Mexico: Mixed sentiments

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The election of Mexico's new president, Andres Manuel Lopez Obrador, raises numerous questions. Although the new president and his team enjoy strong popular support, investors are worried about the policies he is proposing for the next six years. Some of the proposals do not seem to be compatible with his promise to maintain fiscal discipline, central bank independence and economic pragmatism in general. Several existing reforms are being called into question, notably in the energy sector. Given Mexico's strong economic fundamentals, these contradictions are unlikely to have much of a short-term impact. In the medium term, in contrast, the big risk is that they could jeopardise the government's capacity to maintain fiscal discipline, keep the energy sector afloat and preserve investor confidence.

Barely six months after his election as president of Mexico, Andrés Manuel López Obrador's first actions are already raising numerous questions. AMLO, as he is commonly known, was elected on 1 July 2018, but even before he was sworn in on 1 December 2018, his administration made several radical decisions, including the launch of a vast anti-corruption campaign, a referendum on the construction of an airport near Mexico City, which resulted in the project being scrapped, and the cancellation of several initiatives introduced by the previous government, notably energy sector reform. He also raised the minimum wage and announced several measures to reduce inequality. While affirming his intentions to respect his campaign promises concerning economic policy, AMLO and his team also reiterated their commitment to maintaining the central bank's independence, presented a budget that complies with the fiscal discipline seen in recent years and signed a new trade agreement with the United States and Canada.

In general, Mexico benefits from solid macroeconomic and financial fundamentals, but the country is still vulnerable to a change of investor sentiment. The political upheaval triggered by AMLO's election and the lack of clarity concerning his economic policy proposals have left investors dubious.

Although consumer stimulus packages and the anti-corruption fight will continue to ensure strong popular support for the government, investors' loss of confidence and the lack of clarity over economic policies is eroding short-term growth prospects. The government's credibility has been eroded when it comes to meeting its commitments, notably in terms of fiscal discipline. Uncertainty also shrouds the future of energy sector reform, which has played a key role in the country's political life in recent years. Fortunately, the country's external vulnerability is relatively low.

The political environment

On 1 July 2018, Andrés Manuel López Obrador, head of the left-wing Morena party (National Regeneration Movement), largely won Mexico's presidential election with more than 53% of the vote. AMLO, as he is commonly known, was sworn in on 1 December 2018 for a 6-year non-renewable term.

A coalition comprised of the Morena party and several small left-wing parties won the legislative elections held on the same day, winning majorities in both the House of Representatives and the Senate. When the parliamentary session opened in early September, the coalition had strengthened its position, with a total of 310 deputies and 69 senators (out of a total of 500 and 128, respectively). This is the first time since 1997 that a coalition has won absolute majorities in both houses. Moreover, the opposition is fragmented and the next elections (provincial and local) will not be held until 2021, which leaves the ruling coalition a lot of manoeuvring room to implement reforms.

Mayor of Mexico City from 2000 to 2005, and then the anti-establishment candidate defeated in the presidential elections of 2006 and 2012, the victories by AMLO and his Morena party were no small feat. The political alternative they proposed won strong popular support and reflects the clear rejection of Mexico's two traditional parties, which have shared power for almost a century. The Institutional Revolutionary Party (PRI), which was created after the 1910 revolution and became the centre-right party in the mid-1980s, has governed the country from 1929 to 2000, and then from 2012 to 1 December 2018. The conservative National Action Party (PAN) ruled Mexico from 2000 to 2012.

AMLO largely owes his electoral success to his promise to fight corruption and insecurity, even though similar promises have been made by all of the candidates elected since the mid-1980s. All of the reforms implemented so far have failed, and inequality has worsened. Felipe Calderon (PAN member elected in 2006) launched a drug war that flopped, while Enrique Peña Nieto (PRI member elected in 2012) transferred law enforcement to the military, which proved to be ineffective. Their mandates were marred by corruption scandals, collusion between law enforcement agencies and drug dealers, and repression of the press and opposition leaders, which fuelled the fierce rejection of the two traditional parties. On Transparency International's corruption perception index (CPI)[1], Mexico's ranking has deteriorated continuously since the early 2000s (chart 1).

