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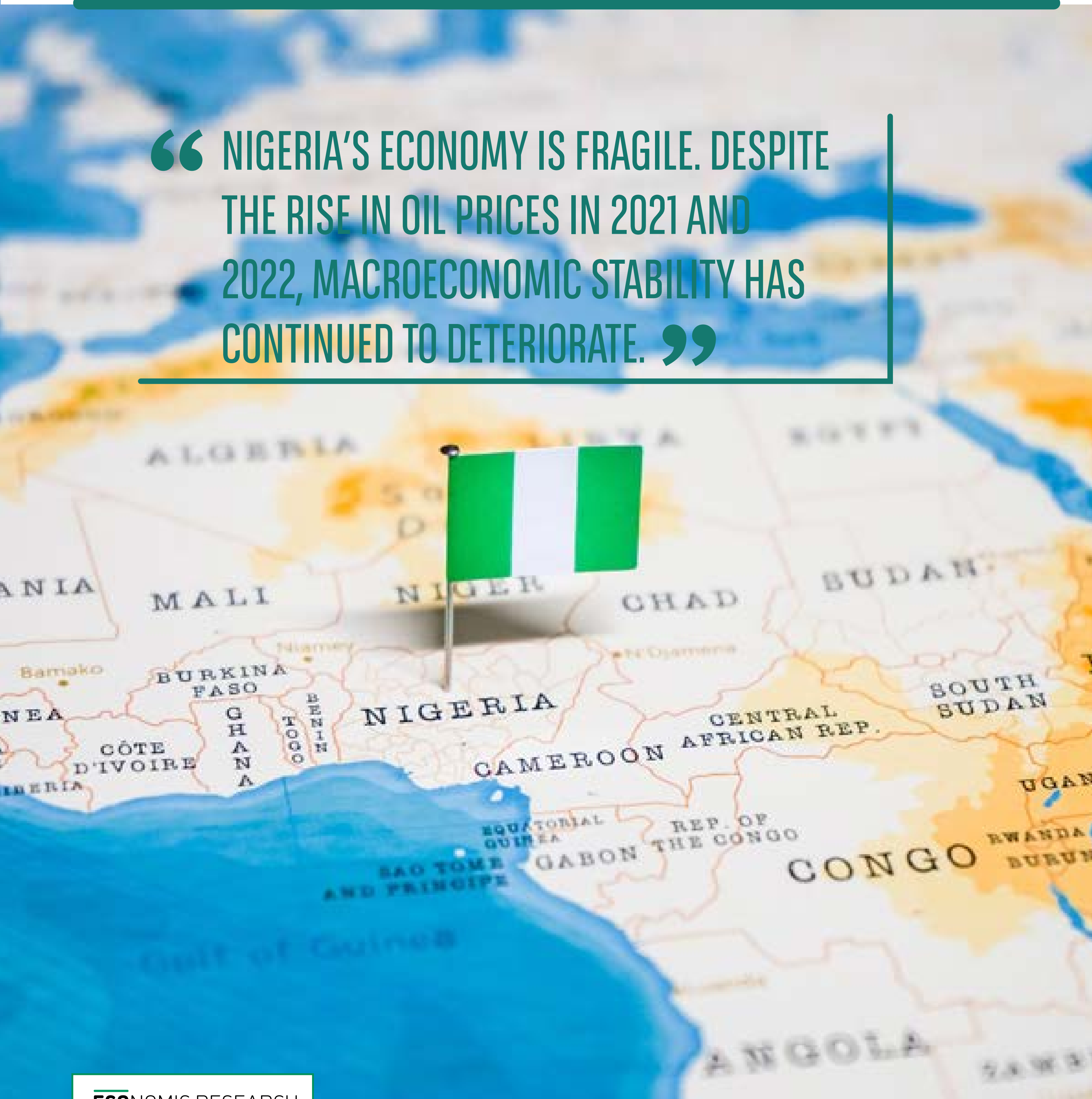
> NIGERIA'S ECONOMY IS FRAGILE. DESPITE THE RISE IN OIL PRICES IN 2021 AND 2022, MACROECONOMIC STABILITY HAS CONTINUED TO DETERIORATE.



