# ECOEMERGING

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THE ELECTION OF DONALD TRUMP HAS NOT TRIGGERED ANY MAJOR FINANCIAL TENSIONS IN THE MAIN EMERGING MARKETS. MORE WORRYINGLY, EMERGING ECONOMIES WILL BE THE DIRECT OR COLLATERAL VICTIMS OF THE TRADE WAR PROMISED BY THE INCOMING UNITED STATES ADMINISTRATION.

ECONOMIC RESEARCH

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# VICTIMS OF A LOOMING TRADE WAR

**The election of Donald Trump has not triggered any major financial tensions in the main emerging markets. Nevertheless, the dollar has strengthened, which should delay the easing of monetary policies. More worryingly, emerging economies will be the direct or collateral victims of the trade war promised by the incoming United States administration. They will face a double shock: a sharp slowdown in global trade and the re-routing of Chinese exports. The first shock is bound to be recessionary or even inflationary. The impact of the second is not clear cut as it hinges on the types of Chinese exports (complementary or competing) and, most of all, on their link with direct investment.**

The election of Donald Trump has darkened the outlook for emerging countries. In the very short term, the impact is mainly financial. Since 4 November, the exchange rates of the main emerging countries have depreciated by a median of 1.5% against the dollar, with Central European currencies the hardest hit, in line with the euro's 2.8% depreciation against the dollar, the Chilean and Mexican pesos (both -2.7%), the Thai baht (-3.1%) and the South African rand (-3.6%). Since October, portfolio investment flows from non-residents to the main emerging countries have dried up, with the exception of a few countries that have continued to attract bond investors. However, government bond yields in local currency and CDS spreads have remained stable. If they remain at this level, currency depreciations are unlikely to accelerate inflation again on a long-term basis. But they could delay the easing of monetary policies.

## PROTECTIONIST SPIRAL: A GLOBAL RECESSIONARY EFFECT

More worrying in the short to medium term, the announced increased protectionism in the United States and the risk of retaliatory measures from China and the European Union are reducing the prospects for global growth, and therefore for emerging countries, via the negative impact on international trade. The Trump administration is planning to raise the existing import taxes by 10 percentage points on all products imported from all countries except China, and by 60 percentage points on Chinese products. According to the CEPII, a French center for research and expertise on the world economy[1], if other countries were to apply equivalent import taxes in return[2], the recessionary impact by 2030 (compared with a scenario without increases in tariffs) would be -3.3% on global exports and -0.5% on global GDP. China and the US would obviously be hardest hit with a 1.3% contraction of their GDP. According to a study published by the Peterson Institute for International Economics (PIIE)[3] using a different methodology[4] the negative impact on the US GDP (assuming retaliation by other countries as well) would be in the -0.9%/-1.3% range[5]. The impact would be -1.2% for China (in the China-specific scenario). In the CEPII study, Canada and Mexico, protected by the USMCA, would benefit greatly from the improved price competitiveness of their exports. In the PIIE study, it would be the opposite; the two countries would suffer more from the increase in tariffs than the other countries since they would be hit harder given their large commercial links with the US.

For the rest of the world, the CEPII simulation concludes that the impact would be negative but limited. The impact on India's GDP would be lower than 0.5%. In the PIIE study, against all odds, the impact of countries' GDP is even slightly positive, despite the overall inflationary impact. The authors do not provide explanations in their article. Compared with the CEPII study, the negative impact of protectionism on world trade seems underestimated in our view. The fact remains that a trade war will have a recessionary effect for all countries (to a lesser extent, perhaps, for Canada and Mexico).

## RE-ROUTING OF CHINESE EXPORTS: MIXED EFFECTS …

The fact remains that a trade war triggered by the Trump administration will have a recessionary impact for emerging countries (except, perhaps and to a lesser extent, for Mexico). In addition to this, there are the more specific effects of i/ the re-routing of Chinese exports, independently of the re-routing caused by the trade war with the United States (which is at the core of the CEPII model), as a means of supporting growth held back by domestic demand ii/ the redeployment of Chinese direct investment to circumvent the rise in American import taxes, or simply that of emerging countries themselves in order to protect their domestic markets (as in the case of Brazil, Thailand and Turkey, which are trying to attract Chinese investment in order to protect their domestic electric-vehicle market).

These more specific effects may intensify the overall recessionary effect of a trade war or, on the contrary, mitigate it in the case of direct investment.

The re-routing of exports has been underway since 2018, when American taxes on Chinese products were first raised. As a result, China's share of exports to the United States has fallen from 19% to 14%, while, at the same time, exports to emerging Asia have risen by the same proportion, from 21% to 25%, with Vietnam in particular seeing its share rise from 3.2% to 4.5%. Emerging Asia is the only emerging region which has seen this share increase significantly over the 2017-2024 period. In the other regions, however, there is one exception: Mexico. Mexico's share of China's exports is still low, at 2.5%, but, as with Vietnam, Chinese exports there have grown very strongly (by a factor of 2.5 since 2017).

1 Antoine Bouët & alii « Le prix du protectionnisme de Donald Trump » - La lettre du CEPII - Novembre 2024.
2 Except for Canada and Mexico as the authors assume that these two countries would not face tariff increases under the USMCA.
3 McKibbin & alii : « The international economic implications of a second Trump presidency » - PIIE working paper - September 2024.
4 In the CEPII study, the authors use a multi country multi sector dynamic computable general equilibrium model, mainly designed to simulate commercial policies. A growth model is conjointly used to simulate main macroeconomic variables like GDP, inflation etc. In the PIIE study, the simulation is based on a standard modern international model which is widely used in central banks, international institutions, government agencies for economic and monetary policy evaluation.
5 The authors simulated 2 scenarii: the first one with a universal +10pp increase applied to all countries including China and the second China-specific one with +60pp increase on Chinese products and 0 for other countries' products. As a first estimation, one can add the two impacts even if the upper bound is slightly overestimated.

Mexico and Vietnam are key examples of the re-routing of Chinese exports with the aim of circumventing American taxes and sanctions (in the case of Mexico) and/or simply expanding the export network (in the case of Vietnam, for both reasons). For both these countries, the re-routing of Chinese exports is not negative as it has been accompanied by an increase in FDI. Indeed, Chinese exports are not necessarily in direct competition with locally produced goods, but help to expand the recipient country's production capacity and export base by becoming part of value chains. According to the OECD, both these countries also have the highest Chinese value-added content in their exports (measured by the countries' backward participation index with respect to China) among the main emerging countries.

There is one reservation, however; the re-routing of Chinese exports may create a dependency on imports of "Made in China" products. For emerging countries as a whole, the share of products imported from China that account for more than 50% of total imports rose from 15% in 2019 to 20% in 2022 (this share is stable for developed countries at around 8%).

## ... MORE FAVORABLE TO ASIAN COUNTRIES THAN CENTRAL EUROPEAN COUNTRIES & TÜRKIYE

Which regions and countries would be most affected by the re-routing of Chinese exports? If we take, as a first step, the share of imports from the trading partner (in this case China) in the total imports for finished manufactured products (where Chinese competition is potentially the strongest), Asian countries are the most exposed (with the share ranging from 28% for Malaysia to 48% for Indonesia). On the other hand, these are the countries with the highest backward participation indexes, which means that a significant proportion of imported Chinese products are complementary (as embedded into value chains) rather than competing. For Central European countries and Turkey, the situation is the other way around. The share of Chinese imports is lower than for Asian countries (ranging from 9% for Romania to 27% for the Czech Republic), but so are the backward participation indexes. What's more, Europe, the main destination for their exports, is already a major outlet for Chinese exports, and for products that are a priori competitors (household appliances, cars). In addition, unlike China, these countries have experienced a sharp rise in real wages and have therefore lost out in terms of cost competitiveness. However, Hungary and even the Czech Republic could do well, as their backward participation index is as high as that of some Asian countries, and Chinese direct investment in both these countries is part of a long-term strategy to gain a foothold in the European market. In the other regions, Latin America, Africa and the Middle East, the re-routing of Chinese exports is likely to lead Chinese companies to strengthen their position mainly in the Brazilian market. Finally, Morocco's manufactured exports and, to a lesser extent, those of South Africa (which account for 40% of its total exports) will also be competing with Chinese products.

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# CHINA



## PREPARING FOR BATTLE

**In China, economic policy has taken a firmly expansionary turn since late September. This has given a boost to activity, which is expected to strengthen further in the very short term. However, over 2025 as a whole, economic growth will continue to slow. The constraints weighing on domestic demand persist, as the adjustments in the property sector are not yet complete, private sector confidence remains fragile and households are waiting for conditions in the labour market to improve. In addition, the risks to growth have increased with the election of Donald Trump. China will be able to respond to new US customs barriers in various ways, ranging from retaliatory measures to depreciating its currency and continuing to re-route its trade flows. Moreover, the authorities are ready to continue to ease their monetary and fiscal policies.**

## A SLIGHT GROWTH ACCELERATION IS UNDERWAY

In Q3 2024, Chinese economic growth accelerated to +0.9% quarter-on-quarter (q/q), after its poor performance in the previous quarter (+0.5% q/q). It stood at +4.8% year-on-year (y/y) in the first three quarters of 2024, and it is expected to reach the target of "around 5%" set by the authorities for this year. This scenario assumes that the series of stimulus measures announced since the final week of September will successfully revitalise activity in services in Q4, thanks to the property market beginning to stabilise and consumer confidence starting to improve. It will not be easy. Yet, over the last two months, the authorities have demonstrated a new resolve to reinvigorate domestic demand, and activity has in fact begun to strengthen.

In services, growth accelerated to +5.1% y/y in September and +6.3% in October, compared with +4.7% on average over the previous four months. This improvement came together with improving retail sales, which were boosted by the launch of sales campaigns and the continuation of government-subsidised "durable consumer goods trade-in" programmes (sales of household appliances leapt up by 39% y/y in October). However, retail sales growth was only +4.5% y/y in real terms in October (after +2.8% y/y on average over the first nine months of 2024), compared with average growth of +7% in the three years prior to the health crisis. In the very short term, the more favourable momentum of private consumption should continue, especially as activity in the property market showed encouraging signs in October. The contraction in sales volumes has almost come to a halt (-1.6% y/y after -12% in Q3 2024 and -20% in H1 2024), pointing to a slight improvement in household sentiment and finally a positive effect from the loosening of prudential rules governing mortgage loans. On the other hand, construction activity (starts and completions) continued to fall in October (by -27% and -20% y/y, respectively).

In the industrial sector, growth accelerated to +5.4% y/y in September after four months of slowdown and stabilised in October (+5.3%). In the very short term, industrial growth could benefit from an improvement in domestic demand, as well as from an increase in export orders in anticipation of the US tariff hikes, expected in 2025. Chinese goods exports rebounded in October, in both volume and value (+12.7% y/y in current USD, after +4.6% y/y on average over the first nine months of 2024), with the average export price still falling (estimated at -4% y/y in Q3).

Investment growth has fallen slightly since the summer compared with H1, standing at +3.4% y/y in value terms over the first ten months of 2024. It was logically driven by investment in manufacturing (+9.3%) and public infrastructure (+4.3%). Meanwhile, the contraction in property investment continued (-10.3%).

FORECASTS

| | 2021 | 2022 | 2023 | 2024f | 2025f |
|---|---|---|---|---|---|
| Real GDP growth, % | 8.4 | 3.0 | 5.2 | 4.9 | 4.5 |
| Inflation, CPI, year average, % | 0.9 | 2.0 | 0.2 | 0.4 | 1.3 |
| Official budget balance / GDP, % | -3.1 | -2.8 | -3.9 | -3.8 | -4.0 |
| Official general government debt / GDP, % | 46.8 | 50.6 | 56.1 | 59.6 | 62.7 |
| Current account balance / GDP, % | 2.0 | 2.5 | 1.4 | 1.5 | 1.4 |
| External debt / GDP, % | 15.4 | 13.7 | 13.8 | 13.6 | 13.3 |
| Forex reserves, USD bn | 3 427 | 3 307 | 3 450 | 3 500 | 3 540 |
| Forex reserves, in months of imports | 13.3 | 12.6 | 13.2 | 12.8 | 12.4 |

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

CHINA: LABOR MARKET CONDITIONS ARE STILL DEGRADED

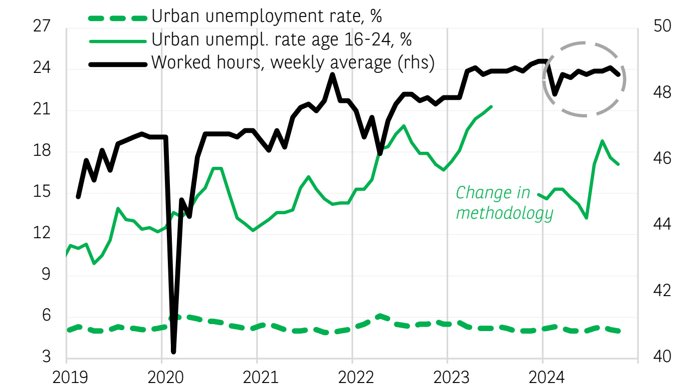


CHART 1 SOURCE: NBS, BNP PARIBAS

## INTERNAL CONSTRAINTS REMAIN

After an acceleration in Q4 2024 and early 2025, economic growth will return to a downward trend. It is expected to stand at +4.5% in 2025 as a whole. The risks to this scenario are high. Domestically, these risks mainly stem from the property crisis and the lasting decline in confidence of households and private investors.

The correction in the property sector is likely to continue, even if the authorities successfully mitigate the crisis by reviving housing demand

and reducing stocks of unsold homes through purchases by local governments. The property market adjustments are far from over, with prices continuing to fall (-8.9% y/y in October for second-hand homes), large stocks of unsold and unfinished homes, and developers still facing serious financial difficulties (the IMF estimates that by mid-2024, around half of them were facing solvency or viability issues).

Private consumption could therefore continue to be depressed by the negative wealth effects linked to the fall in house prices and the impact of the property crisis on household morale and the willingness of households to save. In addition, labour market conditions are still worse than in the pre-Covid years. The average unemployment rate has returned to its 2019 level (it fell to 5% in October), but youth unemployment is still higher. Moreover, the average number of hours worked remains below its long-term trend (*chart 1*), and incomes are growing at a slower pace. Over the first three quarters of 2024, disposable income per capita increased by 4.9% y/y in real terms, compared with the average increase of +6.5% per year recorded in 2017-2019. Against this backdrop, the consumer confidence index has declined since April (standing at 85.7 in September, compared with over 110 before the lockdowns in spring 2022), and its "employment" sub-component hit an all-time low in September (71.3). The household savings rate remains very high; it is estimated to be close to 37% of disposable income, and has not returned to its pre-Covid level (it rose from 34.8% in 2019 to 38.1% in 2020).

Finally, the factors that have adversely affected private-sector confidence and investment since 2020 are likely to persist (private investment was virtually stagnant y/y in the first ten months of 2024). On the one hand, corporate profits have deteriorated due to weak domestic demand and deflationary pressures – producer prices continued to fall (-2.9% y/y in October) and consumer price inflation remained low (+0.3% y/y in October and +0.5% in Q3). On the other hand, political risk and regulatory uncertainties in services remain, while geopolitical risks and trade tensions with the United States are set to intensify.

## EXTERNAL RISKS ARE ON THE RISE

Externally, the main risk to Chinese growth is the rise of protectionism once Trump is inaugurated as President of the United States in January.

Beijing's industrial policy, which has been stepped up in the post-Covid era in order to stimulate economic activity and strengthen national security, has supported the expansion of the manufacturing sector. Helped by public subsidies and a competitive yuan, Chinese exporters have slashed their prices and gained global market share in a wide range of sectors. In recent months, this strategy has already led a growing number of countries to introduce tariff barriers against China. This protectionist drift could worsen considerably in 2025, as Trump has threatened to impose a tariff across-the-board of 10% on imports from all countries and of 60% on imports from China. Since early 2020, the US has been taxing 66% of goods imported from China, with an average tariff rate of 19.3% (compared with 3.1% in early 2018 before the "first trade war" between China and the US).

The direct impact of higher tariffs on Chinese exports, investment and growth will be significant. However, it is difficult to predict what it will be for the time being, as it hinges on the timetable for implementing the new tariffs, their exact scale and the retaliatory measures taken by China and other trading partners. Moreover, the European Union might also increase its trade barriers.

Beijing appears to be preparing for negotiations with Washington to avoid another trade war. However, it is also preparing its response should there be an increase in US tariffs and a slowdown in its exports. China is likely to react in a number of ways: i/ with tariff retaliatory measures

CHINA: THE YUAN IS ALREADY RELATIVELY WEAK

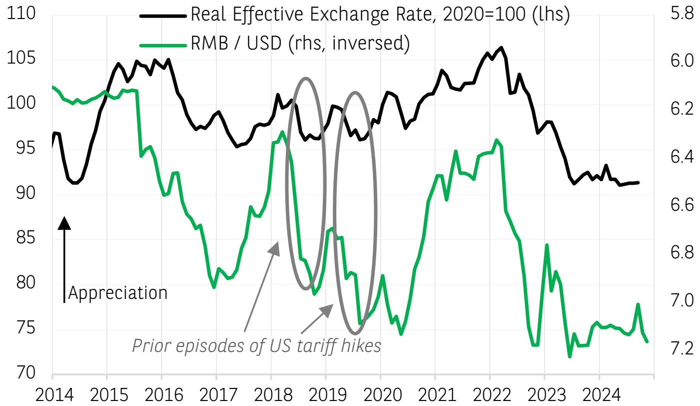


CHART 2 SOURCE: BIS, PBOC, BNP PARIBAS

(its tariff rate on imports of US goods rose from 8% to 21.1% between early 2018 and early 2020, closely following the tariff increase imposed by the US), non-tariff retaliation measures, and new controls on its exports of critical materials; ii/ by allowing the yuan to depreciate, even though the central bank's scope to resort to exchange rate depreciation is more limited than in 2018-2019 (*chart 2*); iii/ by continuing to re-route its trade flows and relocate its production in order to circumvent trade tariffs, offset market losses in the United States and expand its trade relations with political allies; and iv/ by further easing monetary and fiscal policies in order to support domestic demand.