During the campaign, AMLO and his team proposed a *"fourth transformation"*[2], which has proved to be a large-scale project that goes far beyond the fight against corruption and insecurity. The idea behind this "transformation" is to complete the country's modernisation through proposals to overhaul the State and the institutional framework. It promotes "*equitable economic growth, which is essential for reducing inequality, extreme poverty and insecurity."* One key proposal, "*becarios si, sicarios no*", would give scholarships to the 2.3 million Mexican youth who are neither students nor employed. The measure would be accompanied by a minimum wage increase, starting in 2019 for companies located along the US-Mexican border, and then for all companies by 2024. The transition team proposed to raise the minimum wage to 101 pesos (MXN) per day (USD 5.3). Currently, Mexico's minimum wage is MXN 88 (USD 4.6) per day.

Generally speaking, the transformation is built around several priorities, one of which is to reduce the country's external dependence, particularly with the United States, by accelerating export diversification and supporting the agricultural sector, in order to increase food self-sufficiency. Guarantied prices would be set for certain farm products.

Although these measures have not been spelled out in detail yet, it will be hard to meet all of their objectives simultaneously within the course of a single term, and without triggering budget overruns. This raises questions about the social and economic policy that will actually be followed during the legislative session. A priori it will be hard to reconcile all these different goals at the same time.

[1] The CPI index ranks 180 countries and territories according to their perceived level of corruption in the public sector based on the assessments of private and public sector experts.

[2] The "fourth transformation" is a term chosen by AMLO to designate the fourth development phase of the Mexican Republic. The first three transformations were Mexico's independence in the early 19th century, the Madero presidency, which launched the country's modernisation following the revolution of 1910, and the Lazaro Cardenas presidency from 1934 to 1940, which continued the country's modernisation by developing infrastructure, industry, education and public healthcare.

Corruption perception index

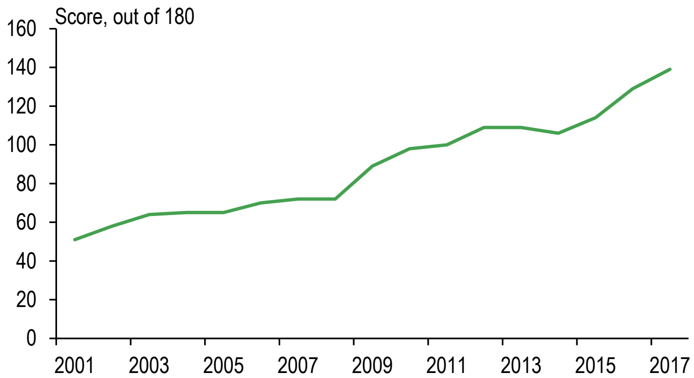

Chart 1 Source: Transparency International

The transition period raises the first doubts

The July-to-December transition period was marked by several contradictory signals. Immediately after his election, AMLO softened his positions and announced that he intended to adopt a "pragmatic" economic policy. He pledged to respect the central bank's independence, fiscal discipline and the trade agreements signed by the country. To prove this point, AMLO and his transition team lent their support to Enrique Peña Nieto during trade negotiations, even though he previously opposed the North American Free Trade Agreement (NAFTA) and the opening of Mexican trade. He approved the signing of the Canada-United States-Mexico Agreement (CUSMA) on 30 November 2018, the new trade agreement that replaces NAFTA.

At the same time, however, he began to push through several campaign promises. A referendum was held in late October on construction of Mexico City's new airport, which resulted in the project being cancelled, even though the financing was already in place and nearly a third of the airport had already been built. According to AMLO, such projects are natural sources of corruption and embezzlement. He sees the cancelation of the airport project in its existing form as the first sign of the country's fight against corruption.

AMLO also announced that referendums would be held frequently over the course of his mandate. He wants to modify the constitution to expand the scope of referendums, notably to include fiscal issues, which raises fears about budget overruns and respecting fiscal discipline.

Lastly, in early November, the Morena party presented a new measure to the Senate to provide a very strict framework for banking commissions. A week later, Morena withdrew the draft bill, and AMLO pledged not to reform the economic and financial sectors for at least the first 3 years of his presidential term.

During the transition period, investor sentiment towards the new administration eroded rapidly. Equity and bond indexes plunged at the end of October, and the Fitch rating agency gave Mexico's sovereign rating a negative watch. These trends reflect growing fears about the risk of budget overruns, but also about the future of reforms adopted by the previous government, notably the energy sector reform.

