the significant imbalance between consumption and available resources. According to the drought risk indicator calculated by INFORM, Egypt achieves the highest score globally in any scenario considered[2]. This indicator analyses the intensity of the risk, the proportion of population affected and the importance of the agricultural sector in the economy. Egypt is dependent on the Nile for around 97% of its water supply and rising temperatures will affect the availability of river water (precipitations, evapotranspiration). It should also be noted that the water resource is subject to a significant geopolitical risk, as the sources of the Nile are located beyond Egypt's borders.

Exposure to risks of flooding (coastal and inland) is also very high, and places the country in the highest risk category. The consequences of global warming are not linear and are expected to lead to the multiplication of extreme weather events, including sudden flooding. While Egypt is not one of the countries most affected by this risk (compared to some countries in Southeast Asia, for example), it may affect a large number of inhabitants given the geographical concentration of the population. Whichever scenario is considered, by 2050, inland flooding could affect about five million people, while coastal flooding could affect about one million.

The level of vulnerability, which measures the predisposition of a population exposed to a risk to be affected, depends mainly on socioeconomic factors and the vulnerability of certain population groups (according to healthcare, food or status criteria). This level is moderate. In fact, even though the downturn in the economic environment in recent years has had negative consequences on the living conditions of Egyptian households, the main indicators of human development, inequality and healthcare place Egypt in an intermediate position in international terms.

FORECASTS

	2020	2021	2022	2023e	2024e
Real GDP growth, %	3.5	3.3	6.6	3.8	4.0
Inflation, CPI, year average, %	5.7	4.5	8.5	24.1	21.3
Central. Gov. balance / GDP, %	-7.5	-7.0	-6.0	-8.3	-8.7
Central. Gov. debt / GDP, %	86	90	89	92	90
Current account balance / GDP, %	-2.9	-4.4	-3.5	-3.3	-2.7
External debt / GDP, %	32	33	37	40	38
Forex reserves (excl. gold), USD bn	38	41	33	35	38
Forex reserves, in months of imports	6.1	6.0	3.9	4.3	4.5

TABLE 1

(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: INDICATORS OF CLIMATE RISK EXPOSURE*

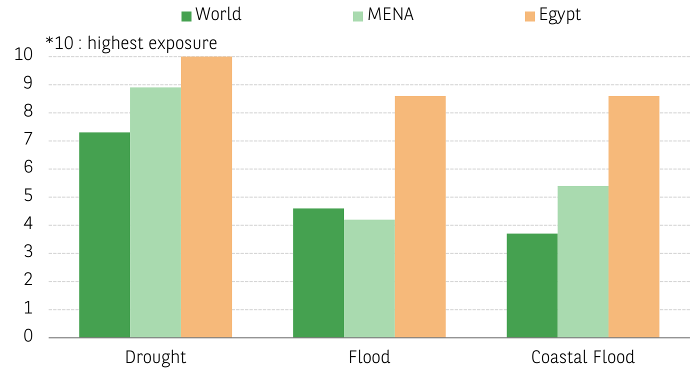

CHART 1

SOURCE: EUROPEAN COMMISSION (INFORM), SCENARIO RCP4,5-SSP2 2050, BNPPARIBAS

1 INFORM Climate Risk, developed by the European Commission (INFORM Climate Change [europa.eu]).
2 We are considering a central scenario (SSP2-4.5) and a high risk scenario (SSP5-8.5) with a horizon of 2050, according to the IPCC nomenclature (Summary for Policymakers [ipcc.ch]).

The capacity to deal with the consequences of climate change reflects a certain level of resilience. In particular, this indicator is made up of governance and infrastructure quality variables and is at a moderate level. Egypt actually enjoys relatively good quality telecommunication, physical and healthcare network infrastructures. For their part, indicators of governance and perception of corruption are somewhat lower than international averages.