## SUPPORT POLICIES CAN BE FURTHER STRENGTHENED

Since the final week of September, the authorities have stepped up their measures to ease monetary conditions, support the property sector and support equity markets. While the first measures align with the policy easing that had been underway for several months, the support for the stock markets is different and aims to boost the confidence of resident savers and investors.

On the other hand, disappointingly, the authorities have not accompanied their monetary and financial measures with significant direct support for household incomes. However, on 8 November, the central government did confirm the budgetary component of its support program. It is a plan aimed at strengthening local government finances, which will reduce credit risks in the financial sector and improve the ability of local governments to stimulate activity. Beijing is therefore once again increasing the quota of "special bond" issues allocated to local governments, by a total of RMB 10,000 billion, or 7.5% of estimated 2024 GDP, to be spread over the next five years. With these new resources, local governments will have to refinance some of their "hidden" debt, incurred through their financing vehicles. The debt swap should reduce the default risks of these financing vehicles in the short term and alleviate the interest burden for local governments, as they benefit from lower rates on their bond debt. However, refinancing hidden debt of local government financing vehicles with on-balance sheet debt of local governments improves only very partially their overall solvency.

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# HONG KONG



## STILL RECOVERING

**The difficult recovery in economic activity experienced over the past two years reflects all of the constraints on the Hong Kong economy. Monetary policy, which must follow the United States' monetary policy, was restrictive until September 2024, with particularly painful consequences, as inflation in Hong Kong remained moderate and domestic demand, conversely, needed support. The economic cycle is much more in sync with mainland China's economic cycle. In the very short term, economic growth is expected to accelerate, supported by ongoing monetary easing and the expected strengthening of Chinese demand. In the medium term, Hong Kong's prospects hinge on its continued economic and financial integration with mainland China.**

## IN 2024, ACTIVITY ONLY JUST RETURNS TO ITS 2018 LEVEL

In Q3 2024, economic activity was down quarter-on-quarter (-1.1% q/q, seasonally adjusted), after modest growth in Q2 (+0.3% q/q) and a stronger start to the year (+2.5% q/q in Q1). The poorer-than-expected Q3 performance is mainly due to the slowdown in exports of goods and the continued decline in private consumption. Moreover, since the start of the year, activity has been hit by the restrictive monetary and financial conditions and weak domestic demand in China – which in particular has dampened confidence and taken a toll on tourism-related sectors in Hong Kong. This has significantly compounded the difficulties experienced by Hong Kong's economy in recovering from the successive shocks caused by the protest movements in 2019, the institutional change since 2020 and the 2020-2022 pandemic crisis.

Over the first three quarters of 2024, economic growth stood at 2.6% year-on-year (y/y), driven by net exports of goods and investment. Meanwhile, private consumption and net exports of services made negative contributions to real GDP growth (*chart 1*). Assuming that there is a strong acceleration in the final quarter and growth of +2.8% over the entire year, real GDP is expected to only just hit its 2018 level in 2024. Private consumption, investment and trade in goods and services will not have got back to their 2018 levels (in real terms) in 2024, while public spending is expected to be around 25% higher.

## MULTIPLE CONSTRAINTS

Major obstacles have restricted the recovery in domestic demand since the end of the health crisis. First of all, while the government has kept a relatively accommodative fiscal policy stance, monetary and credit conditions have been tightened, in line with the monetary tightening cycle in the United States (as Hong Kong has a currency board system). The Hong Kong policy rate rose from 0.5% in March 2022 to 5.75% in August 2023, and then remained at this historically high level until mid-September 2024 – even though the post-COVID recovery was struggling and inflationary pressures remained very moderate. Annual average consumer price inflation has been close to 2% since 2022.

These very restrictive monetary conditions have affected private consumption and investment through various channels, including the continued decline in bank lending (- 3.6% y/y at end-2023 and - 3.1% y/y in September 2024), the rising debt servicing burden for households and companies, and the falling value of property and financial assets (*chart 2*). In September 2024, the volume of property transactions (over a 12-month cumulative period) was 40% below its 2021 level, and average house prices were down 27% compared to the end of 2021 (and down 13% y/y). What's more, the negative wealth effects of these falling house prices were compounded by the stock market correction, as the Hang Seng index lost 22% between December 2021 and September 2024 (but has rebounded recently).

Domestic demand, the property sector and financial markets have also been penalised by the low level of confidence among residents and foreign investors, the contagion effects of the property crisis in China (particularly via the financial difficulties of property developers) and the weak demand of Chinese consumers. The number of tourists visiting the territory (8 out of 10 come from China) has recovered slowly since 2022 and was still 30% below its Q3 2018 level in Q3 2024.

FORECASTS

| | 2021 | 2022 | 2023 | 2024e | 2025e |
|---|---|---|---|---|---|
| Real GDP growth, % | 6.5 | -3.7 | 3.3 | 2.8 | 2.7 |
| Inflation, CPI, year average, % | 1.6 | 1.9 | 2.1 | 1.9 | 2.2 |
| Budget balance / GDP, % (1) | 0.0 | -6.6 | -5.7 | -5.5 | -5.0 |
| Government debt / GDP, % | 5.9 | 7.8 | 8.2 | 7.0 | 8.2 |
| Current account balance / GDP, % | 11.8 | 10.2 | 9.1 | 10.6 | 8.6 |
| Forex reserves, USD bn | 497 | 424 | 426 | 423 | 420 |
| Forex reserves, in months of retained imports | 47.7 | 42.6 | 38.3 | 38.3 | 37.0 |

** 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

HONG KONG: CONTRIBUTION TO REAL GDP GROWTH

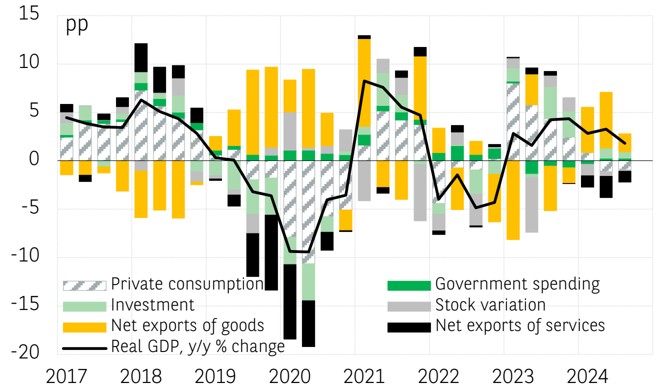


CHART 1 SOURCE: CENSUS AND STATISTICS DEPARTMENT, BNP PARIBAS

This is largely due to the cautious attitude of Chinese households and the appreciation of the HKD against the RMB from spring 2022 to summer 2024. Conversely, outbound tourist numbers from the Hong Kong territory have been above their 2018-2019 level since last summer. Overall, Hong Kong retail sales have posted a very fragile recovery since 2022 (more than a third of retail sales came from tourist spending in 2018). Over the first nine months of 2024, they tumbled even further (-9% y/y in volume terms) and were still 30% below their 2018 level.

In addition, as Hong Kong is a transit and re-export hub for goods (re-exports account for 99% of its exports and 92% of its imports), its foreign trade activity is affected by fluctuations in global demand and trade flows to and from mainland China (which accounts for 56% of its exports and 44% of its imports). As a result, after falling in 2023, the contribution of net foreign trade in goods has recovered, buoyed by the strong exports from China and other industrialised Asian countries in the early months of 2024. However, it declined during the summer, and this trend could continue in the short term, against a backdrop of rising customs barriers.

HONG KONG: MONETARY CONDITIONS AND ASSET PRICES

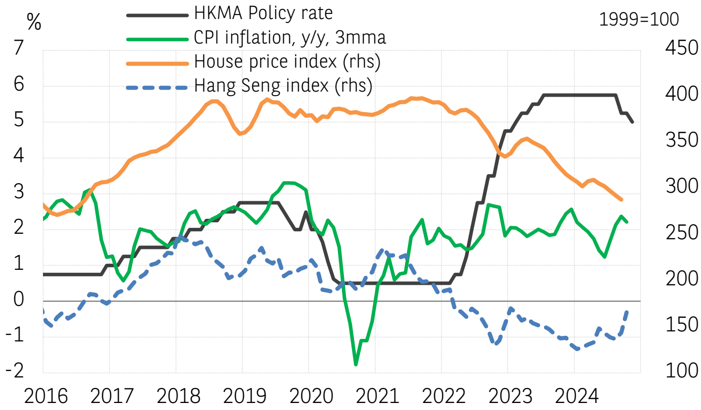


CHART 2 SOURCE: HKMA, CSD, BNP PARIBAS

## AN ONGOING MONETARY CYCLE CHANGE

Conversely, domestic demand and exports of services may increase slightly in the coming quarters. On the one hand, economic policy will become more accommodative. On the monetary side, an easing cycle started in mid-September and will continue at the pace set by the US Federal Reserve: the policy rate was cut to 5% on 8 November and further cuts are expected by the end of 2025. On the fiscal side, the government is seemingly opting to delay the adjustment process and maintain a moderately supportive policy. Last month, the authorities also announced a further easing of prudential rules to boost demand for loans and housing.

On the other hand, tourism-related activities could benefit from renewed interest among Chinese consumers, provided that their confidence is strengthened by the new support measures implemented by Beijing, and that the Chinese yuan appreciates against the US dollar and the HKD. However, the yuan appreciation seen in August-September has stalled, and it is uncertain in the short term given the inflationary risk of the measures proposed by Trump and the risk of new trade tensions between the US and China.

## A FUTURE BOUND UP WITH MAINLAND CHINA

There are therefore high downside risks to our short-term economic growth forecast (2.7% in 2025). In the medium term, we expect real GDP growth of 2.4% per year on average (2026-2029), compared to 2.8% per year over the 2014-2018 period. Growth prospects are still being supported by Hong Kong's solid macroeconomic fundamentals: external accounts and public finances are robust, and large foreign exchange reserves and fiscal reserves provide the authorities with a strong financial capacity to tackle any economic difficulties, support the territory's development and address structural challenges (such as improving the social security system and housing supply, adapting to climate change and the low-carbon transition). Hong Kong also has a strong and well-regulated financial system and competitive service sectors.

However, a number of factors are impairing the potential growth of Hong Kong's economy. Firstly, there are demographic trends: the population is ageing (the proportion of the population above 65 years old has risen from 17% in 2018 to 22.8%, with Hong Kong becoming a "super-aged" society); the working-age population fell to 5.06 million individuals in mid-2024 (-5.2% since 2018), i.e. 67.2% of the total population; and talent is leaving the territory (due to emigration of residents and relocations of headquarters of multinational companies).

Secondly, the institutional change since 2020, the increased political risk and the loss of the Hong Kong Special Administrative Region's "geopolitical neutrality" are dampening confidence among local and foreign investors. This has contributed to the difficult recovery in investment following the 2019-2020 and 2022 periods of contraction (in real terms, investment will be around 10% below its 2018 level in 2024). The investment ratio plummeted to 15.8% of GDP in H1 2024, compared to 21.6% in 2016-2018, which does not augur well for future economic growth. In addition, perceptions of a deteriorating doing business environment could weaken the bases of Hong Kong's success as an international trade and financial hub, built on the free movement of goods and capital and a stable and transparent legal and regulatory framework. Hong Kong is one of the five main global financial centres, but its finance and insurance sector (the economy's largest sector, accounting for 21% of GDP) has been contracting for two years.

Hong Kong is likely to continue to play a crucial role as a services hub and a financial centre, becoming even more focused on China's needs. Firstly, Hong Kong plays a key role in internationalising the RMB; it is the main offshore RMB liquidity pool and the main offshore RMB transaction centre (handling more than 70% of RMB SWIFT payments). Moreover, Hong Kong is a major financing hub for Chinese companies (which account for more than ¾ of its market capitalisation). Finally, the rising number of "connect schemes" over the past decade has made financial transactions and portfolio investment flows between mainland China and Hong Kong easier. In addition, Hong Kong is still the transit point for 60% of total direct investment (DI) flows to and from mainland China. This role could grow going forward: while DI flows into China have been declining since 2022, Chinese companies are expected to increase their direct investments in the rest of the world.

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# INDIA



## STRONG GROWTH, BUT INDIA CANNOT REPLACE CHINA

**Indian economic growth slowed in the first quarter of the current fiscal year and leading indicators suggest that it will stand at 6.9% over the fiscal year as a whole (vs. 8.2% last year). There are a number of risks to GDP growth, but they remain moderate. Apart from rising inflationary pressures, which could delay the expected monetary easing in December, the slowdown in foreign demand is the main risk. Weakening Chinese demand, in particular, may hinder the development of India's manufacturing sector, which is already undersized due to competition from Chinese consumer and capital goods at increasingly competitive prices. While India's growth is the highest among emerging countries, it clearly cannot supplant China as the engine of global growth. Instead, thanks to its growing population, it can provide opportunities for international companies. We are already seeing significant changes in household consumption patterns, with a shift towards durable consumer goods.**

## GROWTH SLOWS DOWN BUT REMAINS STRONG

In the first quarter of the fiscal year (FY) 2024/2025 (April-June 2024), economic growth stood at 6.7% year-on-year (y/y), down 1.1 points on the January-March figure, as a result of a decline in net taxes and lower public spending. Nevertheless, household consumption rebounded (boosted by easing inflationary pressures) and total investment remained solid. Net exports contributed positively to growth for the second consecutive quarter as a result of slowing imports.

Even though economic activity indicators for the second quarter confirm that growth is continuing to slow down, the growth outlook for the entire FY2024/2025 is still favourable. Despite slowing from last year (and from the average of 7.4% during the 2014-2019 period), growth is expected to stand at 6.9%, the highest level among emerging countries. Household consumption (57.2% of GDP on average over the past five years) should remain steady thanks to rural household demand rebounding (due to a favourable monsoon). On the other hand, investment momentum is likely to wane. Although the financial position of companies has strengthened in recent years and production capacity utilisation rates remain above their long-term average, business lending has slowed. Real interest rates on new loans have increased by 490 basis points (bps) since mid-2022. In addition, data published by the Ministry of Finance suggest that public investment fell over the first five months of the current fiscal year (-13% y/y), compared to the same period last year. The government would need to increase its investment very significantly over the rest of the year (+41%) in order to achieve its target of increasing public investment to 3.4% of GDP.

Exports have also started to contract (from July onwards) and no improvement is expected by the end of the year. Changes in external demand pose a risk to short-term growth, despite India being less vulnerable to the external environment than other Asian countries, in view of its limited integration into global trade. Due to the structure of its trade relations and the sources of its foreign investment, India is more exposed to a slowdown in the United States than in China (its exports to the United States and China account for 17.6% and 3.8% of its exports, respectively). However, competition from Chinese consumer and capital goods at increasingly competitive prices could not only hinder the development of India's manufacturing sector, which is already not large enough to meet employment needs, but could also increase the dependence of India's economy on its big neighbour. In addition, the inclusion of sovereign bonds in emerging market indices

**FORECASTS**

| | 2021 | 2022 | 2023 | 2024e | 2025e |
|---|---|---|---|---|---|
| Real GDP growth, % (1) | 9.7 | 7.0 | 8.2 | 6.9 | 6.7 |
| Inflation, CPI, year average, % (1) | 5.5 | 6.7 | 5.4 | 4.7 | 4.3 |
| General gov. balance / GDP, % (1) | -9.5 | -9.6 | -8.5 | -7.9 | -7.5 |
| General gov. debt / GDP, % (1) | 85.2 | 84.8 | 82.5 | 83.9 | 83.7 |
| Current account balance / GDP, % (1) | -1.2 | -2.0 | -0.7 | -1.1 | -1.2 |
| External debt / GDP, % (1) | 19.7 | 18.4 | 18.7 | 19.0 | 18.5 |
| Forex reserves, USD bn | 618 | 562 | 623 | 678 | 721 |
| Forex reserves, in months of imports | 7.9 | 6.7 | 8.6 | 8.1 | 8.5 |

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

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

**INDIA: ECONOMIC SLOWDOWN**

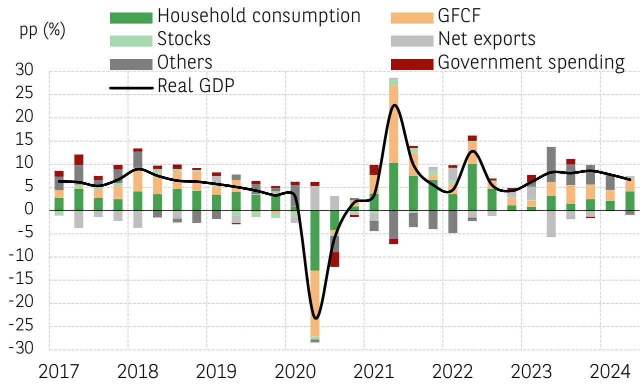


CHART 1 SOURCE: CEIC, BNP PARIBAS

(since June 2024 in the JP Morgan index and from September 2025 for the FTSE Russell EMGBI) could increase the country's vulnerability to an external financial shock. However, this risk will be partially mitigated by a maximum cap of 6% of the total debt on ownership of government bonds by foreigners.