No clear policy lines since taking power

Since his inauguration on 1 December, AMLO has begun making contradictory signals again. He first affirmed that his goal was to end *"neo-liberalism"* and *"cronyism"*, which for him were synonymous with corruption, of confusing economic and political power, and in the end, greater inequality. He also pointed out the failure of the previous administration's reforms, particularly in fighting corruption and the energy sector reform.

At the same time, however, AMLO announced that he would not prosecute former leaders for corruption. In terms of security, he plans to make the militarisation of public security forces part of the constitution, which counters his claims to give priority to defending human rights.

AMLO says he will carry out a *"peaceful transformation, ordered, but profound and even radical"*. Yet his project presentation suggests a presidency characterised by a significant increase in federal power, and especially in the role of the president.

The government presented a list of 100 economic proposals. These closely follow his campaign promises, including overhauling the healthcare system (which is to resemble *"a Scandinavian healthcare system"* by the end of his presidency), constructing 100 new universities, doubling the amount of retirement pensions, and the announcement of several large-scale infrastructure projects to improve the country's attractiveness and competitiveness (construction of two new refineries, the upgrading of existing refineries, and the construction of the Maya train to promote tourism). He also presented a new proposal to reform the energy sector. All these proposals are to be financed by a *"government austerity"* programme, symbolised by the sale of the presidential aircraft on inauguration day, and by the savings generated from fighting corruption.

At the same time, AMLO also renewed his pledge to respect the central bank's independence and to maintain a sufficiently high primary surplus to stabilise the public debt at current levels (47.6% of GDP in 2017).

In early January, AMLO changed course again, this time closing several pipelines (to prevent the theft of fuel) and ensuring direct distribution of petrol by the State. Despite broad popular support, this measure triggered petrol supply shortages in several regions. Worse, it further eroded investor sentiment.

Exchange rate & equity market trends since 2018

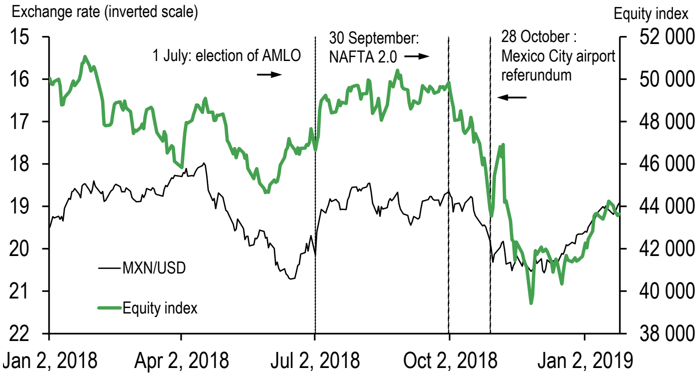

Chart 2 Source: Mexican Stock Exchange, Central Bank of Mexico

What about growth prospects?

Mexico's strong economic fundamentals will facilitate the implementation of the president's programme. The vast reforms launched in 2014[3] have bolstered the economy's resilience to external shocks. The IMF now estimates Mexico's potential growth rate at 3-4% a year, compared to average growth of only 2.3% a year between 2003 and 2013.

Since 2015, inflation and the unemployment rate have held at low levels and real wages have risen, despite falling commodity prices, tense relations with the United States and a series of natural disasters (see table 1).

Real GDP

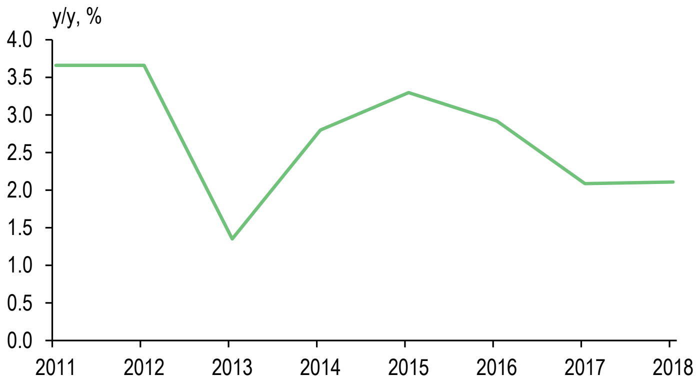

Chart 3 Source: EIA, IMF, Fed, INEGI

[3] Reforms were launched in energy, competition, telecommunications, taxation, the labour market, education and financial services, with the goal of boosting growth to 5% a year.