Overall, by 2050 and according to the two scenarios SSP2-4.5 and SSP5-8.5, the synthetic climate risk exposure indicator classifies Egypt as a moderate risk (5 on a scale of 10), the average level of vulnerability and resilience indicators making it possible to compensate, at least in part, for the high level of exposure to climate risk, given the calculation method for this indicator (equally weighted average). However, we might raise certain objections to this conclusion, in order to put this relative optimism into perspective. In fact, whichever scenario and time horizon are considered, the outlook is challenging. Given the intensification of climate change, significant progress in reducing vulnerability factors and increasing resilience capacities is needed just to keep risk at its current level. Two factors in particular are making this goal of risk stability difficult to reach. First, the extreme value of exposure to drought risk, in our opinion, translates into over-vulnerability beyond the model's forecasts, particularly if we consider the very general nature of the variables taken into account in vulnerability and resilience indicators. Second, the negative dynamics of certain variables of vulnerability and resilience indicators. The improvement in trends of human development indicators (HDI) and governance effectiveness indicators (calculated by the World Bank) has reversed since 2019, as a result of the country's economic and political upheavals over the 2010s.

ENERGY TRANSITION

Globally, Egypt contributes little to greenhouse gas (GHG) emissions (around 0.6% of global emissions), but these emissions are rising due to economic growth. The primary energy mix is dominated by hydrocarbon fuels. According to the International Energy Agency, in 2019, around 55% of the energy supply came from natural gas, 38% from oil and less than 3% from coal. The share of renewable energies is therefore marginal for the time being (around 5%). In the medium term, the energy mix is not expected to change significantly. In fact, production capacity is, for the time being, much higher than peak use (according to the Ministry of Electricity, this difference was 25 GW in 2021 out of a total installed capacity of 59 GW), and relies in particular on recent thermal power plants which are energy efficient. Nevertheless, the expected growth in energy consumption and the need to reduce GHG emissions involves an increasing role of renewables in the energy mix. The target set by the Nationally Determined Contributions (NDC) report is to reach 42% of electricity produced thanks to new and renewable energy sources (including nuclear and green hydrogen in different forms) by 2035, compared to around 9% in 2021. However, according to the projections of the World Bank central scenario[3], the proportion of renewables in the energy mix should only reach around 27% by 2050. In the short term, renewable energy generation capacity is expected to increase by 50% to 4.9 GW by 2025. Part of this increase comes from the commitments made under the NWFE Program[4] launched by the government at COP27 and which provide for the decommissioning of thermal generation capacities (5 GW) and the financing of new renewable energy production capacities.

EGYPT: TOTAL PRIMARY ENERGY SUPPLY BY SOURCE

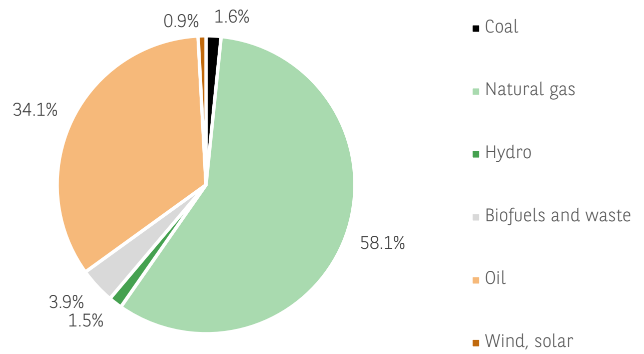

CHART 2 SOURCE: IEA, BNP PARIBAS

A SIGNIFICANT FINANCING REQUIREMENT, BUT WEAK MACROECONOMIC METRICS

It is currently difficult to establish a comprehensive estimate of the funding requirement linked to the prevention of the climate change and its consequences. However, it is possible to provide some sector-based estimates (which may overlap). According to the NDCs, all climate change mitigation and adaptation measures represent a cost of USD 246 billion between now and 2030, i.e., approximately 52% of 2022 GDP. The cost of implementing an urban GHG mitigation and reduction policy (43% of the total population) is estimated by the World Bank to be USD 105 billion (22% of GDP 2022) between now and 2030. Furthermore, the investments required to change the energy mix are estimated at USD 113 billion (24% of GDP 2022) by 2050, according to the World Bank central scenario (approximately, implementation of the NDCs). These amounts are very high and raise a number of questions about the capacity to meet such a financing requirement. The situation of public finances and external accounts is in fact very weak and, in both cases, there is no financial leeway. In fact, despite a proactive policy of reducing energy subsidies and increasing the tax base, budget deficits are recurrent and high (7.5% of GDP on average between 2018 and 2022). The recent rise in interest rates against a backdrop of high inflationary pressures will further increase the government's debt interest burden, which is currently equivalent to around 50% of total revenue. This situation is therefore significantly constraining investments in improving the capacity for resilience to climate change. The total of government green bond issues is, for the time being, very limited (USD 1.5 billion issued in 2020), and the development of renewable energies is based on private and public funding from multilateral donors.