In the medium term, growth is expected to remain at between 6.5% and 7% thanks to buoyant services and the tax incentive programmes adopted by the government since 2020, which should benefit the manufacturing sector.

## LIMITED EFFECT OF THE UPCOMING MONETARY EASING

Inflation accelerated significantly in October (+6.2% y/y), due to unfavourable base effects and the sharp rise in food prices (+10.9%). Inflationary pressures are expected to slow in Q1 2025 thanks to the good harvests, but risks remain on the upside due to highly volatile food prices. Over the entire fiscal year, inflation is expected to stand at 4.7% (with a target of 4% +/- 2 pp), which should enable the Reserve Bank of India (RBI) to make a first rate cut by the first quarter of 2025. However, the timing and scale of its monetary easing hinge on the U.S. Federal Reserve's approach to this. As things stand, a cumulative cut in RBI key interest rates of 75 bps is the most likely scenario (the "neutral" real repo rate would be between 1.4% and 1.9%, according to the RBI), but an easing of just 50 bps (in total) cannot be ruled out. Either way, even a cut of 75 bps would not put downward pressure on the rupee, as the rate spread with the United States would be bigger than it is currently (assuming that the Fed cuts its rates to 3.25%-3.5% by mid-2025).
However, the effect of such monetary easing will be limited, as monetary policy is still not fully transmitting to the economy. The hike in key interest rates (+250 bps between mid-2022 and early 2023) has led to an increase in interest rates on new loans of just 169 bps. In addition, recent changes in the composition of household savings (shifting away from bank deposits and towards savings products with better interest rates) are distorting things even further. Liquidity pressures have increased and banks could be less inclined to make more credit available.

## PUBLIC FINANCES: LIMITED ROOM FOR MANOEUVRE

Public finances are still the weak spot in the economy. Debt remains high (nearly 84% of GDP) and, even though the refinancing risk is low, the government has little fiscal room for manoeuvre to support growth and meet the country's very substantial equipment and infrastructure needs. Although the deficit of the government and all administrations is falling, it is still close to 8% of GDP, and the interest paid on the debt is absorbing nearly 38% of budget revenue. However, since 2021/2022, the government has chosen to slow down the pace of its fiscal consolidation so that it can increase its investment spending.

## INDIA IS NOT CHINA...

India is currently in no position to supplant China as the engine of global growth. Over the past five years (excluding the pandemic period), its contribution to global growth has been less than half of China's. It has neither the industrial capacity nor the income to become an economic power to rival China. However, its domestic market, although still small, is growing.
India's contribution to global trade is low (1.9% of global goods exports and 4.5% of services exports, whereas Chinese exports accounted for 14.5% of global goods exports and 5% of services exports in 2023) and its imports are still small. It is the seventh largest importer in the world (2.9% of total global imports), far behind the United States, China and Germany.
Although its primary energy consumption has increased by 51% over the last ten years, it is still much lower than China's (22.7% of China's consumption), according to the latest data from the Statistical Review of World Energy. This is because its manufacturing sector is still small (17.3% of GDP) and investment,

INDIA: CPI AND MONETARY POLICY

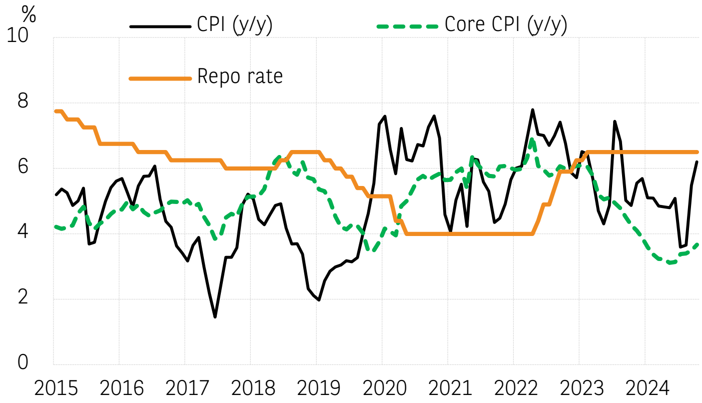


CHART 2 SOURCE: CEIC, RBI

particularly in industry, infrastructure and real estate, which are energy-consuming sectors, remains modest. India's current energy consumption is comparable to China's twenty years ago. Therefore, unless India successfully manages to develop its industry very rapidly and step up its urbanisation, it currently seems unlikely that the country will become as big a consumer of commodities as China over the next ten years. Even if its primary energy consumption doubled (as has been the case in Vietnam over the past ten years, alongside the development of its industry), it would still be less than half of China's current consumption.
Indian household consumption cannot be likened to China's (3.2 times lower), as its level of GDP per capita at PPP is still 2.5 times lower. However, it is by no means small (nearly USD 2.2 billion in 2023), and is similar to Japan's (which was down 4.2% in 2023). It has increased by an annual average of 5.7% in volume terms over the past ten years. This reflects the population growth (+1% per year), but also the emergence of an upper-middle class. According to Euromonitor, 119 million Indians (11% of the population over the age of 15) had an annual income of more than USD 5,000 in 2023 (compared to 37 million in 2010), with 40 million earning an income of more than USD 10,000 per year. In addition, according to data from the World Inequality Database, 1% of the adult Indian population (more than 9 million Indians) had an average annual income of over USD 60,000 in 2022. As a result, India is seeing the emergence of a population with the income to purchase capital goods and vehicles.
The latest survey on household consumption patterns reflects this rising purchasing power. The portion of the consumer basket for non-food items has increased by nearly nine percentage points in twenty years to account for nearly 61% of their consumer basket, while durable consumer goods (such as cars) accounted for 7.2% of urban household purchases in 2022/2023 (compared to 5.6% ten years earlier). The development potential of the car market is reflected in the foreign direct investment trends. Alongside construction, chemicals and renewables, it receives some of the highest levels of FDI among India's industrial sectors.

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# MALAYSIA



## AN ECONOMY HIGHLY VULNERABLE TO THE SLOWDOWN IN CHINA

**Economic growth remains solid, but it is expected to slow down in 2025. Due to its very open economy, Malaysia is more vulnerable to the slowdown in China than India or Indonesia. In addition, tensions between the United States and China could make it more complicated to implement its New Industrial Master Plan, a key pillar in the country's efforts to revitalise growth. The authorities have limited room for manoeuvre in order to support the economy. The Central Bank of Malaysia is expected to leave its key interest rates unchanged over the next six months, unlike other central banks in Asia. Inflation risks are on the upside due to the abolition of energy subsidies and wage increases. In addition, fiscal consolidation, which began two years ago, is hurting investment spending.**

### EXPECTATIONS OF LOWER GROWTH

Malaysia is the emerging Asian country with the highest levels of income (2.5 times the GDP per capita of Indonesia and 1.6 times the GDP per capita of China and Thailand at purchasing power parity), but it has not yet entered the "high income" country category. It may never manage this if it does not successfully speed up the pace of its economic growth, which started to slow down well before the pandemic (from 5.8% over the 2010-2014 period to 4.9% over the 2015-2019 period). Unlike other Asian countries, such as India or Indonesia, Malaysia's growth is structurally more dependent on exports than domestic consumption. However, the country is facing foreign competition, particularly from Vietnam, which has seen its global market share increase over the last ten years, while its own share has virtually stagnated at 1.3%.

As a result, in order to stimulate growth, particularly in the manufacturing sector, the government has adopted the New Industrial Master Plan 2030 (NIMP 2030), which aims to increase its integration into global value chains, particularly in the microelectronics sectors, and to establish itself as a key player in high-value added green technologies. However, implementing this programme could be difficult given its limited fiscal room for manoeuvre. As things stand, according to the latest IMF forecasts, Malaysia's growth is set to slow over the next five years to 3.9% on average per year.

Over the first nine months of 2024, real GDP growth stood at 5.1% y/y (vs. 2.9% in 2023) and is expected to remain at this same level over the year as a whole (vs. 3.6% in 2023). Activity has been buoyed by dynamic household consumption, driven by the strong labour market (the unemployment rate fell to 3.2% in August, slightly below the level prior to the pandemic), wage increases (+5.6% y/y in June 2024 for the median wage), and control of inflationary pressures (1.8% y/y over the first nine months of the year). Investment accelerated and net exports started to make a positive contribution to growth again during the second quarter, due to, in particular, recovering exports of electrical and electronic products, reflecting the upturn in the global electronics cycle.

In 2025, growth is expected to slow. Fiscal policy will be more restrictive and household consumption is likely to slow down as the strong momentum in the labour market is expected to peter out. Growth is expected to stand at between 4% and 4.5% according to the Ministry of Finance's forecasts, which is higher than in Thailand but lower than the other ASEAN countries. The risks to growth remain on the upside. The country is vulnerable to a global economic slowdown, a commodity-price shock and a downturn in the electronics market all at the same time.

**FORECASTS**

| | 2021 | 2022 | 2023 | 2024e | 2025e |
|---|---|---|---|---|---|
| Real GDP growth, % | 3.3 | 8.9 | 3.6 | 5.1 | 4.5 |
| Inflation, CPI, year average, % | 2.5 | 3.4 | 2.5 | 2.0 | 2.8 |
| General gov. balance / GDP, % | -6.4 | -5.6 | -5.0 | -4.4 | -3.9 |
| General gov. debt / GDP, % | 63.3 | 60.2 | 64.3 | 63.9 | 63.4 |
| Current account balance / GDP, % | 3.9 | 3.2 | 1.5 | 1.8 | 2.0 |
| External debt / GDP, % | 70.0 | 63.9 | 68.2 | 70.8 | 71.1 |
| Forex reserves, USD bn | 104 | 103 | 101 | 107 | 103 |
| Forex reserves, in months of imports | 5.7 | 4.6 | 4.5 | 4.9 | 4.8 |

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

**MALAYSIA: EXPORT REBOUND (VOLUME)**

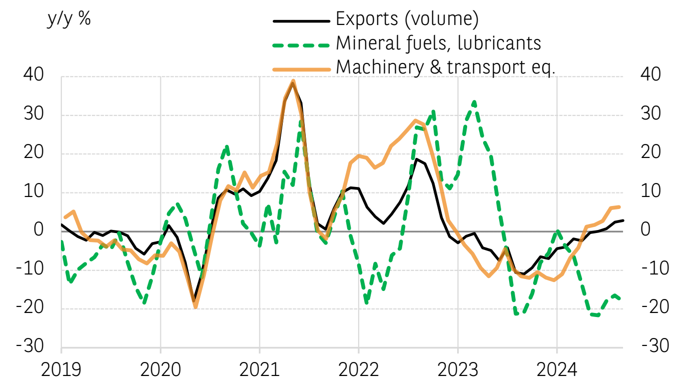


CHART 1

SOURCE: CEIC, BNM, BNP PARIBAS

### NO MONETARY EASING IN SIGHT

Unlike other central banks in Asia, the Central Bank of Malaysia (*Bank Negara Malaysia*, BNM) has, for the time being, kept its key interest rates unchanged. It seems unlikely that it will relax its monetary policy over the next six months, as its growth is robust.

In addition, even though inflation is under control, risks are on the upside due to government policy changes. In its 2025 budget, the government stated that subsidies on petrol prices (RON 95) would be fully phased out by mid-2025. In addition, the wages of civil servants will be increased in December 2024 and January 2025 (with the total increase ranging from 7% to 15% depending on the pay grade), as well as the minimum wage for the private sector (+13.3%). This measure will buoy domestic demand but could increase inflation, which is set to stand at between 2% and 3.5% in 2025, according to the Ministry of Finance.

## CONTINUED FISCAL CONSOLIDATION

In the budget approved by Parliament in October, the government plans to continue its fiscal consolidation. Although still above its 2019 level, its fiscal deficit is expected to fall from 4.3% of GDP this year to 3.8% of GDP next year, and its primary deficit is expected to decrease by 0.5 pp to 1.2% of GDP. Its expected budget revenue is slightly down on this year (-0.1 pp to 16.1% of GDP) and is set to remain 2.4 percentage points (pp) below the 2019 level. The government refuses to reintroduce the tax on goods and services that had been abolished in 2018 and revenue from oil and gas activity is expected to fall. The reduction in public spending, thanks to the abolition of subsidies, will be used to reduce the fiscal deficit and not to increase investment spending, which will fall to 4.1% of GDP.

Federal debt is expected to remain stable at around 64% of GDP. Debt interest payments should absorb 15.6% of revenue. In the medium term, the government reaffirmed its commitment to bringing down the deficit and debt to 3% and 60% of GDP, respectively.

## HIGH VULNERABILITY TO CHINA'S SLOWDOWN

Malaysia is vulnerable to the economic slowdown in China. According to estimates by the Malaysian bank UOB, a drop in Chinese growth of 1 pp would result in a fall in Malaysian growth of between 0.3 pp and 0.5 pp. The slowdown in China is being adversely felt through three channels: i) trade flows (the most prominent transmission channel) and commodity prices, ii) the influx of tourists, and, to a lesser extent, iii) foreign direct investment (FDI).

Malaysia is more integrated into global trade than other ASEAN countries, with exports accounting for 68.6% of GDP (on average over the last five years). In addition, it has become much more vulnerable to global economic cycles, as the concentration of its exports per product has increased since 2016. Apart from Hong Kong and Taiwan, Malaysia is the Asian country with the highest concentration per product. China is its main supplier and second largest export market (13.5% of its exports in 2023), behind Singapore but ahead of the United States. Malaysia mainly exports electrical and electronic products (38.4% of its exports), particularly to China (14.9% of the total), as well as hydrocarbons (which make up 10.5% of its exports to China). Although still modest, its market share in China has increased since 2017 (+1 pp to 4% of total Chinese imports), particularly on sales of electronic products (excluding parts), aluminium, copper and refined oil. However, unlike other Asian countries (such as Vietnam, Taiwan and South Korea), Malaysia has failed to capitalise on the trade frictions between China and the United States to increase its market share on American soil. Since 2017, its market share in the United States has actually fallen slightly, dropping by 0.1 pp to just 1.5% in 2023 (while Vietnam's market share has increased by 1.7 pp to 3.8%). Slower growth in China has already led to a drop in Malaysia's exports over the first nine months of 2024 (-1.9%), particularly its machinery and transport equipment exports (-10.4%).

MALAYSIA: EXPORTS BY COUNTRY

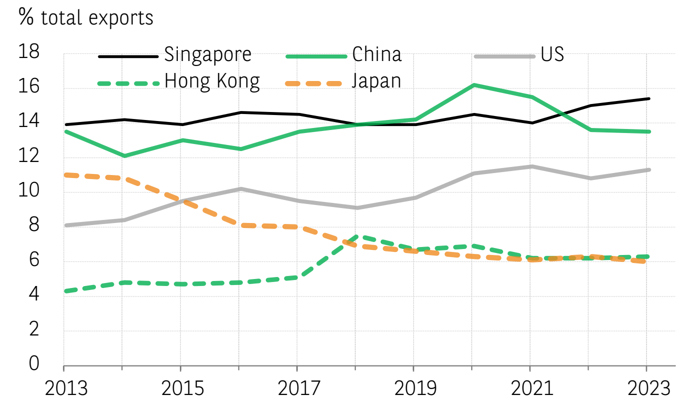


CHART 2 SOURCE: CEIC, BNM, BNP PARIBAS

If the economic slowdown in China was to continue, it could also result in falling commodity prices that would adversely affect not only Malaysia's external accounts, but also its public finances. Commodity exports accounted for 31.4% of its exports in 2023 and income from oil activity is still expected to account for nearly 16% of its fiscal revenue in 2025 (2.7% of GDP). At the end of October, the increase in metal prices in year-on-year terms continued (excluding nickel), but the international price of crude oil was almost 16% lower y/y. The fiscal slippage risks are still currently under control, as budgetary assumptions are fairly conservative (the Ministry of Finance forecasts an oil price of between USD 75 and USD 80 per barrel).

The second channel through which the slowdown in China could adversely affect Malaysia is tourism, with revenues standing at 6% of GDP before the pandemic. In 2019, Chinese tourists accounted for 18% of total tourism revenue, but, in 2023, this revenue was still 5.7 pp below pre-pandemic levels and no rebound is expected in the short term. Household confidence in China is still low and tourist arrivals fell sharply in September.

Finally, in relation to the investment channel, although Chinese FDI has been on the rise since 2021, it is still modest (3.7% of FDI received by the country in 2023) compared to investments from other Asian countries (FDI from Singapore, Hong Kong and Japan accounted for 21.3%, 10.9% and 9.9% of net FDI received by Malaysia in 2023, respectively) and the United States (11.5% of the total). In addition, although the Malaysian government is considering greater cooperation with other Asian economies, particularly with China under the NIMP 2030 plan, its plans could be constrained by geopolitical pressures between China and the United States. This is because the US government could ban its companies from investing in countries where China has businesses operating in order to circumvent restrictive measures.