Greater resilience to external shocks

Change (%)	Q2 2000 – Q3 2002	Q2 2008 – Q2 2009	Q2 2014 – Q1 2016
Oil prices (WTI)	-17.7	-42.9	-65.6
US industrial output	-4.8	-15.5	-2.9
Mexican industrial output	-9.5	-10.6	0.3
Employment in Mexico	1.7	-0.6	3.0

Table 1 Source: EIA, IMF, Fed, INEGI

Monetary policy is deemed to be credible. The public deficit and debt have been reduced in recent years and fiscal revenues are less dependent on the oil business. The strong performance of non-oil exports (combined with the inflow of remittances from workers abroad) has helped reduce the current account deficit to a moderate level. Despite major portfolio investment flows, the country still has a solid external position (in terms of both solvency and liquidity).

Yet growth figures have deteriorated recently. Worries about renegotiating the trade agreement with the United States and uncertainty over the presidential election strained investment and private consumption in 2017, and public investment was scaled back under the fiscal austerity plan introduced by the previous government. Real GDP slowed to 2%, from 2.9% in 2016. As a result, growth is barely expected to surpass 2% in 2018, despite more buoyant private consumption. Moreover, growth is not expected to accelerate again before 2021, according to the latest IMF estimates.

Private consumption will continue to be the main growth engine, bolstered by a very dynamic labour market, the previous government's social policies and remittances from workers abroad. Yet these factors will not offset the cancelation of the Mexico City airport project nor investors' loss of confidence, which is bound to strain private investment. Even if the infrastructure projects are launched as promised, and the public-private partnerships actually work, it will take time to set them up, which means they are unlikely to have an impact on growth in 2019. The renewed confidence reported after the elections has been squandered (chart 4).

Although growth is slowing, it will also be important to monitor the central bank's capacity to contain inflationary pressures in the quarters ahead. The Board of Governors raised the key policy rate to 8.25% in December, the highest level in more than 10 years. Inflationary pressures, which have been present since the elimination of energy price subsidies in early 2017, are likely to persist at least through the first half of 2019, driven by January's minimum wage increase, as well as higher prices for petrol, fruit and vegetables.

External conditions will also be less favourable. The trade deficit will probably widen slightly further, mainly due to the sluggish US manufacturing sector and ongoing trade tensions with the United States, despite the signing of CUSMA. The new trade agreement still has to be ratified by each of the three member countries, which will take some time, straining investment and FDI in 2019, at least during the first half of the year.

Investor sentiment

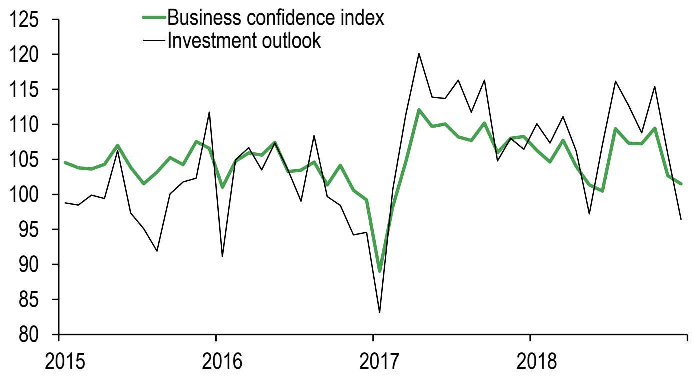

Chart 4 Source: Banxico

Inflation & the central bank's key policy rate

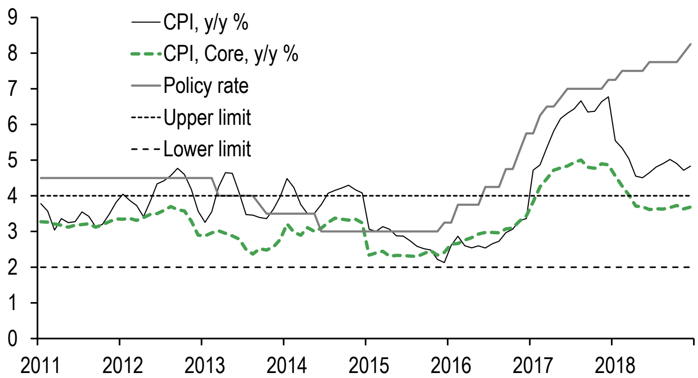

Chart 5 Source: Banxico

What about the future of energy sector reform?