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3 Egypt Country Climate and Development Report (worldbank.org)
4 NWFE: Nexus Water Food Energy is a coordinated promotion mechanism for green projects in the water, food and energy sectors through international mixed private-public funding.

KENYA

WALKING A TIGHTROPE

After years of financing through international markets and China, Kenya is facing a considerable increase in external debt servicing, which has led to strong pressure on external liquidity and on the shilling. Sustained economic growth in 2021-2022 was not enough to stabilise debt ratios. Renewed in late May 2023, support from multilateral creditors has helped to partially reconstitute official foreign exchange reserves and somewhat reassured investors. But the risk of social instability has increased significantly due to committed fiscal consolidation efforts and persistent high inflation.

SEVERE CONSTRAINTS ON LIQUIDITY ...

Over the past decade, Kenya has registered significant fiscal and current account deficits - i.e., twin deficits - financed by an increased use of China's bilateral loans and of international capital markets, against a backdrop of historically low interest rates. As a result, the country's external debt gradually increased to almost 60% of GDP in 2022.

With the war in Ukraine and the cycle of global monetary tightening, Kenya has lost its access to foreign capital markets, the cost of which has become prohibitive. In June 2022, the country had to cancel the sale of a USD 980 mn Eurobond, while spreads exceeded the threshold of 1,000 basis points (bps).

Since then, the country has not been able to reduce its current account deficit and financing requirements. First, the drought in 2022 increased Kenya's dependence on food imports and restricted its exports, primarily made of agricultural goods. Second, with oil accounting for almost 30% of the country's imports, the deterioration in terms of trade also contributed to widening the trade balance deficit. The slight upturn in tourism revenues after the pandemic and diaspora revenues were not enough to offset this gap, so 2022 ended with a current account deficit of 5% of GDP.

In the absence of external financing on capital markets, the interbank liquidity in foreign currency has dried up. As a result, between the end of January and the end of May 2023, the Central Bank of Kenya (CBK) had to draw USD 1 bn from its foreign exchange reserves to cope with foreign currency payments and the servicing of external debt. Foreign exchange reserves fell to their lowest level in ten years, covering over the period less than four months of imports, the convergence criterion set by the East African Community. At the same time, the Kenyan shilling depreciated at an accelerated rate (-14% over H1 2023, compared to -9% in 2022).

... DESPITE SUPPORT FROM ENERGY PROVIDERS AND IFIs

Pressure on external liquidity eased somewhat in May. First, Kenya reached an agreement with its oil suppliers in the Middle East to import fuel on credit, with a grace period running to the end of September 2023. Second, the government received the first tranche of a syndicated loan of USD 500 mn, as well as a disbursement of USD 1 bn from the World Bank. Thanks to this support, Kenya's foreign exchange reserves recovered at the beginning of June, rising slightly above the 4-month import threshold.

However, pressure on external liquidity will remain strong in the coming months. In fact, the country will have to deal with substantial external debt repayments, notably with the settlement of a USD 2 bn Eurobond due to mature in June 2024. However, renewed confidence among multilateral creditors is a recent positive sign for investors. At the end of May, the IMF increased its financial support to the country by an additional USD 1.1 bn as part of its extended credit facility, and through its new Resilience and Sustainability Trust (RST). The programme was extended until April 2025 and therefore covers the period of high repayments. With this support, the government hopes to make half of the repayments in principal of the Eurobond by the end of 2023, and to refinance the other half at a rate of 11% before it matures. After peaking at 21% at the beginning of May, the Eurobond yield currently returned to around 13%, thanks to the announcement of increased support from multilateral creditors. However, efforts must continue to ensure that investors' confidence returns. This is the aim of the new finance bill introduced in Parliament by the Ruto government last June.