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# BRAZIL

## LOOKING FOR BALANCE

**Brazil's macro-financial portrait is one of striking contrasts: on the one hand, unemployment is at an all-time low, external accounts exhibit a notable resilience, and economic growth continues to outperform expectations as it draws on multiple levers ; On the other hand, the currency has continued to weaken, residents have increased their holdings abroad, and risk premiums have widened – as defiant markets call for additional measures to curb public spending. The Central Bank – bucking the global trend – has initiated a phase of monetary tightening in response to rising inflation. The latter has witnessed upward pressures on both the supply and demand side in recent months. Looking forward, the trade-off between fiscal consolidation and social support will be undoubtedly difficult for authorities, especially as growth is set to slow in 2025. Economic policy is indeed anticipated to be less supportive, and the projected softening of Chinese demand should affect Brazil through various channels. For the government, the results of the last municipal elections highlight the low political dividends associated with an overall favourable economic record.**

## ECONOMIC GROWTH: A MULTIPLICITY OF LEVERS

The Brazilian economy continues to defy expectations. Economic growth picked up speed in Q2 2024, rising by 1.4% q/q despite initial concerns of significant output losses due to flooding in southern parts of the country in April and May. Q1 growth prints were meanwhile revised upwards (1% q/q vs. 0.8% previously). Despite some signs of slowing down in both July and August, activity indicators available for the second half of the year have overall displayed positive tilts. Agricultural output is also anticipated to hold up better than initially expected. Although credit growth in real terms has been slowing since the summer, it still outpaces the rate of growth of the economy (+5.8% on average in Q3). Real GDP is expected to grow by just over 3% this year – in line with its annual average since the beginning of 2022, but well above potential growth estimates (1.5% to 2%).

The economy has benefitted from a diverse range of growth drivers over the past couple of years: industry in Q2, services in Q1 and agriculture in 2023 – when looking at the supply side of the economy; on the demand side, investment (including changes in inventories) drove growth in Q2 (vs private consumption in Q1) ; in 2023, external demand fueled the economy. The multiplicity of growth sources enhances the economy's resilience to sectoral fluctuations and to slowdowns in Brazil's main export markets (China, the United States, the EU, Argentina).

FORECASTS

| | 2021 | 2022 | 2023 | 2024e | 2025e |
|---|---|---|---|---|---|
| Real GDP growth, % | 5.1 | 3.1 | 2.9 | 3.1 | 2.0 |
| Inflation, CPI, year average, % | 8.3 | 9.3 | 4.6 | 4.4 | 4.2 |
| Fiscal balance / GDP, % | -4.3 | -4.6 | -8.9 | -7.2 | -7.6 |
| Gross public debt / GDP, % | 77 | 72 | 74 | 79 | 81 |
| Current account balance / GDP, % | -2.8 | -2.9 | -1.3 | -2.2 | -2.0 |
| External debt / GDP, % | 42 | 36 | 34 | 36 | 37 |
| Forex reserves, USD bn | 362 | 324 | 355 | 360 | 362 |
| Forex reserves, in months of imports | 14 | 11 | 12 | 11 | 12 |

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

BRAZIL : LABOR MARKET DYNAMICS

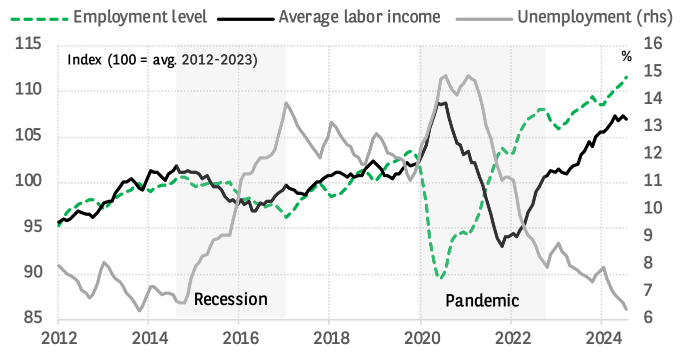


CHART 1

SOURCE: IBGE, BNP PARIBAS

## MONETARY POLICY: GOING AGAINST THE GRAIN

In addition to the appointment of Gabriel Galipolo as the new Central Bank governor, set to take office on January 1st, 2025, September was primarily marked by the BCB's monetary policy U-turn. The authorities tightened policy – a first in two years – hiking rates twice by 25 bps and 50 bps, bringing the SELIC policy rate back up to 11.25%. This decision – which diverges from the global trend and contributes to keeping Brazilian monetary policy in restrictive territory[1] – followed the rise of inflation in recent months closer to the upper limit of the target (3% +/- 1.5 pp). Several determinants have contributed to the resurgence of inflation since April: i/ macro-financial pressures (record low unemployment, fiscal stimulus, currency depreciation, drift in inflation expectations), ii/ regulatory changes (increase in gasoline prices controlled by Petrobras) and iii/ climatic events (severe droughts in northern and central-western regions[2] impacted electricity production, while fires and floods in southern regions disrupted agricultural output and supply chains).

A positive output gap and tensions in the labour market continue to be important points of attention for the BCB (unemployment reached a historical low in September at 6.4% and strong labour demand is driving wage growth upward). In the absence of labour productivity gains, rising wages risk feeding into consumer prices through higher production costs. The rise of the US dollar, following the election of Donald Trump, is also a source of concern for authorities.

1 The *ex-ante* real rate (adjusted by 12-months inflation expectations) is close to 7.2%, above the BCB's neutral rate estimate of 4.75%.
2 The country's energy matrix relies on hydroelectric power for about 65% of its electricity generation. While a strength from an energy transition perspective, it can be a source of vulnerability from the perspective of inflation as dam reserves tend to be highly sensitive to droughts, with adverse consequences on electricity prices.

In its communications, the BCB has not provided clear guidance on the pace of monetary tightening it envisions. Initially, markets expected an aggressive tightening cycle, betting on nearly 275 basis points of cumulative rate hikes by May 2025. These expectations, however, have since been tempered.

## PUBLIC ACCOUNTS: DEALING WITH DEFIANT MARKETS

The solid economic performance in the first half of the year alongside Moody's upgrade of Brazil's sovereign credit rating (now just one notch below investment grade) were insufficient to quell market concerns about fiscal risks. Local investors, who hold 90% of the government's debt stock, have shown increased unease with the debt trajectory which reached 78.5% of GDP in August – an increase of 7 percentage points since January 2023. Markets have also cast doubt over the government's ability to even achieve the targets it revised downwards last April: in 2025, the government will have to achieve a balanced primary balance (excluding interests) with a tolerance of 0.25 points of GDP, or, at worst, a deficit of around BRL 30 bn[3]. To meet this target, the government will need to freeze over BRL 15 bn in spending.

The growing worries of local investors has been reflected in tensions in the bond market. The Treasury has experienced more difficulties placing fixed-rate or inflation-linked bonds owing to the rising preference for floating-rate instruments. The share of debt instruments indexed to the SELIC rate has, as a result, increased rapidly, adversely affecting the composition of public debt – shortening maturities, and increasing the debt's sensitivity to interest rate fluctuations. The rise in the yields required to hold public debt (12.9% in November for 10-year bonds compared to 10.3% at the end of 2023), the weakening of the currency (-18.6% against the USD since January) and the accumulation of assets by residents abroad (USD 9.2 bn in the first nine months of the year compared to USD 4.5 bn for the whole of 2023) have underscored the prevailing pessimism amongst local investors.

To regain investor confidence and eventually lower debt costs (the effective interest rate on sovereign debt stood at 11% while interest expenses represented some 7% of GDP over 12 months in Q3), the government has announced it was negotiating new measures to lower spending. These announcements have come on the heels of municipal elections marked by the weakening of Lula's PT party and the concurrent strengthening of both the center-right bloc (the Centrão) as well as some right-wing groups – a sign of continued resilience of *Bolsonarismo* in the country. More strikingly, the election – which was seen as a sort of mid-term test for Lula – underscored the growing disconnect between economic performance and public opinion, mirroring trends observed in other countries.

## 2025 OUTLOOK: THE CHINESE UNCERTAINTY

In 2025, economic activity is expected to slow down. Domestic demand is likely to suffer from a less supportive policy mix (monetary tightening, reduction of fiscal support for households and businesses). Real GDP is projected to grow around 2%, with nearly one percentage point coming from the carryover effect from 2024.

**BRAZIL : FISCAL METRICS OF THE CENTRAL GOVERNMENT**

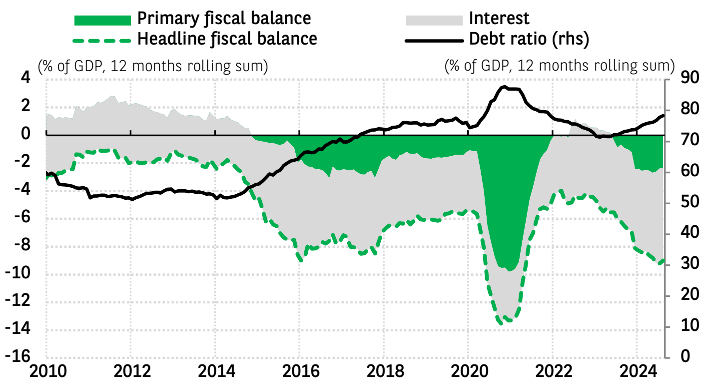


CHART 2 SOURCE: NATIONAL TREASURY, BNP PARIBAS

Uncertainties surrounding the strength of Chinese demand[4] pose a downside risk to growth due to close trade ties between the two countries[5]. Simulations using the NIGEM model suggest that a 1% reduction in Chinese demand (via a -3.3% shock on private consumption over two years) would typically lead to a 0.25% decline in Brazilian activity after one year, all else being equal. In addition to its impact on external trade and the stock market (with commodities playing a sizeable role in the Bovespa index), a slowdown in China would also affect domestic demand via the investment channel (lower sales/turnover of Brazilian companies due to falling commodity prices and reduced export volumes). A Chinese slowdown could also prompt Brazil to tighten its tariffs – as it did back in April, when the country doubled down on its steel import duties up to 25% to help insulate its industry from the influx of cheap Chinese steel (competition channel)[6].

The slowdown in foreign direct investment (FDI) flows from China to Brazil, on the other hand, appears less certain, given China's current industrial policy[7]. China is seeking to expand markets for its solar and wind energy producers as well as electric vehicle manufacturers; it is also trying to secure access to essential minerals for its EV battery supply chain. Despite Brazil's recent decision not to join the "Belt and Road Initiative", the country has expressed desire to continue collaborating with Chinese investors (a topic that will likely fuel discussions between Presidents Lula and Xi Jinping during the latter's official visit on November 20 in the wake of the G20 in Rio de Janeiro). Between 2020-2023, Brazil captured just over a third of Chinese direct investment flows to Latin America.

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3 The initial target was a primary surplus of 0.5% of GDP.
4 Despite the support measures announced by the Chinese authorities since September, the economy is projected to slow down in 2025. In addition, Donald Trump's return to the United States presidency reinforces the scenario of a strengthening of American protectionist measures, with likely adverse effects on Chinese exports (in the worst-case scenario, an increase in customs duties to 60% for goods from China, compared to an average of nearly 20% in 2023).
5 China has been the country's main trading partner since 2009, absorbing between 25 and 30% of its exports, nearly three times more than the United States. The nature of the trading relationship, however, remains very unbalanced. Cf. *Brazil: current trade patterns with China threaten the promise of re-industrialization*.
6 China produces more than half of the world's steel. The real estate crisis in the country has reduced domestic demand for steel, creating overcapacity and lowering prices. These surpluses have become available on the international market but have been increasingly confronted with protectionist measures in the United States, Europe but also in many emerging markets (i.e. India, Vietnam, Thailand, Mexico, Brazil, Chile).
7 China sees, amongst others, a trio of industries as key to its future growth prospects: electric vehicles, lithium-ion batteries and solar panels.

# CHILE



## GROWTH CLOSE TO ITS POTENTIAL

**In Chile, the recovery in economic activity seen in 2024 is expected to continue in 2025. Commodity exports will remain strong, while private consumption will benefit from slowing inflation and a gradually improving labour market. Against a political backdrop marked by ongoing tensions, and an opposition coalition strengthened by the results of recent local elections, the government is trying to press ahead with its flagship reforms, relating to the energy sector in particular, before the end of its term, which will be in late 2025. Against this backdrop, public finances are still being gradually consolidated, at a slower pace than initially anticipated.**

### RECOVERING ACTIVITY

GDP growth is expected to be close to its potential level in 2024 and 2025, after a year of almost zero growth in 2023 (+0.2%). The recovery in activity in 2024 has been driven by exports (principally copper, lithium and cellulose), up 5% on average and year-on-year over the first 9 months of the year, with this growth expected to continue over the coming months. Copper exports, in particular, are expected to remain strong, partly thanks to technical issues being resolved. Private consumption is the second driver of growth, buoyed by rapidly easing inflation (from 14% in August 2022 to 3.7% in March 2024), the gradually improving labour market (the unemployment rate was 8.7% in September and is expected to continue falling, hitting 8% by the end of 2025, according to IMF estimates) and incrementally better access to credit. Investment is expected to gradually improve over the coming quarters.

The inflation rate has recovered slightly in recent months (hitting 4.1% in September 2024), due to transitory shocks, in particular, the end of the electricity price freeze (in place since 2019). The price of electricity is expected to rise by around 50% by 2026. The Central Bank of Chile has lowered its key interest rate by 600 basis points since June 2023 (to 5.25% in October) and has signalled that this decrease will continue over the coming months, in line with macroeconomic forecasts.

FORECASTS

| | 2021 | 2022 | 2023 | 2024e | 2025e |
|---|---|---|---|---|---|
| Real GDP growth (%) | 11.7 | 2.4 | 0.2 | 2.5 | 2.2 |
| Inflation (CPI, year average, %) | 4.5 | 11.6 | 7.6 | 4.0 | 4.4 |
| Central Gov. balance / GDP (%) | -7.5 | 1.1 | -2.5 | -2.4 | -2.1 |
| Public debt / GDP (%) | 36.3 | 38.0 | 39.2 | 40.5 | 40.7 |
| Current account balance / GDP (%) | -6.6 | -8.7 | -3.5 | -2.8 | -2.6 |
| External debt / GDP (%) | 75.0 | 76.4 | 71.1 | 74.1 | 70.4 |
| Forex reserves (USD bn) | 51.3 | 39.1 | 46.3 | 47.8 | 49.3 |
| Forex reserves, in months of imports | 5.3 | 4.9 | 7.0 | 7.3 | 7.5 |

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

CHILE : TOTAL AND COPPER EXPORTS

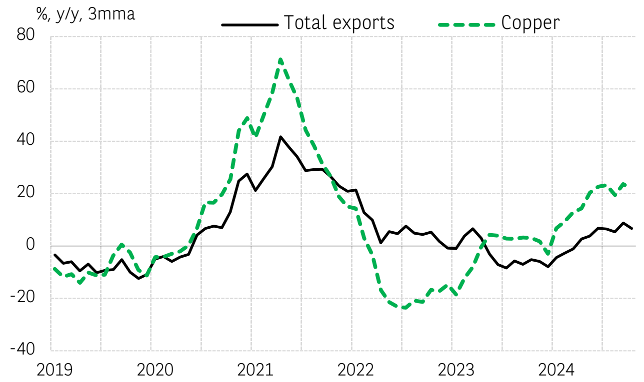


CHART 1

SOURCE: CENTRAL BANK, BNPP

### BALANCE OF RISKS

In the very short term, risks to growth are still on the downside, mainly due to external factors. The potential escalation of conflicts in the Middle East could lead to higher oil prices (with Chile being a net importer of oil), while the very likely hardening of the United States' trade policy will adversely affect the Chilean export sector.

It is harder to assess the effect of the slowdown in Chinese growth on the Chilean economy. Although Chinese copper demand currently accounts for nearly half of the global demand and China is Chile's leading trading partner (the destination for more than 40% of the country's total exports, and 70% of copper exports), the copper demand from sectors more or less directly linked to the low-carbon transition is buoyant and could partially offset the falling copper demand from the construction sector (estimated at around 30% of Chinese copper demand). Overall, Chinese copper imports have slowed, but are still increasing nevertheless (+4.5% y/y over the first 9 months of 2024) and the outlook remains relatively optimistic. In its most recent report, the International Energy Agency also notes that the (moderate) fall in copper prices seen in recent months is predominantly due to excess supply (as a result of new mining operations starting up and maintenance work in various countries ending) and that the forecasts for the next two years are on the upside. Therefore, the effect of the Chinese slowdown could remain marginal on copper exports.

That being said, the relationship between the Chinese and Chilean economies covers so much more than just copper exports. Chile is China's main partner in the region, with diplomatic relations between the two countries dating back over 70 years and many trade agreements signed between them over the past fifteen years.