Introduced in 2013 and 2014, the previous government's energy sector reform ended a 75-year monopoly in the country's oil and gas sector. The main goal of the reform was to promote an open, competitive market between public and private companies throughout the sector, in the upstream, intermediary and downstream segments. The strategy consisted of opening the capital of the two state-owned companies (Pemex, the national oil company, and CFE, the electricity utility) and attracting private investment. A core part of the reform was an auction system to attribute oil fields to private companies. More than a hundred contracts have been signed since 2015.

After several failed attempts since the 1990s, this reform was considered to be a success. Yet the downturn in commodity prices in 2014 severely handicapped its implementation. The budgets of the two state-owned companies, Pemex and CFE, were scaled back sharply and their debt has swollen significantly since 2015. Blocks were not auctioned to private investors (including non-residents) until 2016, and continued in 2017 and 2018. Altogether, the previous administration hoped to attract USD 200 bn in oil sector investment over 20 years, and to boost production levels to more than 3 million barrels a day.

Production continued to plunge, dropping from 3.5 million barrels a day in 2005 to less than 2 million barrels today (see charts 6 and 7). Faced with a shortage of investment, the sector was unable to develop the necessary production capacity to offset the decline in oil production at Cantarell, Mexico's largest oil field.

Yet the previous government's commitment played a key role in the auctions' success and in lifting investor confidence, notably among foreign investors. This is why AMLO's proposals have raised so much concern since his presidential campaign was launched.

AMLO affirmed that when it comes to energy, his priority is national sovereignty. His intentions still need to be spelled out in detail, but on the whole, they mark a step backwards, with the exception of the development of renewable energy. AMLO intends to cancel the reform in its current form, provide greater financial support for the two state-owned companies (Pemex and CFE), and limit the stakes of both foreign and domestic private investors in the sector.

Auctions of oil blocks were also halted (the fourth series was to have begun in February 2019). Private companies selected during previous auctions must complete their pledged investments within the next three years or have their blocks withdrawn. Concerning the oil sector in particular, he announced that six existing refineries would be upgraded and a new refinery would be built (construction costs are estimated at 0.7% of GDP). Oil exploration and production would also be stepped up. The goal is to increase production to 2.4 million barrels a day by the end of his mandate in 2024.

Mexican oil production

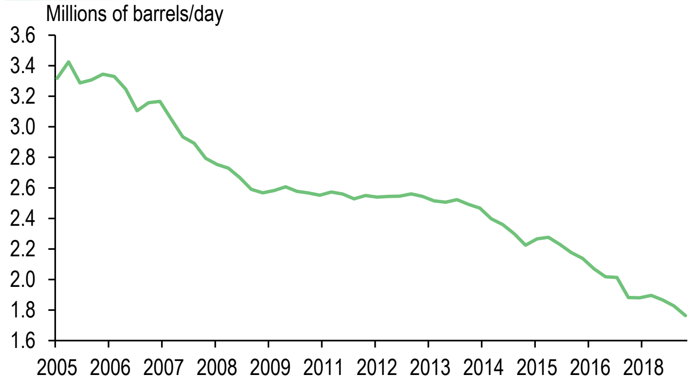

Chart 6 Source: Petroleos Mexicanos

Oil prices

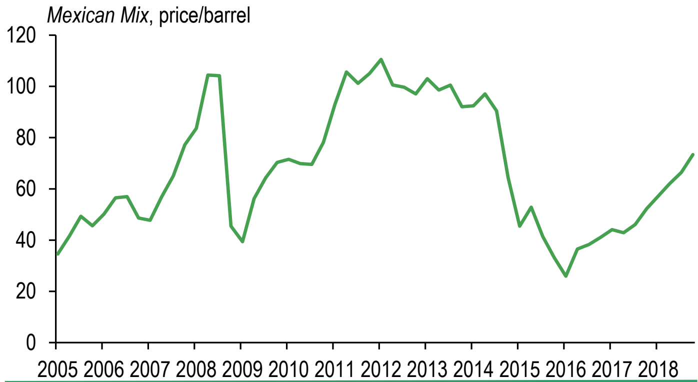

Chart 7 Source: Petroleos Mexicanos

The government has relatively little credibility when it comes to implementing all these measures. The majority of these proposals must still be spelled out and financed. The resources needed to implement all the proposed measures are close to 1% of GDP, in addition to the investment already planned in Pemex (see next section).