FORECASTS

	2020	2021	2022	2023e	2024e
Real GDP growth, %	-0.2	7.6	4.8	5.3	5.4
Inflation, CPI, year average, %	5.3	6.1	7.7	7.8	5.6
Central. Gov. balance / GDP, %	-8.1	-7.1	-6.0	-4.4	-4.4
Central. Gov. debt / GDP, %	68.0	68.2	68.4	69.5	67.9
Current account balance / GDP, %	-4.8	-5.2	-5.1	-5.3	-5.3
External debt / GDP, %	57.9	58.1	59.4	62.4	64.9
Forex reserves (excl. gold), USD bn	7.7	8.8	8.0	7.5	5.5
Forex reserves, in months of imports	4.7	5.3	4.1	4.0	3.0

TABLE 1

KENYA: INCREASE IN FOREX RESERVES THANKS TO INTERNATIONAL LENDERS

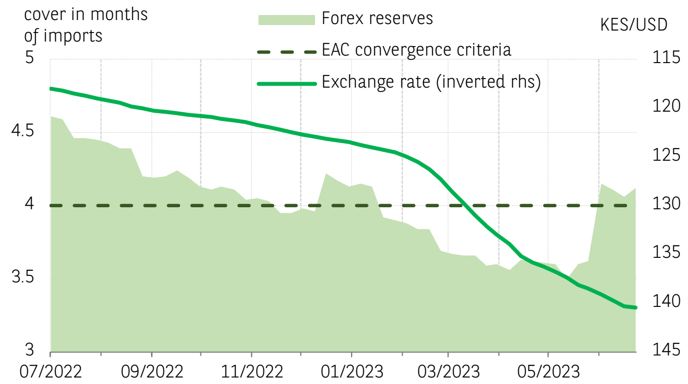

CHART 1 SOURCE: CENTRAL BANK OF KENYA, BNP PARIBAS

FISCAL CONSOLIDATION IS MAINTAINED ...

Years of substantial fiscal deficits (7.3% of GDP on average over 2015-2021) brought public debt to almost 70% of GDP and debt servicing to 50% of government revenues in 2021. Sustained growth over the last two years has barely stabilised the debt-to-GDP ratio. The government is facing increasing difficulties in refinancing its debt on the domestic market. In fiscal year (FY) 2021/22 already, it failed to reach its financing target, due to investors' lack of appetite and their perception of increased sovereign risk, while the Central Bank systematically rejected the highest risk premiums demanded by investors.

Coming to power in August 2022, the Ruto government therefore faced the complex task of implementing fiscal consolidation measures in order to restore the sustainability of public debt. Despite these measures, which have enabled the fiscal deficit to decrease to 6% of GDP over FY 2022/23, the government's refinancing capacity has continued to deteriorate. Over the first ten months of the financial year, the government only reached 57% of its financing target on the domestic market. This led to arrears with local institutions, which stood at USD 4 bn at the end of March. Despite renewed support from the IMF at the end of May, demand for domestic debt has remained low and focused on very short-term maturities. However, the share of Treasury bills in total domestic debt is stable, at 15%, and the average maturity of Treasury bonds is still long, standing at 9 years in March 2023.

Pursuing fiscal consolidation has thus been necessary. Last June, the Ruto government introduced in Parliament the 2023 Finance Bill, prepared in conjunction with the IMF. According to projections, the Treasury expects a budget deficit of 4.4% of GDP for 2023/24. The new Finance Bill aims to increase tax income by 17% and contains key measures, such as doubling VAT on fuel (from 8% to 16%), raising the top personal income tax rate, and introducing a mandatory contribution to a national housing fund for all salaries. These highly unpopular measures have revived tensions with the opposition and dissatisfaction among the population, which has endured high inflation for the past year.

... BUT SOCIOECONOMIC AND POLITICAL TENSIONS HAVE INCREASED

Elected by a small majority, President Ruto took over a deeply divided nation. The fiscal consolidation measures implemented since 2022 have profoundly eroded the popularity of his government against a backdrop of high inflation. In October 2022, inflation peaked at 9.6% y/y, a 5-year record high. In the same month, food price inflation, which makes up 30% of Kenya's CPI basket, reached 16%. Since then, inflation has receded but remains very high, stabilising at 8% on average in Q2 2023. It has exceeded the Central Bank's upper target limit since June 2022, despite the various monetary tightening measures. Monetary tightening could be more incisive with CBK's new governor, Kamau Thugge (former Senior Advisor to Mr Ruto), invested last June. Calling