Most notably, the Chinese government's energy sector investment strategy (broadly covering lithium, wind energy, solar energy and green hydrogen) has understandably focussed on Chile. Foreign direct investments and position-taking in Chilean energy companies have increased exponentially over the past three decades. In the case of lithium, for example, China holds a stake of approximately 30% in Chile's largest producer, Sociedad Química y Minera (which currently accounts for about half of Chile's total lithium production). Therefore, beyond the short-term challenges, the challenge faced by Chile's economy is successfully reducing its dual dependence, on commodities on the one hand (the economy is currently being diversified, but commodity exports still account for more than 50% of the total), and on China on the other hand (the main player in the entire critical material value chain and, in particular, in the lithium value chain). The policies required to move up the value chains are gradually being put in place, but the effects are still weak. According to the TiVA database (which is produced by the OECD and quantifies the value added by each country in international trade), the value added of Chilean exports to China has increased steadily over the last two decades (including outside the mining sector), but the value added remains relatively low. In addition, the upgrading in value chains, as is the case in the lithium-ion battery industry, for example, is inextricably linked to the anticipated development of a large-scale electric-mobility industry in a neighbouring geographical area, which is not currently the case in Latin America.

## THE START OF AN ELECTION YEAR

The end of wrangling over a potential new constitution (for "several years", according to the government) has significantly reduced the political noise and the many uncertainties among investors about Chile's institutional framework. The government has been able to focus on a number of major reforms, including the new budget law, which was adopted in July 2024 and formally set the public debt ceiling at 45% of GDP. A tax compliance law was then passed in September, which aims to "make taxation fairer", while also combating tax evasion. Its main objective is to increase revenue by an amount equivalent to 1.5% of GDP, in order to finance the future increase in retirement pensions and other social welfare spending.

That being said, Chile's political landscape is still polarised and fragmented. There is widespread consensus that structural reforms are needed, but the approach to the reforms to be adopted are being debated long and hard. The government has to contend with falling popularity, high public expectations and a strong opposition (opposition parties have a majority in the Senate). The government's room for manoeuvre to implement its reforms before the end of its term (the next general election is scheduled for autumn 2025) has been further reduced by the opposition coalition strengthening in the municipal and regional elections held at the end of October. The government's two flagship reforms for its term, relating to the pension system and the energy sector (including highly anticipated details among domestic and foreign investors about the National Lithium Strategy and mining in "strategic" salt flats) are still being debated in the National Congress of Chile.

SHARE OF CLEAN ENERGY TECHNOLOGY SUPPLY CHAIN, 2023

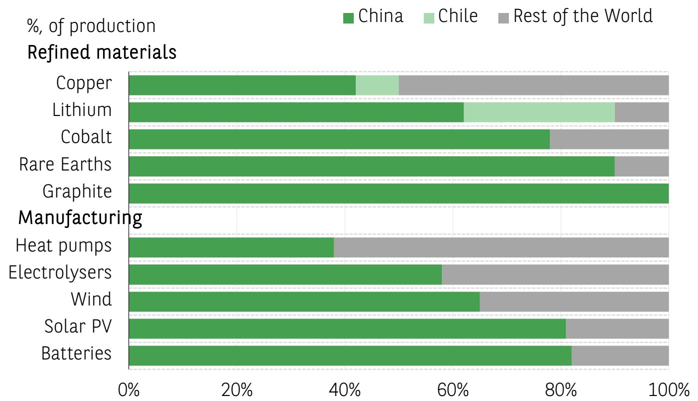


CHART 2 SOURCE: IEA, BNPP

It is against this backdrop that President Boric presented the government's budget for 2025. Fiscal consolidation is expected to continue at a slower pace than initially anticipated (the public deficit will be gradually reduced, with the books balanced by 2029, compared to 2028 in the previous budget). This scenario still seems optimistic to us. For 2025, for example, the government is relying on a small increase in spending (4% in real terms, i.e. an equivalent growth rate to the rate seen over the last two years) and an (unlikely) increase in revenue of more than 9% in real terms (over the past ten years, revenue has increased by just over 3.5% per year on average). Recovering activity, rising revenue from the (lithium and copper) mining sector and the effects of the new law will most probably not be enough to achieve this objective.

However, the public finance risk is still moderate in Chile. Public debt has risen steadily in recent years, but is still moderate, standing at close to 40% of GDP, and has a favourable profile (it is mainly denominated in local currency and has an average maturity of over 10 years).

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# CENTRAL EUROPE



## THE REGION IS STILL ATTRACTIVE DESPITE WEAK GROWTH

**In Central Europe, economic activity slowed in Q3 2024. Over the first three quarters, the Polish economy performed better than its neighbours. In the region, inflation has picked up again and a return to the inflation target is not expected until 2026. With the exception of the Czech Republic, all Central European countries are under excessive deficit procedure. Moreover, several countries have tapped international capital markets. This is accompanied by a higher currency risk, but generally, Central European countries have adopted a cautious management of foreign currency debt. Meanwhile, capital flows rebounded in Q3. The region remains an attractive destination for short- and medium-term capital flows.**

### SLOWDOWN IN ECONOMIC ACTIVITY

OIn the first half of this year, household consumption recovered in all Central European countries, thanks to the strength of real wages. The improvement was particularly marked in Romania, Poland and Hungary. On the other hand, investment and external demand have slowed down significantly for all countries in the region since the end of 2023.

In Q3, growth slowed to 2.3% y/y after 3.6% in Q2 in all Central European countries (Poland, Hungary, Romania, Czech Republic, Slovakia and Bulgaria). More importantly, Hungary entered a technical recession with a decline in GDP for two consecutive quarters (Q2: -0.2%, Q3: -0.7%). In the Czech Republic and Slovakia, economic activity proved resilient with relatively similar growth compared to the previous quarter. In Q4, growth is likely to remain weak, reflecting the effects of the floods faced by all Central European countries in September.

Over the year as a whole, however, Poland could be one of the region's best performing economies despite headwinds. The carry over already amounts to 2.5% in Q3. In comparison, Hungary and Romania are likely to lag behind in 2024 with a carry over of 0.6% and 0.7% respectively in Q3.

Growth prospects for the region remain well-oriented for 2025. Monetary policy is likely to become more accommodative again next year, and fiscal policy is unlikely to tighten. Although moderate, the improvement in external demand should also provide support. However, risks are tilted to the downside due to a very likely increase in protectionist measures by the Trump administration, which could weaken the European economy, the main export destination of Central European countries.

### NO RETURN TO INFLATION TARGET BEFORE 2026

In the region, inflation rose again in October. One of the reasons for this is the rise in food prices. Specifically in Hungary, the Financial Transaction Tax introduced last August also contributed to the increase. For Poland, the rise in inflation is temporary as it is the result of the increase in the cap on electricity and gas prices in the second half of this year. Inflation is expected to peak in Q1 2025 in Poland. However, the common denominator in several of these countries (Hungary, Poland and Romania) is a return to moderate disinflation in 2025 as wage pressures remain high and core inflation is therefore higher than headline inflation. Slovakia, meanwhile, is expected to see a more marked acceleration due to the removal of energy-related support measures and the increase in the VAT rate from 20% to 23% from 1st January 2025. A return to the Central Bank inflation target is not expected until 2026 for most Central European countries including Poland, Hungary, Romania and Slovakia.

**REAL GDP**

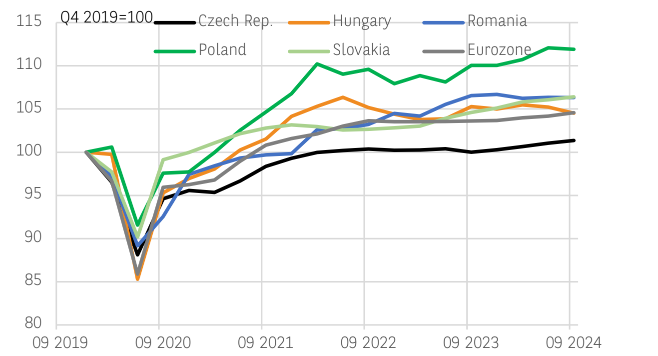


CHART 1 SOURCE: EUROSTAT, BNPPARIBAS

**CENTRAL EUROPE: CONSUMPTION GROWTH IN VOLUME**

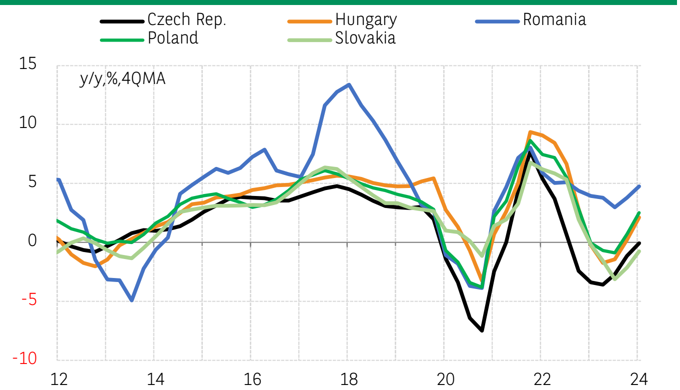


CHART 2 SOURCE: EUROSTAT, BNP PARIBAS

## ACCOMMODATIVE MONETARY POLICY

The significant drop in inflation since the peak observed at the beginning of 2023 facilitated the adoption of monetary easing in most countries in the region in late 2023, but the extent of such easing differs from country to country. The central banks of the Czech Republic and Romania opted for relatively moderate easing with a cumulative drop of 225 bps and 25 bps, respectively. In Hungary, the key rate cut was more aggressive at 650 bps cumulatively, although this stemmed from a more aggressive tightening a year earlier. Poland, which had lowered its key rate twice in September and October 2023, has maintained a monetary status quo since then (key rate unchanged at 5.75%). This caution can be explained by expectations of a rise in inflation from mid-2024 onwards.

In the short term, a change of course in monetary policy is expected for both Hungary and Poland. Monetary easing in Poland is expected by the end of Q1 2025 at best, based on recent comments from the Central Bank. At the end of 2025, Poland's key rate could reach 4.00%. In Hungary, the monetary authorities have recently shifted towards a pause, probably until March 2025, which is when the mandate of the current Central Bank Governor comes to an end. After that, easing should not be ruled out.

## TAPPING INTERNATIONAL BOND MARKETS

Four countries in Central Europe have been placed under excessive deficit procedure by the European Union. Poland, Hungary and Slovakia are concerned since this summer. Romania has been under this status for a much longer period (since early 2020). In Poland, the budget deficit of 5.3% of GDP in 2023 is expected to worsen in 2024. In Central Europe, the widening fiscal deficit and the resulting increase in public funding requirements have prompted governments to raise more funds from international bond markets since 2023. This momentum intensified in 2024 and is also expected to be sustained in 2025. According to Bloomberg, before 2023, the amount for all Central European countries was barely USD 10 billion per year. This amount was over USD 30 billion in 2023 and is expected to largely exceed USD 40 billion in 2024. Poland, Hungary and Romania have raised external funds several times this year. In 2025, Poland is also planning to do so.

Central European countries have highly developed domestic bond markets, therefore raising debt on the international bond markets may initially seem surprising. The explanation is twofold. Firstly, the cost of borrowing in eurobond markets is much lower than the cost of borrowing in domestic markets, despite the monetary easing that has already begun in some countries. Secondly, making use of external financing helps limit a crowding out effect of private companies on the domestic market in competition with the State.

The increase in bond issues in foreign currency obviously comes with a higher currency risk for the sovereign. This risk remains manageable at present, taking into account prudent management of public debt in Hungary and Poland. The limit of public debt in foreign currency is 30% in Hungary and 25% in Poland The limit of public debt in foreign currencies is 30% in Hungary and 25% in Poland (with temporary overruns possible in the case of Poland). For both countries, the ratios are close to their limit but have not gone beyond that limit. In Romania, on the other hand, the ratio is very high at 51.8% in 2023. Given that the majority of foreign currency debt is in euros, currency risk remains contained, since the country has adopted a managed currency regime, which maintains relative stability of the Romanian currency against the euro.

CENTRAL EUROPE: POLICY RATE

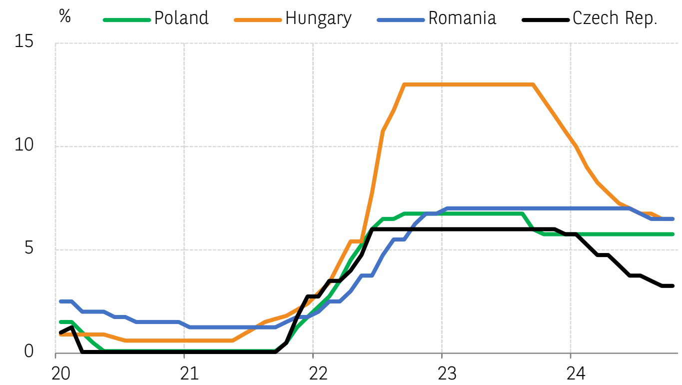


CHART 3 SOURCE: CENTRAL BANKS, BNP PARIBAS

## REBOUND IN CAPITAL FLOWS IN Q3

Foreign currency reserves in Central European countries reached EUR 467 billion at the end of October 2004, that is, an increase of EUR 39.5 billion over the first 10 months of the year. This figure is already higher compared to 2023. Poland alone contributed 50% to this increase, followed to a lesser extent by Hungary and Romania.

The more marked increase in foreign currency reserves since 2023 can be explained in part by the return of the current surplus in Hungary, Poland and the Czech Republic. In addition, the importance of foreign capital flows in the region also supports this. In particular, 2021 and 2022 were marked by a strong return of foreign direct investment (FDI) and portfolio flows. These slowed down in 2023 but remain close to the average of pre-COVID-19 years. This year, net capital flows remained strong, even though there was a decline in Q2 2024. The preliminary estimates for some countries in Q3 show a rebound that has largely offset the decline in the previous quarter.

Poland, Hungary and Romania have captured most of the net FDI flows over the past three years. Importantly, Romania has also become a key destination for net portfolio flows since 2020 (1.7% GDP in 2021, 2.4% in 2022, 6.5% in 2023). Meanwhile, reforms have been put in place to obtain the emerging country status (currently in the frontier markets category) and to be included in the MSCI Emerging Markets Index. Romania's attractiveness for capital flows should be enhanced if this objective was to be achieved quickly.
In the short and medium term, the region remains an attractive destination for capital flows due to the reorganisation of the production activity of developed countries, in response to the supply shocks experienced during the COVID-19 crisis and to the rise of protectionism. Meanwhile, Hungary has also benefited from Chinese FDI since 2022.

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# HUNGARY



## INVESTMENT: A STRATEGY TO BOOST ECONOMIC GROWTH

**In 2024, Hungary is expected to be among the region's worst performing economies, entering a technical recession in Q3. Real GDP growth is one of the government's priorities, with an official target of 3% to 6% next year. The budget for 2025 recently submitted to Parliament aims at both revitalising the economy and consolidating public accounts. However, medium-term potential growth, estimated at 3% by the IMF, has been revised upwards compared to its 2019 estimate. In particular, it is buoyed by favourable prospects for FDI, particularly from China, which would support investment.**

### FOCUS ON GROWTH IN 2025

Contrary to expectations, Hungary entered a technical recession in Q3 2024 with a decline in GDP of 0.7% q/q after -0.2% q/q in Q2. The details of the national accounts have not yet been published, but investment and external demand are expected to have contributed significantly to this economic contraction. Investment, which has been sluggish since September 2022, fell significantly in recent quarters (-13.3% y/y in Q2, -8.6% in Q1), and more sharply than in neighbouring countries. In addition, industrial activity is suffering from the weakening German economy. On the other hand, consumption, which has been recovering for the past two quarters, has held up well probably thanks to rapid growth in real wages (+10.2% y/y on average over the first eight months of the year), strong retail sales and improved surveys on purchasing intentions for durable goods. With a carry over of only 0.6% at the end of Q3, real GDP growth will be weak this year, after -0.8% in 2023.

For 2025, economic growth is clearly stated as a priority for the Orban government with a target of 3% to 6%. The support measures aimed at revitalising the economy, the details of which are not yet known, will focus on access to housing, the convergence of the minimum wage towards the average wage and support for SMEs. Moreover, households can now use their pension fund to finance real estate projects (buying a home, renovation). In any case, the high end of the growth target range seems difficult to achieve without a substantial budget. Apart from consumption, other sources of growth are limited. The moderate upturn in the German economy expected in 2025 suggests only a slight improvement in external demand. Similarly, the recovery in investment is likely to be postponed until 2026, taking into account the likely continuation of the blockage of part of the European funds used to finance public investment. The rise in electoral uncertainties in the second half of 2025 (general elections scheduled for April 2026) should lead to the postponement of private investment projects.