What are the risks of budget overruns?

Unsurprisingly, the 2019 budget proposal presented on 15 December complies with the fiscal discipline that has been observed in recent years: 1/ the new administration's first budget proposal was largely prepared by the outgoing administration, and 2/ after the turmoil of October and November, the government naturally wanted to be reassuring. Parliament adopted the budget proposal without any major modifications in the last week of December, and the budget was well received by investors and the rating agencies.

For the year 2019, the government is targeting a primary surplus of 1% of GDP, slightly higher than the 0.7% expected in 2018. The 2019 deficit is projected at 2.5% of GDP, very close to the expected 2018 deficit of 2.4% of GDP. The medium-term outlook calls for the primary surplus to hold at about 1% of GDP through 2024, and the debt ratio to be fairly stable at 45% of GDP.

The government's 2019 targets are based on reasonable assumptions: real GDP growth is estimated at 2%, inflation at 3.4% and the USD/MXN exchange rate at MXN20 (annual average). Even the assumption for oil prices is rather conservative, at USD 55 a barrel.

Revenues will fall, but the decline is expected to be limited (21.1% of GDP in 2019, compared to 21.7% of GDP in 2018). The new administration has pledged not to raise taxes. Moreover, on 31 December the president decreed that more than 40 municipalities near the US border would benefit from a lower VAT rate (to 8%, vs 16% for the rest of the country) and income tax cuts (by two thirds).

Spending will also be cut back to 23.2% in 2019, from 23.7% of GDP in 2018. In keeping with his campaign promises, spending will be increased on AMLO's new list of *"priorities"* (social welfare spending will increase by the equivalent of 1% of GDP), but to the detriment of other items. Certain ministries will be hit by major budget cuts (for example, -30% for the environment ministry, -29% for industry, -25% for communications & transport, and -9% for the interior ministry). Resources for Pemex and CFE, the two state-owned energy sector companies, will increase by 14% and 8%, respectively (relative to the 2018 budget), mainly to finance capital expenditure.

Lastly, contrary to initial announcements, social spending programmes will no longer be launched simultaneously, but rather one after the other. Some of the announced projects actually englobe existing projects that were financed by the previous government's budget, which explains why they do not engender additional spending.

On the whole, considering the solid macroeconomic fundamentals that the new administration inherited, there seems to be little risk of budget overruns in 2019. The debt profile (47% of GDP in 2017) is favourable, with non-resident holdings of public debt limited to only 30% of the total, a figure that has tended to decline in recent years. Similarly, the share of debt denominated in foreign currencies is also moderate, accounting for about 16% of GDP. The forex risk associated with the depreciation of the peso against the dollar or with a large share of non-resident investors during the rollover of existing debt seems relatively low.

Yet several questions persist in the medium term. First, the previous government already made significant spending cutbacks over the past two years, leaving little manoeuvring room for further cuts.