KENYA: INFLATION HAS REMAINED OVER THE CBK TARGET

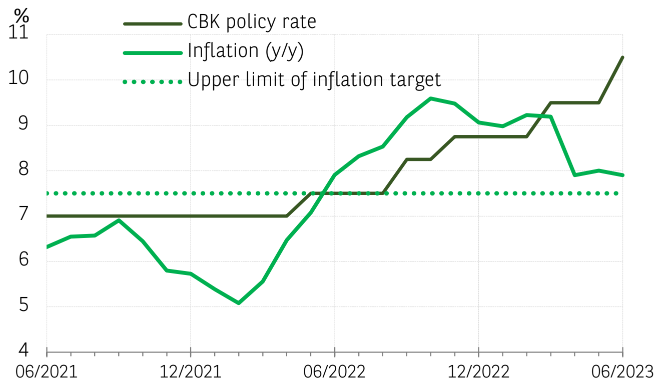

CHART 2 SOURCE: CENTRAL BANK OF KENYA, BNP PARIBAS

an exceptional meeting of the Monetary Policy Committee on 26 June, the CBK raised its key interest rate by 100 bps to 10.5% (compared to an average of 60 bps at the last four committee meetings). The new governor of the Central Bank has therefore adopted a much more hawkish tone than his predecessor, and now expects inflation to reach its target by September.

The cost-of-living crisis has resulted in a series of public disturbances, encouraged by the unsuccessful candidate in the election of August 2022, Raila Odinga. As leader of the opposition coalition Azimio la Umoja, which holds 45% of the seats in Parliament, Raila Odinga has been able to mobilise its electorate to organise major protests in the capital. In March and April, weekly riots severely disrupted economic activity and caused the death of around a dozen people. Despite the return to calm, social stability remains fragile, pending the heated discussions between the majority party and the opposition in Parliament. This stability might once again be compromised in the coming weeks by the Finance Bill. The Bill was temporarily suspended by the country's High Court at the end of June, despite some amendments made by Parliament a week earlier. Further amendments are possible, to appease the opposition and calm protests among the population. This would then delay fiscal consolidation.

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CÔTE D'IVOIRE

RESILIENCE BEING PUT TO THE TEST

The Ivorian economy seems to have weathered well the various external shocks since 2020. Growth has remained robust and inflation relatively under control. However, the measures put in place by the authorities to protect the population and the continuation of major public infrastructure projects have significantly widened the budget deficit, while financing conditions have deteriorated. In order to reduce pressure on public finances and external accounts, the authorities have called on the IMF. They have embarked on a fiscal consolidation programme that could prove difficult to complete.

Côte d'Ivoire is doing more than weathering the storm. In 2020, it was one of the few African economies to avoid recession. Since 2021, it has continued to significantly outperform its regional peers. After a strong upturn in economic activity to 7.4% in 2021, real GDP growth remained high at 6.7% in 2022, compared to less than 4% for the subcontinent. However, unlike the pre-Covid period, this momentum was accompanied by a significant increase in public and external imbalances, which could weaken economic activity in the future. Especially since Côte d'Ivoire also has to cope with the deterioration in external and domestic financing conditions. This situation does not raise any major concerns for the time being. Public debt and external debt remain relatively moderate, and the IMF has just granted an envelope of USD 3.5 billion over forty months to support implementation of structural reforms by the government. However, the scale of the new IMF programme raises questions. The programme amount is more than five times higher than the previous programme, completed at the end of 2020, highlighting the fragility of the current situation.

FORECASTS

	2020	2021	2022	2023e	2024e
Real GDP growth (%)	1.3	7.4	6.7	6.2	6.0
Inflation (CPI, year average, %)	2.4	4.2	5.2	3.7	2.0
Gen. Gov. balance / GDP (%)	-5.4	-4.9	-6.8	-5.2	-3.5
Central. Gov. debt / GDP (%)	46.3	50.9	56.7	58.1	58.5
Current account balance / GDP (%)	-3.1	-4.0	-6.5	-5.5	-4.7
External debt / GDP (%)	29.7	30.9	34.5	35.6	35.8
Forex reserves (USD bn)	9.4	10.7	8.9	10.0	10.7
Forex reserves, in months of imports	8.5	8.0	5.5	5.6	6.4

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

EXTERNAL ACCOUNTS: A TIPPING POINT

The deterioration of external accounts is one of the most visible consequences of the impact associated with the war in Ukraine. Traditionally posting a surplus, the Ivorian trade balance moved into the red in 2022, despite good performances of exports (+20%). Given the structurally high needs for imports of services, the current account deficit reached 6.5% of GDP in 2022 compared to 4% in 2021 and just 2.3% in 2019. For the first time since the early 2000s, the Ivorian economy posted a current account deficit above the average of oil-importing countries in Sub-Saharan Africa (Figure 1).