FORECASTS

| | 2021 | 2022 | 2023 | 2024e | 2025e |
|---|---|---|---|---|---|
| Real GDP growth, % | 7.1 | 4.3 | -0.8 | 1.4 | 2.3 |
| Inflation, CPI, year average, % | 5.1 | 14.5 | 17.6 | 3.6 | 3.5 |
| General gov. balance / GDP (%) | -7.2 | -6.2 | -6.7 | -5.0 | -4.7 |
| General gov. debt / GDP (%) | 76.2 | 73.8 | 73.4 | 74.8 | 75.3 |
| Current account balance / GDP, % | -3.9 | -8.5 | 0.8 | 2.1 | 1.4 |
| External debt / GDP, % | 86.5 | 91.9 | 85.9 | 88.4 | 90.2 |
| Forex reserves, EUR bn | 38.4 | 38.7 | 41.4 | 46.9 | 52.0 |
| Forex reserves, in months of imports | 3.8 | 3.0 | 3.4 | 4.1 | 4.4 |

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

CENTRAL EUROPE: INVESTMENT GROWTH IN VOLUME TERMS

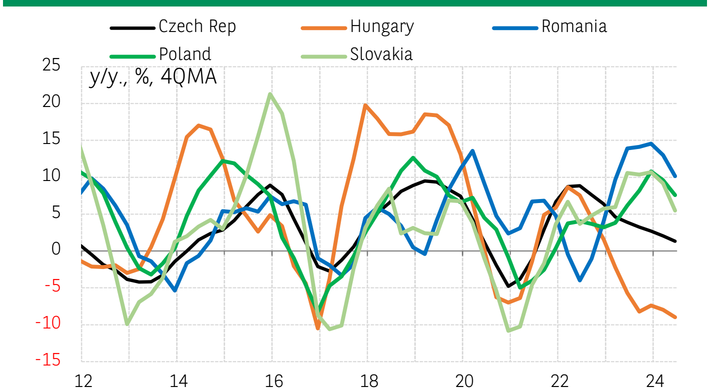


CHART 1

SOURCE: EUROSTAT, BNP PARIBAS

### UPWARD INFLATIONARY PRESSURES

Inflation has fallen significantly in recent months. It reached 3.2% y/y in October (the peak was 25.6% y/y in January 2023). It is now slightly above the Central Bank target of 3% but could rise again to 4% y/y by December 2024. Food prices have recently started to rise once again. Disinflation in the services sector is slowing. Wage pressures will remain sustained in the short term due to the expected increase in the minimum wage to 50% of the average wage by 2027. This increase would be in stages, probably at a rate of 10 to 15% per year. The fiscal measures on financial transactions, introduced in August, will only have a moderate impact on total inflation, in the order of +0.1 points this year and +0.2 to 0.3 points in 2025 according to Central Bank estimates. Inflation is not expected to return to its target before 2026.

### A SHORT-TERM MONETARY PAUSE

Monetary easing, which began in October 2023, continued uninterrupted until July. A further drop of 25 basis points (bps) took place in September 2024, bringing the key rate to 6.5%. However, the rather aggressive pace of easing at the start of the cycle, at 50-75 bps at each meeting, has slowed since last June.

Last October, the Central Bank once again opted for a pause, which is expected to last longer this time. This new direction is due to core inflation remaining high (4.5% y/y in October) and higher than overall inflation. Downward pressures on the Hungarian forint were undoubtedly a factor in the Central Bank's decision.

## WEAK BUDGETARY CONSOLIDATION

Consolidation efforts since 2022 have failed to significantly reduce the budget deficit over the past two years. Along with six other European Union countries, Hungary has been placed under the excessive deficit procedure for failure to comply with the budgetary rules that came back into force this year, after a short period of suspension. In 2024, even if the budget deficit is expected to ease slightly, it will still be well over 3% of GDP due to the still high burden of debt interest payments (4.7% of GDP in 2023). The cost of financing on the bond market is the highest in the region, with a yield differential of 444 bps between 5-year Hungarian and German government bonds. However, the Hungarian government has made use of international markets to finance itself at lower interest rates. It raised funds on the Japanese market twice in 2024.

For 2025, large-scale fiscal consolidation is unlikely due to concerns about growth and the electoral calendar (general election scheduled for 2026). The budget for 2025 is banking on a deficit of 3.7% of GDP, but economic growth projections of 3.4% are optimistic. Public debt, at 73.4% of GDP in 2023, is the highest in Central Europe. It is expected to increase over the next two years, then gradually fall to below 70% (but far from the 60% threshold) by 2029/2030, thanks in particular to a primary surplus expected from 2027/2028 onwards.

## THE WINDFALL OF CHINESE FDI

According to the latest UNCTAD figures, Hungary received the equivalent of USD 119 billion in cumulative foreign direct investment (FDI) at the end of 2023. In the region, Poland led the way with FDI stock worth USD 335 billion, ahead of the Czech Republic with USD 216.6 billion. However, Hungary ranks second ahead of Poland when FDI is considered as a share of GDP.

In 2021 and 2022, net FDI inflows reached record levels at 5.6% and 8.3% of GDP, respectively. In 2023, they returned to pre-Covid levels, but a rebound in these flows is expected in the coming years. Overall, these FDI inflows have mainly benefited the automotive and services sectors. In addition, there is a change in the geographical composition of the FDI stock, with a significant increase in the share of Asian countries, particularly South Korea and China, to the detriment of the American continent and, to a lesser extent, Europe. Over the recent period, China has positioned itself as a significant investor. According to Rhodium Group, Hungary receives a significant proportion of Chinese FDI for Central Europe. In Hungary, the total stock amounts to USD 6.7 billion, out of a total of USD 414.7 billion in Europe.

These observations are in line with the Hungarian government's strategy in the electric mobility sector. Hungary aims to become a major player in the field of batteries for electric vehicles.

HUNGARY: CUMULATIVE VALUE BY INDUSTRY

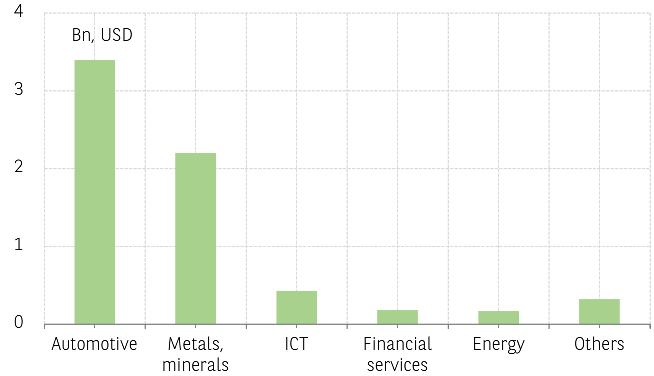


CHART 2 SOURCE: RHODIUM GROUP, BNP PARIBAS

On the European level, Hungary is expected to become the second largest supplier by 2030, after Poland. Moreover, the country is relying on local production of electric vehicles with the production site of the Chinese company BYD, which is expected to be operational in two years. This strategy goes with incentives, including tax benefits, aimed at increasing the attractiveness of Hungary. The country is in fact offering one of the lowest corporate tax rates in Europe at 9%, compared to 19% in Poland and the Czech Republic, and 29.9% in Germany.

The prospects for FDI remain strong in the short term, given greenfield investment projects announced over the last three years (2021: USD 6.3 billion, 2022: USD 12.5 billion, 2023: USD 9.2 billion). Chinese FDI is likely to increase in 2025 and 2026 as protectionist measures on Chinese electric vehicles, which already exist in Europe, are expected to intensify in the US after Donald Trump's recent presidential election victory. Hungary is an attractive production and export base for the EU, enabling Chinese producers to bypass tariff measures. In the long run, the domestic market could also be affected, although for the time being new car registrations in Hungary still show a clear preference for European (54%) and Japanese makers (33% in 2023). Nevertheless, two factors could mitigate the prospects for FDI, including weakening activity in the automotive sector and a possible extension of the timeframe for the transition to electric vehicles in the US or Europe.

In the medium term, the outlook for Asian FDI in Hungary, particularly Chinese FDI, should revitalise investment and support potential growth. The IMF estimate of Hungary's potential growth is now 3%, an increase of 1 point compared to its previous 2019 estimate. In the short term, however, caution remains necessary. The revitalisation of investment will struggle to fully materialise if a proportion of European funds remains blocked (around EUR 20 billion). As a matter of fact, in 2022, total investment in volume remained low, despite the record year recorded for FDI.

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## STRONGER FUNDAMENTALS TO FACE A HIGH-RISK 2025

**Since July, the three main rating agencies have upgraded the Turkish government's medium-term and long-term debt ratings. Macroeconomic fundamentals have really improved over the past twelve months, despite the tightening of monetary policy and the resulting slowdown in growth due to positive real interest rates for households and businesses. The slippage in the core budget deficit is still under control and the debt ratio is at an all-time low. The current account deficit has fallen sharply and the recovery in portfolio investment has helped with rebuilding official foreign exchange reserves. Finally, the de-dollarisation of bank deposits has continued and bank credit risks are generally under control. However, the economy's resilience will be put to the test in 2025, as fiscal policy will become restrictive, prevalent inflation could delay monetary easing and the external environment will be more challenging, with the economic slump in Germany, competition from China on the European market and the threat of increased protectionism.**

Following the annual review of sovereign ratings, the three main rating agencies (S&P, Moody's and Fitch) revised upwards the rating of the Turkish Treasury's medium-term and long-term currency-denominated debt: by one notch for Fitch and S&P from B+ to BB- (on 06/09 and 01/11, respectively) and by two notches for Moody's from B3 to B1 (on 19/07). These improvements have not been awarded by positive developments neither in the domestic bond market nor in the foreign-exchange and equity markets. The 5-year CDS risk premium has widened very slightly since Moody's decision. At around 250 basis points at the end of October, it remains at an all-time low level but is still slightly higher than the new ratings would suggest. At the same time, the lira has continued to depreciate (-4% against the dollar since Moody's decision, -14% since the start of the year). The yield on lira-denominated Treasury bonds rose from 26% in mid-July to almost 29% at the end of October. Finally, the main index on the Istanbul stock exchange lost 20% in local currency terms, wiping out the gains made during the first part of the year.

Recent developments in financial variables illustrates the jitters being felt by investors and market operators, which may be due to Türkiye's sluggish economic situation. However, macroeconomic stability has improved significantly since mid-2023.

### ANOTHER TEST OF THE ECONOMY'S RESILIENCE IN 2025

In Q2 2024, real GDP stagnated compared with the previous quarter (+0.1%), meaning that year-on-year growth was only 2.5%, compared with an average of 5.1% over the Q1 2023-Q1 2024 period. In Q2 2024, household consumption and current public spending slowed sharply, while investment and exports contracted. The supply indicators (industrial production, services activity index) available for July-August suggest, at best, a new stagnation. By contrast, domestic demand indicators (retail sales and capital goods imports) are pointing to a rebound. Exports (measured in dollars) rose sharply in July-August before decreasing in September-October. To sum up, GDP growth in Q3 2024 is likely to be modest at best. The positive aspect of this economic outlook is that the household and business confidence indices both strengthened in September and October.

As a matter of fact, the severe tightening of monetary policy since May 2023 has not pushed the economy into recession. However, disinflation is slower than hoped; in September and October, the monthly rise in the all-items consumer price index was still 3%, meaning that, measured over a year, the inflation rate was still 49% in October, compared with the government's forecast of 41.5% at the end of the year. The central bank (CBRT) has left its key rate unchanged at 50%, and lending rates to individuals and businesses have returned to positive territory in real terms. Domestic credit has slowed very sharply, from +80% year-on-year in mid-May 2023 to +30% in mid-October 2024, making a major contribution to the slowdown and landing of growth as a result.

**FORECASTS**

| | 2021 | 2022 | 2023 | 2024e | 2025e |
|---|---|---|---|---|---|
| Real GDP growth, % | 11.4 | 5.5 | 5.1 | 3.0 | 3.0 |
| Inflation, CPI, year average, % | 19.6 | 72.3 | 53.9 | 58.3 | 30.2 |
| Central gov. balance / GDP, % | -2.8 | -1.0 | -5.2 | -4.6 | -3.0 |
| Gen. Gov. debt / GDP, % (EU standards) | 40.4 | 30.8 | 29.3 | 27.6 | 26.8 |
| Current account balance / GDP, % | -0.8 | -5.1 | -3.6 | -1.0 | -1.3 |
| External debt / GDP, % | 53.1 | 50.3 | 44.6 | 41.7 | 40.2 |
| Forex reserves, USD bn | 72.5 | 82.9 | 92.8 | 98.0 | 103.0 |
| Forex reserves, in months of imports | 3.1 | 2.6 | 2.9 | 3.3 | 3.4 |

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

**TÜRKIYE: FX RESERVES REPLENISHMENT**

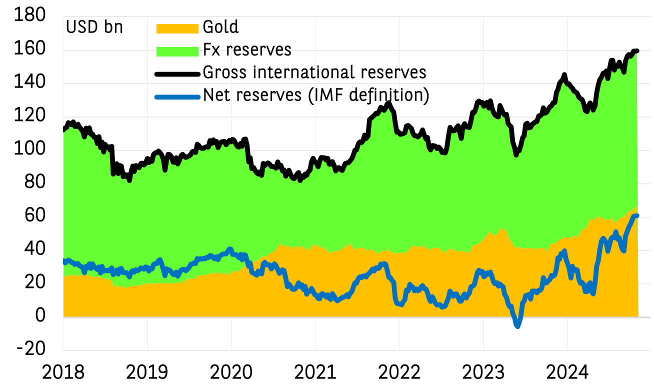


CHART 1 SOURCE: CBRT, BNP PARIBAS

The resilience of the economy to the monetary shock since 2023 is due to i) the support of fiscal policy, with a fiscal impact (fiscal impulse, i.e. the annual change in the primary budget balance) estimated by the IMF at +1.2 points of GDP in 2024, following +0.7 points in 2023, ii) the very strong wage catch-up due to the indexation of hourly wages to the minimum wage, which has increased by around 50% in real terms since the end of 2022, iii) the rise in employment (around +4.5% since the end of 2022), iv) sustained exports over the year as a whole (+1.4% over Jan-Oct compared with the 2023 average) and rising tourism revenues.

The resilience of the Turkish economy will be really put to the test in 2025; on the one hand, fiscal policy is likely to become restrictive (the fiscal impulse would be negative by 0.8 pp), and on the other hand, the stronger than expected tightening of the external environment would continue to adversely affect exports and investment. Maintaining growth will therefore depend on the success of disinflation, which should enable the CBRT to loosen its grip. The consolidation of purchasing power gains and lower interest rates would then enable consumption and investment to pick up again. However, if disinflation is to continue and become more pronounced, the tightening of fiscal policy alone will not be enough. An additional dose of real exchange rate appreciation is needed. The difficulty for the fiscal and monetary authorities will be striking a delicate balance between stimulating domestic demand and preserving the external balance at a time when the economic slump in Germany is likely to persist, competition from China is set to intensify and Trump's second term in office is raising fears of widespread rekindled protectionism. Against this backdrop, our scenario of growth remaining at 3% and inflation falling to 26% y/y by the end of 2025 is an optimistic one.

## GREATER MACROECONOMIC STABILITY

Although prevalent inflation remains a serious problem for the lower and middle classes of the population, macroeconomic stability has improved over the last two years.

The current account deficit measured cumulatively over 12 months has narrowed considerably, from USD 55 bn in May 2023 to USD 11 bn in October 2024. The reduction in the oil bill accounts for just over half of this. However, excluding energy and net gold imports, the current account remains in substantial surplus thanks to the resilience of exports and, above all, tourism revenues, which reached an all-time high of USD 52.5 bn (still in cumulative terms over 12 months in October). The reduction in the current account deficit, coupled with the resurgence of portfolio investment (USD +22 bn) and the ability of banks and corporations to renew their medium-term and long-term debt on a large scale (USD +10.5 bn), have enabled official foreign exchange reserves to rise sharply since April, by USD 36 bn (including gold stocks) and USD 24 bn (excluding gold stocks). At the beginning of November, foreign exchange reserves as defined by the IMF exceeded USD 60 bn, whereas they were slightly negative at the end of May/beginning of June 2023.

Better still, net of the CBRT's off-balance sheet positions (which mainly consist of foreign exchange swaps with commercial banks), the CBRT's foreign exchange position, which had been monitored by the markets during previous periods of stress, was once again positive at USD 45 bn, whereas it was still largely negative until April 2024[1]. The de-dollarisation of deposits has led commercial banks to reduce their off-balance sheet foreign exchange credit position vis-à-vis the central bank.

The improvement in macroeconomic stability is also due to a slippage in the budget deficit (excluding exceptional spending linked to the earthquake in February 2023) remaining under control and the spectacular reduction in the debt ratio despite the depreciation of the lira (59% of central government debt is denominated or indexed on the exchange rate and 6% indexed on inflation). As a result, the Treasury's 'cash basis' deficit widened from 2.4% in 2023 to 4.4% in September 2024[2], but central government debt accounted for only 22% of GDP in September[3]. The interest burden has increased with the rise in interest rates (from 2.1% to 2.6% of GDP) but is largely sustainable.

Finally, the improvement in macroeconomic stability is due to the control of credit risk in the banks (at the end of September, the overall non performing loan ratio was still very low at 1.7%) and the improved solvency of corporations as a whole.

## STRONG EXPOSURE TO COMPETITION FROM CHINA ON THE EUROPEAN MARKET

The Turkish economy is structurally vulnerable to external shocks, including financial shocks, of course, as external financing requirements remain very high (even though they have fallen), and a sudden outflow of portfolio investment, which has picked up over the last 12 months, would affect the lira and interest rates almost as severely as in the past.

The Turkish economy is also vulnerable through its foreign trade, particularly in the current circumstances. Exports will suffer both from the slump in Germany (the biggest trading partner of the EU and the UK, accounting for 8% of Turkish exports) and from increased competition from China. On the one hand, Chinese products imported into Türkiye account for 17% of total imports excluding energy and gold. Up until now, these imports have been mainly consumer products with low added value, but Chinese goods' penetration is growing and its Chinese corporations are moving upmarket. On the export side, the Chinese market is marginal for Türkiye (just 1.3% of exports). On the other hand, Chinese corporations are very serious competitors on the European market. For finished or semi-finished manufactured products, if we combine the share of Chinese exports in total imports from the Eurozone and the importance of the Eurozone for a given country, Türkiye's exposure to competition from China is only slightly lower than the exposure of the Central European countries, which are by far the most exposed.