Public deficit

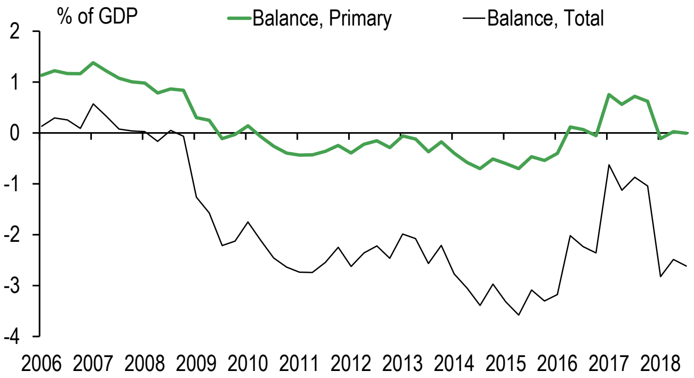

Chart 8 Source : INEGI

Public debt

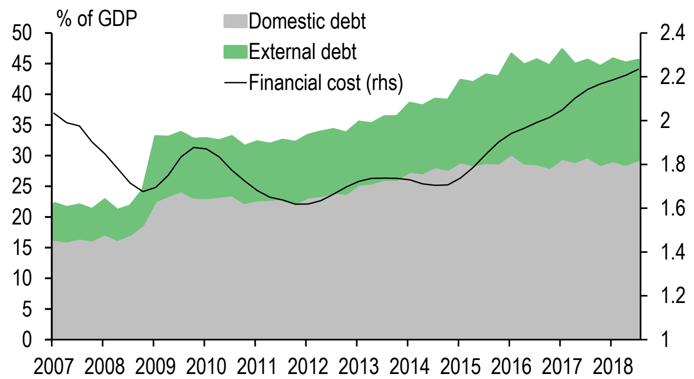

Chart 9 Source : Secretary of Finance & Public Credit

Second, the budget could be strained by several "overlooked" items, such as the costs associated with the cancellation of the Mexico City airport project, the upgrading of Pemex refineries, the installation of hydroelectric power plants, and the conversion of CFE's thermoelectric power plants. Third, the reallocation of spending on behalf of state agencies and state-owned companies in the energy sector creates a major new source of vulnerability for public finances given the capital expenditure necessary to increase production (oil-related revenues still account for nearly 20% of the total).

In particular, the government's determination to increase capital expenditure at Pemex and CFE could require recurrent capital injections in the two state-owned companies in the years ahead. Moreover, additional resources allocated to the state-owned companies could prove to be too small to halt the decline in production at Pemex and the contraction in oil reserves. Oil production dropped by 9% and 8%, respectively, in 2017 and 2018, and the decline could continue in 2019-2020. Pemex's financial situation is likely to remain (very) fragile in the years ahead, especially if it continues to increase its capital expenditure.

What about the impact on external vulnerability?

Although the Mexican economy boasts solid macroeconomic fundamentals on the whole, the country is still vulnerable to a reversal of investor sentiment. The proposed policies lack clarity, especially concerning the future of the energy sector reform. This could tarnish the country's attractiveness for foreign investors. Consequently, external vulnerability risks increasing during AMLO's mandate.

Nonetheless, Mexico's external vulnerability is not a real source of concern in the short term. Over the past 10 years, the current account deficit (which averaged 1.7% of GDP between 2010 and 2017) was usually covered by FDI inflows (which also averaged 1.7% of GDP between 2010 and 2017). This tendency is expected to continue (chart 10). In the medium term, we expect the current account deficit to level off at about 1.5% of GDP. It will continue to be financed by FDI. Mexico has substantial reserves, roughly USD 175 bn in December 2018 (about 4 months of imports). Even if investor sentiment were to deteriorate rapidly, Mexico has the necessary resources to meet its liabilities.

Since 2008, Mexico has also had access to a Flexible Credit Line (FCL) with the IMF[4], an immediately available contingent credit facility of nearly USD 88 bn. This credit line provides additional assurance that the country can withstand any shortages of capital flows.

Fears about future trade relations with the United States (the US accounts for nearly 80% of Mexican exports) have eased significantly since the final signing of CUSMA, which ended more than a year of tense relations between the three countries during which the US threatened to definitively withdraw from the trade agreement. The details of the new agreement have not been released yet and it is still difficult to evaluate its impact on Mexico.

The main changes are likely to pertain to the automotive sector. The "rules of origin" were changed: for goods to circulate freely without tariffs, the percentage of a vehicle's components manufactured in North America was increased to 75%, from 62.5% previously. The goal is to