However, the rebalancing of external accounts could be slow. The surge in food and energy imports accounts for only part of the 44% increase in imports in 2022. Imports of capital goods (18 to 20% of total imports) also continued to post strong growth (+40% in 2022). However, the momentum should not reverse while massive public investment in infrastructure continues and development of the Baleine oil and gas field has not been completed (2027).

With an average current account deficit of 5% of GDP in 2023-24, Côte d'Ivoire will therefore remain vulnerable to the ups and downs of the international economic situation. And it is not certain that the country will be able to once again borrow on the international financial markets. In 2022, the authorities decided to abandon their plan of Eurobond issuance due to deteriorated financing conditions. The current context is barely more favourable. Alternatives do exist (green bonds), but Côte d'Ivoire will mainly rely on massive support from bilateral and multilateral creditors. In 2023, more than half of the current account deficit is expected to be covered by official net financing flows, to which will be added foreign direct investment inflows (1.5 to 2% of GDP). This should ease the pressure on foreign exchange reserves, which fell by 17% in 2022.

CURRENT ACCOUNT BALANCE

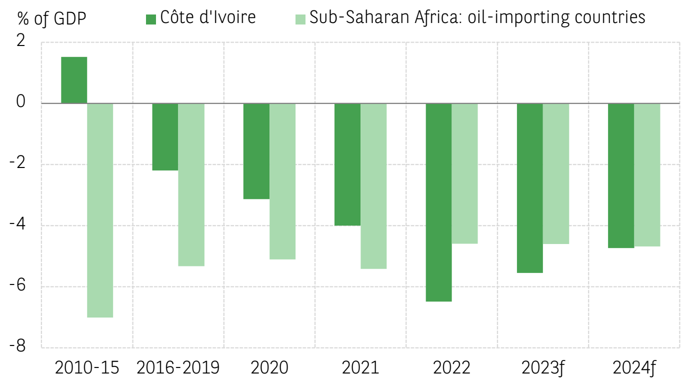

CHART 1

SOURCE: IMF, BNP PARIBAS

As Côte d'Ivoire is the main contributor to the foreign assets of the regional central bank, the BCEAO, the rapid erosion of its external liquidity weakens the solidity of the peg. The regional foreign exchange reserves coverage ratio therefore decreased from 5.6 months of imports at the end of 2021 to 4.5 months at the end of 2022, which corresponds to the low tranche of the comfort threshold for this monetary zone according to the IMF. However, thanks to strong support from official donors to most Member States and the gradual dissipation of the terms-of-trade shock, this ratio is expected to stabilise in the next 2 or 3 years.

PUBLIC FINANCES: TRICKY CONSOLIDATION AHEAD

Support from official creditors will also be key for public finances, but this will require a consolidation effort that could be difficult to apply.

In fact, the budget deficit reached 6.8% of GDP in 2022, 2 points higher than in 2021 and more than triple its 2019 level (Figure 2). Compared to its African peers, Côte d'Ivoire is therefore posting one of the most significant downturns in public finances since the pandemic. The country has also seen one of the most marked increases in debt: from 38% of GDP in 2019, government debt rose to 56.7% of GDP in 2022. This has led to an increase in interest payments, which now absorb 15% of revenue compared with less than 11% in 2019. However, debt remains well below the regional norm of 70%. In addition, its profile is favourable. More than 90% of debt is fixed-rate and average maturity remains long (7.5 years). Despite the high proportion of external debt (61%), foreign exchange risk is also contained since only 15% of debt is denominated in a currency other than the CFA franc or the euro. Furthermore, the next peak in Eurobond amortization is not expected before 2028.