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1 The negative position peaked at USD -61 bn at the end of March 2024. The return to a positive position is due to the accumulation of reserves recorded in the balance of payments, but, above all, to the non-renewal of foreign exchange swaps with commercial banks, which had enabled commercial banks to comply with the regulatory limit on their own general foreign exchange position (i.e. including the off-balance sheet position).

2 The Treasury's budget balance on a 'cash basis' (which is not usually the benchmark) is a better indicator for monitoring budget performance since December 2023, unlike the central government's balance on a accrual basis or commitment basis (the usual benchmark). This is because the latter includes spending commitments for the earthquake, whether any of this spending has been disbursed or not. As those commitments for 2023 were booked in December, the central government deficit rose from 2.7% of GDP in September 2023 to 5.2% in December. Conversely, between December 2023 and September 2024, the commitment-based balance fell (to 4.9% of GDP in September 2024) while the cash-based balance increased. Temporarily, the cash-based balance more accurately reflects the current stance of fiscal policy.

3 The figures for September 2024 are calculated on the basis of the deficit and debt figures published by the Ministry of Finance on that date and an assumption of 58% growth in GDP in value terms compared with Q3 2023. The ratio is expected to rise temporarily in December as earthquake-related expenditure is included in the deficit. The debt ratio is slightly higher by European standards, at 3.5 pp of GDP.

## WHAT ARE THE CONSEQUENCES OF THE INCREASED GEOPOLITICAL RISK IN THE MIDDLE EAST?

**Although tensions in the Middle East and the geopolitical risk have risen sharply since October 2023, there have been contrasting developments in the maritime trade and energy markets. While the cost of some freight categories has risen, oil prices have fallen, mainly due to abundant supply. An escalation of the conflict is still a possibility and would drive energy prices higher. In an already tense market, the price of LNG on the European market is particularly sensitive to the geopolitical context. It is against this backdrop of geopolitical tension and depressed oil markets that the Gulf countries are seeing their financing requirements increase. Furthermore, as part of their diversification policy, they need a peaceful regional environment, particularly in the Red Sea.**

### INCREASED GEOPOLITICAL RISK IN A STRATEGIC REGION

The outbreak of war between Israel and Hamas in October 2023 and the subsequent escalation of tensions resulted in a significant increase in geopolitical risk in the Middle East region. The GPR[1] geopolitical risk index rose sharply at that time and has remained at a high level ever since. It is both the changing nature of the conflict and its location that explain why the indicator is remaining at a high level.

Since it broke out, the conflict has increased in intensity, moving from multiple, localised conflicts played out in part via proxies, to a direct confrontation between two regional powers. While the consequences of this escalation of the conflict are relatively limited for the time being, the risk of intensified confrontations persists.

The geopolitical importance of the Middle East is primarily linked to the region's role in the hydrocarbon market. This is because 34% of the world's oil exports and 14% of its liquefied natural gas (LNG) exports come from the Gulf countries. Secondly, the region is home to some of the world's most strategic maritime trade chokepoints. Shipping through the Bab el-Mandeb Strait, south of the Red Sea, accounts for around 12% of global merchandise flows by volume (16% by value), including around 11% of maritime crude oil flows and 23% of wheat flows. In addition, around 27% of maritime trade in petroleum products passes through the Strait of Hormuz (more than 80% of which is destined for Asia), which handles 10% (by volume) of the world's goods flows.

### LIMITED IMPACT ON THE OIL MARKET AND MARITIME TRADE

The rise in geopolitical risk initially resulted in only a limited increase in oil prices, before they fell back again. Thus far, various estimates of the "geopolitical risk premium" component in the price of oil put it at around 10% of the price per barrel, corresponding to a limited escalation of the conflict (without any damage to oil production and transport facilities) despite its geographical spillover. The limited reaction of the oil market to geopolitical risk is due to two factors: despite the spillover of the conflict, passage through the Strait of Hormuz has not been affected. A blockage in the strait is not currently deemed a likely scenario, even though its consequences would be very significant given the lack of alternative routes for some major exporters (for example, Kuwait and Qatar). Alternative routes available for Saudi Arabian and Emirati exports have limited capacity (5 mb/d and 1.5 mb/d, respectively, for total exports of 11 mb/d).

HYDROCARBON FLOWS AND CHOKEPOINTS

| | | 2023 |
|---|---|---|
| | Bab el-Mandeb transit | 0.9 |
| Crude oil and other liquids (mb/d) | Strait of Hormuz transit | 2.1 |
| | World maritime oil trade | 7.8 |
| | Global consumption | 102 |
| | Bab el-Mandeb transit | 4.1 |
| Liquified Natural Gas (bcm) | Strait of Hormuz transit | 108 |
| | World maritime LNG trade | 550 |

TABLE 1 SOURCE: IEA, BNP PARIBAS GROUP ECONOMIC RESEARCH

GEOPOLITICAL RISK INDEX GPR (INDEX 100=JANUARY 2022)

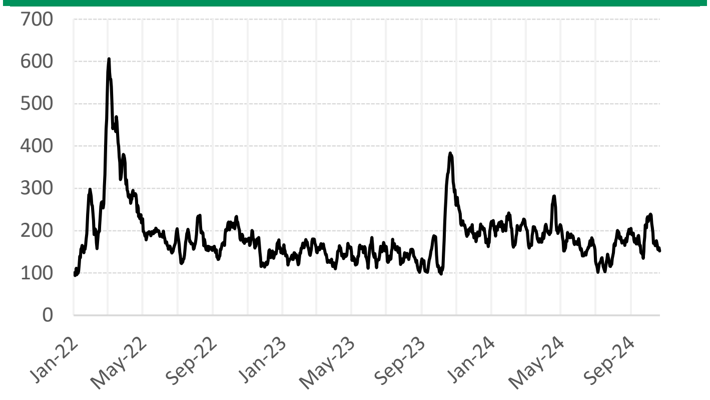


CHART 1 SOURCE: GPR INDEX MATTEOIACOVIELLO.COM, BNP PARIBAS

In addition, the fundamentals of the oil market are currently bearish, partly because of weak demand from China, and partly because of rising production from countries not subject to OPEC quotas, mainly the United States, Canada, Brazil and Guyana.

Maritime transport has been disrupted by the blockage of the Bab el-Mandeb Strait, but the existence of alternative shipping routes has helped to limit the consequences at global level. Traffic in the Red Sea has fallen since the end of 2023, but in different ways depending on the type of goods. The reduction and rerouting via the Cape of Good Hope has affected containers and most raw

1 The GPR index, developed by D. Caldara and M. Iacoviello (Geopolitical Risk (GPR) Index (matteoiacoviello.com)) is a geopolitical risk indicator based on textual research in a dozen or so English-language newspapers.

materials, particularly refined petroleum products. Maritime traffic in the Red Sea decreased by more than 70%, and the Suez Canal's market share of total maritime flows of goods fell from 10% prior to October 2023 to 6% in August 2024[2]. There were two exceptions to these plummeting volume figures: the fall in crude oil flows was limited, mainly due to flows from Russia continuing. For the same reason, wheat transit via the Suez Canal has increased.

On a more general level, the impact on prices of the disruption to shipping in the Red Sea has not been uniform, with the cost of transporting containers mainly affected. Thus, the Shanghai Containerized Freight Index rose by 120% between October 2023 and June 2024 and, according to UNCTAD[3], more than 80% of this increase is due to the disruption in the Red Sea (the disruption caused by the lower water level in the Panama Canal played only a marginal role). In terms of volumes, global maritime freight has continued to grow (+2.9% in volume year-on-year over 8M 2024, after +2.6% for 2023 as a whole).

## PROSPECTS

- **Geopolitical risk set to remain high**

According to our central scenario, geopolitical risk is likely to remain high in the region for at least part of 2025. As in 2024, there could be periods of very high tension, but the most likely scenario remains one of targeted military operations.

The Middle East policy of the new US administration is a new element of uncertainty. The policy of the first Trump administration (diplomatic rapprochement with some Gulf monarchies and Israel and economic pressure on Iran) will have to take into account the current conflict, and therefore a very different geopolitical backdrop, where the risk of escalation is high. Added to this is the partly "transactional" nature of Trump's diplomacy, which complicates any forecasting exercise.

- **LNG market**

Although around 3/4 of LNG exports from the Gulf are to Asia, the rise in the share of flexible contracts that facilitate arbitrage opportunities between Asian and European markets increases Europe's vulnerability to geopolitical tensions in the Middle East. The two main risks are: a blockage in the Strait of Hormuz, which would push prices to new heights given Qatar's importance in global LNG exports (20% in 2023), and constraints on production in the eastern Mediterranean. Israeli gas production is expected to reach 27 bcm in 2024, with around 10 bcm exported to Egypt. A hit to Israeli production capacity or a disruption to exports to Egypt would increase regional demand for gas, and could have repercussions on the price of European LNG. Indeed, the balance of the European market is relatively tight in the short term, for seasonal reasons (increased consumption in winter), as well as the likely end of Russian exports to Europe via Ukraine at the end of 2024, and delays in some liquefaction and export units starting up in the United States.

- **Oil market**

A blockage in the Strait of Hormuz would be the main factor that could significantly push up oil prices (above $100/bbl). Apart from this potential event, which is not part of our central scenario, the fundamentals of the oil market should tend to push prices down, as evidenced by the recent decision by the OPEC cartel to postpone raising its production quotas. For the time being, the oil market has not really reacted to the election of the new US President.

OIL AND FREIGHT PRICES (INDEX 100=JANUARY 2023)

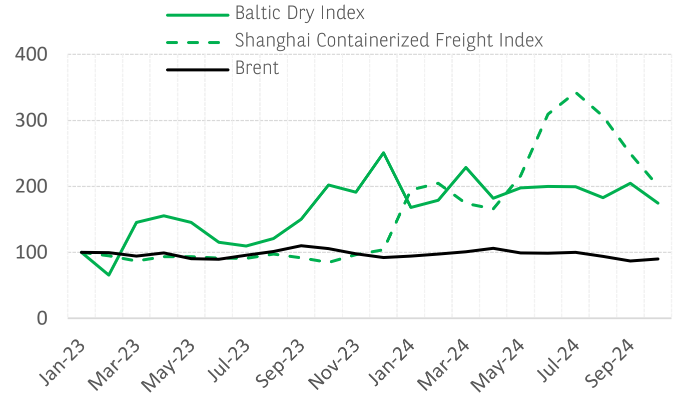


CHART 2 SOURCE: DATASTREAM, BNP PARIBAS

Apart from his stated desire to boost US production, one of the main short-term uncertainties will be potential further sanctions on Iranian exports (around 1.6 mb/d). In this case, the willingness of Gulf producers (who have the main spare production capacities) to quickly offset the reduced supply will determine the direction of prices, at least in the short term. Indeed, it may be in their interest, at least temporarily, to allow the price of oil to rise.

- **Gulf countries**

This backdrop of a relatively depressed oil market and high geopolitical risk in the region is affecting certain Gulf countries in particular. While the region is still a net exporter of capital due to portfolio investments by the main sovereign wealth funds (notably in the UAE and Qatar), the financing of budget deficits (Saudi Arabia) and investments supporting economic diversification (the "Vision" programmes) is increasing capital inflows. The situation in Saudi Arabia is significant in this respect. Given the very large investment projects (Vision 2030), foreign direct investment that is falling short of expectations (equivalent to 0.9% of GDP in H1 2024) and the high fiscal breakeven oil price (around $100/bbl for Saudi Arabia), the kingdom's financing requirements are increasing significantly. Thus, the government and the Public Investment Fund (PIF) have issued more than USD50 billion in international bonds this year (around 5% of GDP), the largest amount among emerging economies outside China. In addition, the PIF has announced its intention to reduce its exposure to foreign assets (from 30% to 18% of the total) in order to give priority to investment in the kingdom. In the medium term, the Red Sea region is set to become increasingly important to Saudi Arabia's economy under Vision 2030. The areas of development include the tourism sector, which is particularly vulnerable to geopolitical risk, and other sectors which are partly export-oriented (mining resources, renewable energies and hydrogen) and which therefore depend on secure and available maritime routes.

According to our central scenario, the economic impact of the increased geopolitical risk on the Gulf countries should remain limited in the short term. However, in the medium and long term, the security of the straits will continue to adversely affect their economic prospects.

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2 Kpler, Update on Red Sea trade flow impacts, 1 Oct 2024.
3 UNCTAD, 2024 Review of maritime transport.

# ANGOLA



## THE NOOSE TIGHTENS

**In 2024, Angola's economic growth struggles to bounce back significantly. The non-oil economy is facing multiple headwinds, while the hydrocarbon sector is seeing a moderate return to growth. Despite large current account surpluses, pressure on external accounts has remained strong since resumption, in 2023, of the servicing of the external debt owed to China. The kwanza continues to depreciate against the dollar, which is severely deteriorating the State's solvency. The noose tightens on the government. It is facing ever-higher external debt repayments at a time when the risk of depletion of Chinese capital inflows is higher.**

## ECONOMIC GROWTH DEPENDENT ON THE OIL SECTOR

Between 2015 and 2023, Angola's real GDP contracted by an average of 0.5% per year. Economic activity was systematically driven down by the hydrocarbon sector (30% of GDP). It contracted by 37% in real terms over the same period due to the natural decline in active oil wells and the considerable lack of investment to boost the sector.

In 2024, economic growth is expected to rebound to 3.2%. It is buoyed in particular by the return to growth in the oil sector (*chart 1*). Over the first nine months of the year, oil production was up 4% year-on-year (y/y) and stood at 1.13 million barrels per day (mb/d). Since its exit from OPEC in January 2024, Angola has been free to produce more than 1.11 mb/day, the quota imposed on the country by the cartel for the current year. This sharpened investor appetite somewhat: in May 2024, a consortium of oil companies announced a final investment decision of USD 6 bn for a drilling project of 70,000 mb/d, which is expected to be operational in 2028. However, oil production is not expected to take off significantly. Together, current and future investment projects should just about compensate for the natural decline in active oil wells. As a result, oil production is expected to remain at around 1.1 to 1.2 mb/d until 2030, well below the 1.8 mb/d that Angola was producing on average over the period 2010-2016.

At the same time, non-oil GDP growth was limited to an average of 1% per year between 2015 and 2023. A rebound is expected, reaching 3.3% in 2024, but even at this level, non-oil growth remains very low given the population growth rate. The economy continues to face a number of headwinds: corporate activity is heavily constrained by currency shortages and a difficult business climate, while inflation is structurally high and impacting household purchasing power, fuelling a tense social climate. Consumer price inflation peaked at 31.1% y/y in July 2024 and remained at 29.2% in October. The monetary policy of the Central Bank of Angola (BNA) is failing to contain inflation. Since May 2024, it has left its key rate unchanged at 19.5%, but the effectiveness of monetary policy is restricted above all by the strong dollarisation of the economy and the low weight in the economy of bank lending to the private sector (8% of GDP).

## EXTERNAL ACCOUNTS UNDER PRESSURE DESPITE CURRENT ACCOUNT SURPLUSES

Since 2018, Angola has managed to generate a current account surplus every year. In 2024, it is expected to rebound to 6.3% of GDP, compared to 4.6% of GDP in 2023. Over the first half of 2024, the increase in oil production and the stabilisation of Brent prices helped increase oil export revenues by 7.5% y/y. At the same time, imports contracted by 17% y/y. As a result, the current account balance posted a surplus of USD 3.5 bn in H1 2024, compared to only USD 0.5 bn in H1 2023.

However, the performance of the financial account is significantly less favourable. Since 2023, resumption of the servicing of foreign debt owed to China has caused net inflows of long-term debt to fall into negative territory. In addition, net outflows of portfolio investments resumed in H1 2024 (USD -1.4 billion), after briefly entering positive territory in 2023. Positive point: net FDI flows entered positive territory in H1 2024 (USD +460mn) for the first time since 2016. While they remain largely insufficient to offset the net

**FORECASTS**

| | 2021 | 2022 | 2023 | 2024e | 2025e |
|---|---|---|---|---|---|
| Real GDP growth, % | 1.2 | 3.0 | 1.0 | 3.2 | 3.2 |
| Inflation, CPI, year average, % | 25.8 | 21.4 | 13.6 | 28.2 | 21.3 |
| Gen. Gov. balance / GDP (%) | 3.4 | 0.6 | 0.4 | 0.2 | -1.5 |
| Public debt / GDP (%) | 87.6 | 65.8 | 84.7 | 69.8 | 63.6 |
| Current account balance / GDP, % | 11.9 | 10.4 | 4.6 | 6.4 | 4.8 |
| External debt / GDP, % | 93.6 | 53.1 | 71.8 | 64.9 | 59.2 |
| Forex reserves, USD bn | 15.5 | 14.7 | 14.7 | 14.9 | 15.1 |
| Forex reserves, in months of imports | 9.9 | 6.2 | 7.4 | 8.5 | 8.5 |

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

**ANGOLA: OIL SECTOR DEVELOPMENTS**

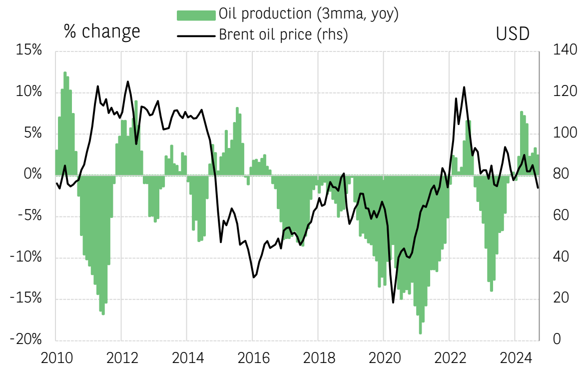


CHART 1

SOURCE: ANPG, EIA, BNP PARIBAS

outflows of portfolio investments, they could however continue to grow in H2 2024 and 2025, taking into account investment projects in the hydrocarbon sector.