Current account deficit & FDI

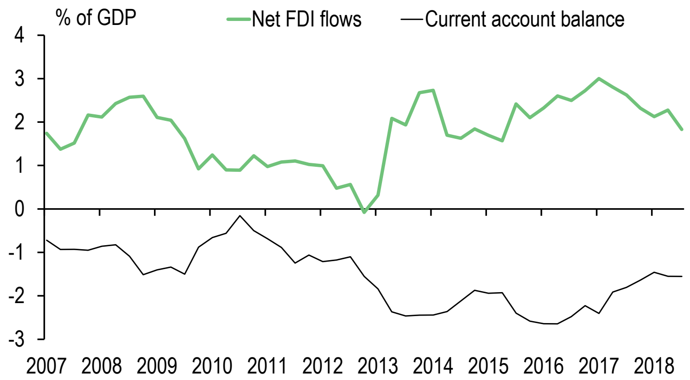

Chart 10 Source: Central Bank of Mexico

Hot money

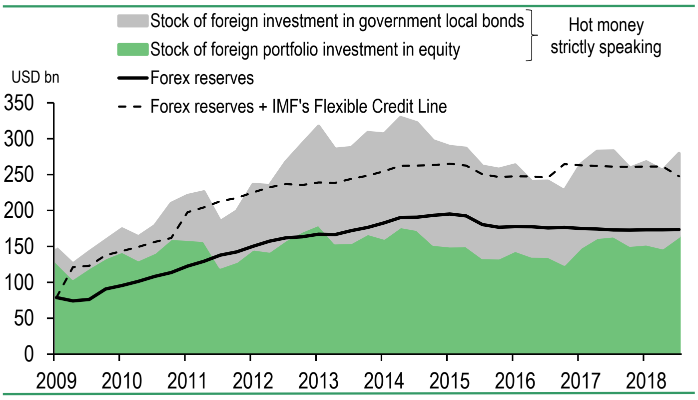

Chart 11 Source: Central Bank of Mexico, IMF

prevent NAFTA's advantages from spreading to products originating in non-member countries, with only minor transformations being made in North America. In the automotive sector, 40% of production must also come from factories that pay a minimum wage of at least USD 16 an hour.

Imposed by the United States, this measure targets Mexico directly so that vehicle assembly can be repatriated to the United States. Yet it might not suffice: vehicles that do not meet this criterion will still be able to enter the US by paying a tariff of 2.5% (based on the World Trade Organisation's most-favoured nation clause). This means it would still be attractive to assemble vehicles in Mexico before exporting them to the US. Moreover, a special clause will partially exempt Mexico and Canada from the punitive tariffs stipulated in article 232, which the US president can call on when invoking "national security" concerns. In practice, this means that Mexico can export a quota of 2.6 million vehicles to the US without risking punitive tariffs. This measure limits the growth potential of Mexico's automotive industry, since total exports to the US accounted for 2.3 million vehicles in 2017.

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[4] Flexible credit lines were designed to respond to the financing demands of a country that presents very solid economic policies and a track record for preventing and resolving crises. This instrument was created as part of the reform engaged by the IMF to modify the conditions under which it grants loans to countries which encounter cash flow problems, by adapting to their specific situation and needs. To date, three countries have called on FCL: Colombia, Mexico and Poland (until 2017). None have drawn on the credit lines, but the FCL provides these countries with precious assurance and assistance to strengthen market confidence during periods of growing risks.

The final agreement contains a radical change in the "sunset clause" proposed by the United States, which would have "automatically" terminated the trade agreement every five years, if the signing partners are unable to agree on the terms of renewal. In the end, the new treaty will be valid for 16 years and can be revised after six years, a period beyond the Trump presidency, even if he were to win the 2020 elections.

Conclusion

In general, the Mexican economy has solid macroeconomic fundamentals, but the country is still exposed to a change in investor sentiment. AMLO has launched a two-pronged policy, with one part designed to reassure investors (central bank independence; commitments to avoid eroding public finances and to support the free trade agreement, despite campaign promises to the contrary) and the other to uphold his campaign promises (fight corruption, reduce inequality, reform the energy sector), but he will not be able to conduct both over the course of his mandate.

The lack of clarity over energy sector reform raises fears of backtracking, which risk straining public finances and discouraging investors. From a broader perspective, any signs of backtracking could damage the government's credibility and undermine the country's attractiveness.

Completed on 25 January 2019

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Prepared by Economic Research – BNP PARIBAS
Registered Office: 16 boulevard des Italiens – 75009 PARIS
Tel: +33 (0) 1.42.98.12.34 – www.group.bnpparibas.com
Publisher: Jean Lemierre. Editor: William De Vijlder

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