Debt sustainability is therefore not threatened, but its rise must be halted. Positives: financing strategy now favours concessional or semi-concessional resources. In fact, despite the appetite of local and regional investors for Ivorian debt, conditions have deteriorated, due in particular to the tightening of BCEAO monetary policy (four key rate hikes since June 2022 to 3% for a cumulative total of 100 bp). Continuing to make extensive use of financing on the domestic and regional markets, as seen in 2022, would therefore risk of further increasing the burden of debt interest. Also, the government has committed to gradually reducing the budget deficit to 3% of GDP by 2025, which would allow debt to be contained below 60% of GDP.

The government's credibility in terms of fiscal policy is quite strong. Over the period 2012-2019, the authorities managed to contain the budget deficit at 2.4% of GDP while more than doubling the public investment total, helped by well-controlled current expenditure. In particular, the public service wage bill was reduced from 42% of tax resources in 2012 to 35% in 2022. Nevertheless, the coming adjustment could be more complex. Although the gradual abolition of measures put in place to deal with the inflationary shock (mainly energy subsidies) could save around 1% of GDP, most of the public finance restructuring programme is based on the rise in budgetary revenues by 2025 by 2.2 percentage points of GDP, of which 1.1% by 2023. This is a huge challenge. The tax base of the Ivorian economy is actually one of the narrowest in the region (less than 13% of GDP) and its level has only increased slightly since 2012 (+1.2% of GDP). In addition, 40% of revenue comes from tax on foreign trade. Revenue is therefore also vulnerable to fluctuations in commodity prices.

ECONOMIC GROWTH: STRONG PROSPECTS BUT UNDER CONSTRAINTS

The capacity of the Ivorian economy to maintain such a strong growth trajectory for the long term was already being queried before the succession of shocks that have occurred since 2020. And this question is even more relevant today.

Support from the public authorities has been a key factor in the good growth figures seen in recent years, and more specifically in 2022. Côte d'Ivoire was relatively protected from the shock to global commodity prices thanks to the measures put in place by the authorities. As a result, inflation reached 5.2% last year compared with 7.4% on average within UEMOA and 13.1% for African oil-importing countries. Domestic consumption therefore remained robust, up 4.5%, in line with the momentum seen in 2020 and 2021. Above all, investment posted an increase of almost 20%, more than half of which came from the continuation of large public infrastructure projects. Standing at 9.7% in 2022, the public investment rate has never been higher. After three years of growth of more than 20% on average, its contribution to gross fixed capital formation also reached historic highs: 37% in 2022 compared to 33% in 2020 and 24% in 2015-2019.

CÔTE D'IVOIRE : FISCAL AND DEBT INDICATORS

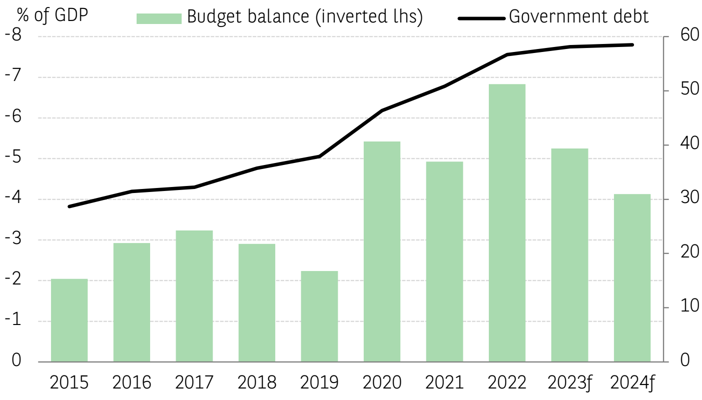

CHART 2 SOURCE: IMF, BNP PARIBAS

A rebalancing of the drivers of investment growth is expected this year. According to the latest government projections, investment should remain robust (+11.8% on average in 2023-2025) but with a 70% contribution from the private sector. Nevertheless, this assumption could prove optimistic despite the many assets of the Ivorian economy (mining, oil, and primary product processing sectors). The government is in fact expecting average growth of 13% in private investment, i.e., more than double the growth prevailing in the period 2015-19. In addition, the need to consolidate public finances questions the authorities' ability to maintain its effort in high levels of public investment (it is supposed to continue to grow to 9.9% of GDP in 2025).

Against this backdrop, the government expects economic activity to accelerate to 7.2% this year, while we expect growth to slow to 6.2%, in line with IMF forecasts. There is a risk of underperformance of tax revenues, which should lead to difficult budgetary trade-off for the Ivorian authorities.

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