As a result, external liquidity remains historically low. In September 2024, foreign exchange reserves reached USD 14.9 bn (+0.1 bn compared to the end of 2023) and remained close to a record low level reached last February. In 2024, the BNA continued its operations on the foreign exchange market to limit the depreciation of the kwanza. Despite this, the Angolan currency depreciated by 11% against the US dollar between December 2023 and September 2024, after -39% in 2023.

## CONCERNS ABOUT PUBLIC FINANCES

At 19% of GDP on average over 2015-2023, government revenues are low. Moreover, they are highly volatile, as on average over the period, more than half comes from oil income. As a result, since 2018, the government has been cautious and has adjusted its expenditure during the year in order to preserve the fiscal balance (with the exception of 2020, taking into account the Covid-19 pandemic).

However, the leeway for public finances is shrinking. The decline in oil production since 2015, while non-oil revenues are stagnating, is a major concern. In addition, the continued depreciation of the kwanza is threatening the solvency of public debt, of which 75% of stock is denominated in foreign currency. In 2023, the sharp depreciation of the kwanza in June forced the government to cut its expenditure drastically in the second half of the year in order to honour its payments to creditors, while preserving a slight fiscal surplus (0.4% of GDP). The IMF estimates that, over the period 2024-2025, interest payments on debt should exceed 30% of fiscal revenue, a very alarming level.

Against this backdrop, the elimination of fuel subsidies, initiated in June 2023, is a key reform to recover fiscal margins. However, so far, the effect on public finances of the rise, in local currency, in the price of gasoline (+87% in June 2023) and diesel (+48% in April 2024) has been undermined by the depreciation of the kwanza. In September 2024, the price for a litre of gasoline at the pump was just USD 0.32 according to the official BNA exchange rate, which is well below global market prices. As a result, the World Bank estimates that fuel subsidies should still cost Angola's public finances 3% of GDP in 2024. Full liberalisation of fuel prices, initially planned for 2025, has been postponed in view of the adverse social climate and high inflation.

## HIGH LEVEL OF VULNERABILITY TO CHINA

In 2023, the IMF estimated that a fall of one percentage point (pp) in China's real GDP growth rate would result in an average fall of 0.5 pp in the growth rate of oil-exporting African countries. However, this group is characterised by deep disparities. Angola is one of the countries most vulnerable to the slowdown in Chinese activity and to China's strategy of better directing its lending. This vulnerability is transmitted through two channels: i) bilateral trade flows and commodity prices, and ii) capital flows.

Oil accounts for more than 90% of Angola's exports, and China is by far its largest market. However, after peaking in 2017, Angolan oil sales to China gradually fell (in volume) until 2023. While Angola was China's second largest oil supplier in 2010, the country was ranked eighth in 2023, outperformed by the Gulf States, which are geographically closer with less volatile and larger production. As a result, on average over 2022-2023, China's share of Angolan oil exports fell to 50%, compared to 70% on average over 2018-2021. So far, Angola has been able to redirect its exports to Europe, taking advantage of the European embargo on Russian oil. As a result, the top five European importers of Angolan oil saw their share increase from an average of 7% over 2018-2021 to 26% of total Angolan oil exports over 2022-2023. However, Europe's ability to continue to absorb the decline in Chinese demand in the medium term is severely limited. In addition, China's slowing demand for hydrocarbons could also result in falling oil prices, as China alone accounts for 16% of global demand. The impact would be very negative for Angola's external accounts and public finances.

**ANGOLA: STOCK & FLOWS OF EXTERNAL DEBT OWED TO CHINA**

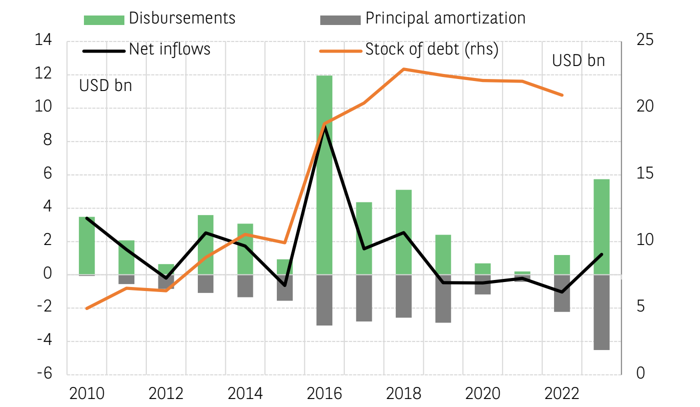


CHART 2 SOURCE: WORLD BANK, BNP PARIBAS

In addition, Angola is the African country most vulnerable to the risk of Chinese capital inflows drying up, as a result of China's strategy of redirecting its lending towards less risky borrowers. Since 2000, China has committed to lending USD 46 bn to Angola[1], making it the continent's main recipient country (far ahead of the USD 14 bn lent to Ethiopia, ranked second). But China has reduced its financial support since the pandemic shock, when Angola was on the brink of default. According to the World Bank, net inflows of long-term bilateral debt entered negative territory over the period 2019-2022, driven down by high repayments of principal; gross inflows meanwhile fell to USD 1.1 bn per year on average, compared to USD 3.9 bn per year on average over 2010-2018 (*chart 2*). While one third of its external debt is owed to China, and bilateral debt repayments will remain at record high levels over 2025-2027 (more than USD 4 bn per year), Angola could face an increased risk of external refinancing if China decides to further reduce its financial support.

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1 Boston University Global Development Policy Center. 2024. Chinese Loans to Africa Database.

# MOROCCO



## POTENTIAL YET TO BE CONFIRMED

**The economy continues to hold up. A new period of drought will affect growth in 2024, but non-agricultural activity remains sustained. Investment is recovering sharply and the rapid drop in inflation is buoying household consumption. The country's macroeconomic stability is not under threat. Another cause for satisfaction is the surge in FDI project announcements. Ideally located and providing undeniable advantages against a backdrop of geoeconomic fragmentation, Morocco seems to be taking advantage of the reconfiguration of global value chains. The impact could be considerable. Nevertheless, more will probably be needed to contain rising unemployment.**

## GROWTH: A SLOWDOWN TO BE PUT INTO PERSPECTIVE

After a rebound to 3.4% in 2023, economic growth will slow to below 3% in 2024. It has only reached 2.5% y/y on average over the first six months of the year. The 5% contraction in agricultural value added, due to a new drought, explains a large part of the slowdown. Excluding agriculture however, activity remained sustained at 3.3% y/y in H1 2024, a rate similar to its pre-pandemic momentum. Above all, growth drivers are rebalancing as shocks dissipate.

In 2022 and H1 2023, activity was primarily driven by external trade in goods and services (*chart 1*). Since H2 2023, its contribution to growth has fallen back into negative territory, which is not concerning as most external-oriented sectors are continuing to see strong performances. At the end of August, goods exports and tourism revenues rose by 5.5% and 7.1% y/y, respectively. At the same time, domestic demand continued to show encouraging signs of consolidation, particularly investment, which has recovered sharply since Q4 2023 after two difficult years. The resilience of private consumption has also been borne out. Despite low household confidence, particularly due to a deteriorating labour market (see below), private consumption is now growing at an annual rate of slightly over 3% thanks to two drivers that will continue: significant financial transfers from the Moroccan diaspora and falling inflation.

## FALLING INFLATION OFFERS ROOM FOR MANOEUVRE

The inflationary risk has decreased significantly. Consumer price inflation has fallen rapidly from the 10% y/y peak seen in early 2023. It is now fluctuating at around 1% thanks to the drop in food inflation, which was driven up sharply as a result of the outbreak of the war in Ukraine, contributing to 3/4 of the rise in the consumer price index (CPI). Non-food inflation remained much more contained, moving from a high of 5% in mid-2022 to 1% in September 2024 thanks in particular to the fall in global energy prices.

Against this backdrop, the monetary authorities made a preliminary rate cut of 25 basis points (bps) to 2.75% in June 2024, then maintained the status quo in September. Will they decide to cut the key policy rate further at the next meeting in December ? On the one hand, many indicators are positive: re-anchoring of inflation expectations close to 2% compared to almost 5% in Q2 2023, and a rather favourable external environment thanks in particular to the easing of monetary policy by the ECB and the Fed (the MAD is tied to 60% for the euro and 40% for the dollar). On the other hand, strong domestic demand or geopolitical uncertainties in the Middle East could prompt the Central Bank to play for time once again. Moreover, monetary conditions are still accommodative. The real key rate (ex-ante) is once again positive, but it remains below the neutral rate, estimated at 1-1.5% by the IMF.

**FORECASTS**

| | 2021 | 2022e | 2023 | 2024e | 2025e |
|---|---|---|---|---|---|
| Real GDP growth, % | 8.2 | 1.5 | 3.4 | 2.6 | 3.9 |
| Inflation, CPI, year average, % | 1.4 | 6.7 | 6.1 | 1.5 | 2.3 |
| Central Gov. balance / GDP, % | -5.9 | -5.2 | -4.4 | -4.3 | -3.8 |
| Central Gov. debt / GDP, % | 69.4 | 71.5 | 69.4 | 69.5 | 68.5 |
| Current account balance / GDP, % | -2.3 | -3.6 | -0.6 | -1.1 | -1.9 |
| External debt / GDP, % | 45.7 | 49.5 | 48.0 | 48.2 | 48.8 |
| Forex reserves, USD bn | 35.6 | 32.3 | 36.3 | 39.1 | 38.0 |
| Forex reserves, in months of imports | 7.1 | 5.3 | 5.9 | 6.0 | 5.6 |

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

**MOROCCO: REBALANCING ECONOMIC GROWTH**

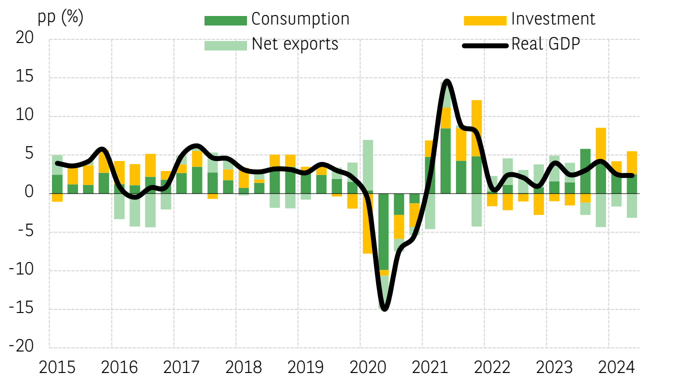


CHART 1 SOURCE: HCP, BNP PARIBAS

In any case, the Central Bank has more comfortable leeway to steer its monetary policy, especially since macro-financial risks are also contained.

## STRONG EXTERNAL AND FISCAL ACCOUNTS

Despite high oil prices (15-20% of Morocco's total imports) and a difficult economic situation in Europe, Morocco's main trading partner, the current account deficit narrowed sharply in 2023 to 0.6% of GDP. It will widen this year on account of an increase in imports due to both new investment projects and increased needs for foodstuffs (linked to the poor agricultural season). But the strong performance of the main sources of foreign currency (goods exports, private transfers, tourism revenues) should allow the current account deficit to be maintained at between 1 and 2% of GDP. This moderate level of deficit is not a source of instability for an economy that also benefits from robust capital inflows. In addition, foreign exchange reserves are close to six months of imports. With external debt below 50% of GDP and risk premiums back to pre-pandemic levels, Morocco also has leverage to borrow on international financial markets if necessary.

Public finances remain solid too. Since the pandemic shock, the budget deficit has shrunk by almost 3 GDP points (to 4.4% of GDP in 2023) despite a sometimes unfavourable economy, the government's sustained investment effort (+1.7 GDP points between 2019 and 2023) and the implementation of costly reforms (redesign of the social security system: 1.5-2% of GDP per year). The deficit is expected to stabilise at 4.3% of GDP in 2024 and then be reduced again in 2025, thanks in particular to the continued reform of the subsidy system. According to the new finance law, the budget deficit would, as a result, be reduced to 3.5% of GDP in 2025, an ambitious but credible target given the good performance of the public finance consolidation programme so far. In doing so, government debt would continue to fall slowly. At 69.5% of GDP, it remains high but its profile is favourable. Only a quarter of debt stock is denominated in foreign currency. Moreover, the easing of monetary policy can only improve financing conditions that are already favourable for the Treasury. The apparent rate of Moroccan government debt stands at 3.3% at the end of 2023, one of the lowest in the region, and the renewed confidence of investors in macroeconomic stability is accompanied by a lengthening of domestic debt maturity, which is now seven years and three months.

## A STEADY DETERIORATION IN THE LABOUR MARKET

The outlook is brighter, particularly in terms of economic growth: a rebound of 4% is expected for 2025, assuming a better agricultural season and good investment performance. Despite the persistence of risks, especially those related to global oil prices, public and external finances dynamics should remain under control without hindering the authorities' ability to support the economy and successfully complete several structural projects, of which the extension of social protection is undoubtedly the most ambitious.

Nevertheless, the continued deterioration of the labour market raises fundamental questions. The unemployment rate now reaches 13.6%, 3 points higher than its pre-pandemic level, while the activity rate continues to fall. In fact, Morocco has lost an average of more than 90,000 jobs each year since 2020, which can be explained largely, but not exclusively, by the increasing number of droughts (the agricultural sector accounts for 30% of employment). The limits of Morocco's economic model were already visible before 2020. Average economic growth slowed from 5% per year over the first part of the 2000s to 3-3.5% over the period 2015-2019. In addition, the job content of growth has deteriorated. Each additional GDP point was already generating only 12,400 jobs between 2010 and 2019, compared to 31,300 between 2001 and 2009. If there is a shock in agriculture, the economy is therefore no longer able to absorb the loss of jobs in this sector. The situation is not expected to improve in the coming years, given Morocco's vulnerability to climate change and the lack of expected acceleration in economic growth. Growth is expected to reach 3.4% per year on average over the period 2026-2029, according to IMF forecasts. It should remain among the highest of the region's oil importing countries, but insufficient to meet Morocco's economic and social development needs.

**MOROCCO: FOREIGN DIRECT INVESTMENT**

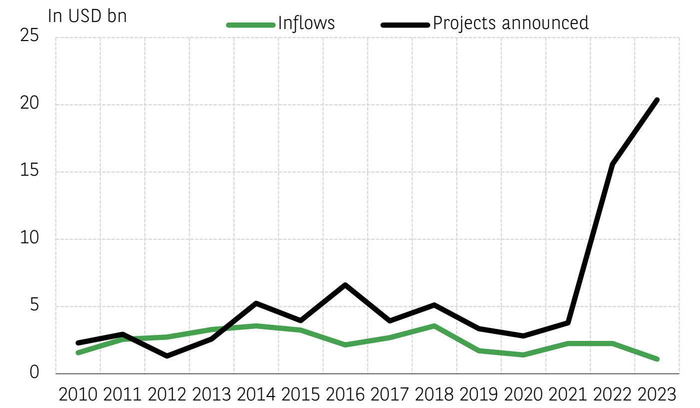


CHART 2 SOURCE: UNCTAD, BNP PARIBAS

## FOREIGN INVESTMENTS: A GROWTH DRIVER WITH STRONG POTENTIAL

Aware of these difficulties, the authorities launched a comprehensive long-term programme in 2021 that aims to profoundly reshape Morocco's development model. The scope of reform remains hard to assess. Nevertheless, the Moroccan economy has undeniable assets that should help it take advantage of the current context of reorganisation of global production chains: a strategic geographical situation, good infrastructure, a stable macroeconomic environment, and trade agreements with the European Union and the United States.

Several indicators, as a result, point to a profound change in the attractiveness of the Kingdom. Announcements of greenfield foreign direct investment (FDI) projects have increased five-fold over the past two years (*chart 2*). Morocco is the country with the highest share of new projects announced in percentage of GDP compared to other "connector" countries: 14% in 2023 compared to less than 2% for Mexico and Turkey. In addition, this surge is being accompanied by the emergence of a new investor: China. China historically accounted for less than 2% of FDI flows, but accounted for almost 30% of FDI project announcements in 2022-23. The increasing weight in the composition of FDI in the manufacturing sector, which is now the main recipient, also reflects increased integration into global value chains.

The impact of these new projects is, potentially, considerable but should not be overestimated for the time being. Morocco has just undergone profound changes with the development of the automotive sector. Exports in this sector have more than tripled in a decade, which has significantly improved the economy's ability to withstand external shocks without increasing its growth potential. Strengthening the links between the development of these high-value-added industrial niches and the rest of the economy will therefore be one of the main challenges in the coming years.

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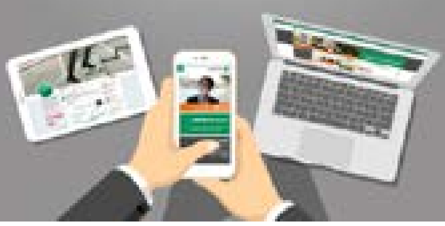

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