ECONOMIC RESEARCH

BNP PARIBAS

The bank for a changing world

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NIGERIA: REMAINING ON COURSE

Stéphane Alby

Nigeria's economy is fragile. Despite the rise in oil prices in 2021 and 2022, macroeconomic stability has continued to deteriorate. This is due to the low level of oil production, an artificially overvalued exchange rate and the surge in energy subsidies. Without a change in economic policy, the situation was only going to get worse. The new President, Bola Tinubu, decided to act quickly and decisively. Shortly after taking office in May, he announced the flexibilization of the exchange rate system and the end of energy subsidies. Unsurprisingly, the first measure fuelled inflation, which is expected to come close to 30% by the end of the year. More problematic is the fact that we are once again seeing a gap between the official exchange rate and the parallel exchange rate. The second measure should lead to significant budgetary gains. But the government had to take action to offset the inflationary shock, and debt funding costs are rising. The public finance situation therefore continues to be a cause for concern. However, remaining on course will be crucial for restoring investor confidence.

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A NEW EXECUTIVE NURSING AN AILING ECONOMY

Robust decisions and a certain amount of hesitation

The beginning of 2023 was dominated by the presidential election. Declared the winner in the first round (despite a record rate of voter abstention), Bola Tinubu did not hesitate in distancing himself from his predecessor, Muhammadu Buhari, who is still a member of the same party. In the month following his appointment at the end of May, he replaced the Governor of the Central Bank and completely overhauled the security system. He formed his cabinet just as quickly. The cabinet is made up of 45 ministers, and some key roles, such as finance minister, have been allocated to technocrats. Most importantly, President Tinubu surprised investors by announcing the end of energy subsidies and the flexibilization of the exchange rate system, with the setting up of a single window for all transactions at a price supposed to be determined by market forces. Since then, the domestic price of petrol has more than doubled and the naira has lost 40% of its value against the US dollar.

For the government and the monetary authorities, these drastic measures should restore macroeconomic stability in the medium term. Nevertheless, the short-term consequences will be severe in a country where 40% of the population lives in extreme poverty and where inflation is already very high. These measures could therefore be a blessing in disguise. But the President's recent announcements have cast doubt on this idea. In fact, he has stated that there would be no further increases in domestic petrol prices until the end of the year, and that the naira rate, delivered in foreign exchange bureaus, should now fluctuate within a range of -/+ 2.5% compared to the official rate on the previous day. Increased monitoring of foreign exchange bureau activity will also be implemented, with the aim of bringing the parallel and official exchange rates into line, with the gap between them now standing at 30% after being bridged at the time of devaluation of the currency (Chart 1). Although the difficulties encountered in implementing such reforms were foreseeable, taking into account significant social pressure, this remains a concern.

A weakened economy

The Nigerian economy has been weakened. From 6.1% per year between 2010 and 2014, economic growth has fallen to 1.3% on average since 2015, which is lower than demographic growth (+2.6%). As a result, real GDP per capita has contracted by 9% over the past seven years, which represents a real breakdown in the country's economic development. Real GDP per capita more than doubled between 2000 and 2014. More worryingly, the economy has not seen much benefit from the rise in oil prices since 2021. The post-Covid recovery has rapidly slowed (3.1% in 2022 after a moderate rebound in growth to 3.6% in 2021, compared to a downturn of 1.9% in 2020), making Nigeria an exception among the major oil-producing countries. In addition, macro-financial stability has continued to deteriorate.

OFFICIAL & PARALLEL EXCHANGE RATES

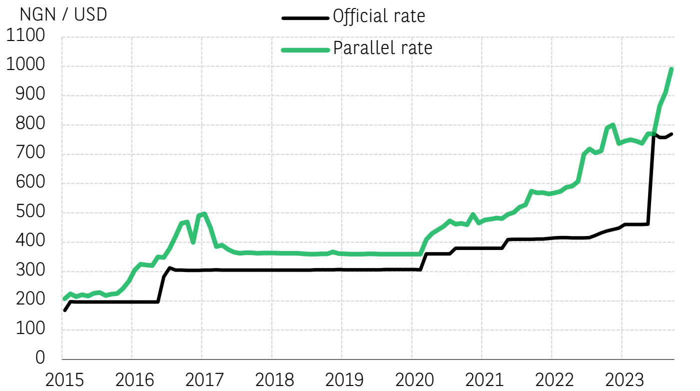

CHART 1 SOURCE: CENTRAL BANK, NAIRAMETRICS, BNP PARIBAS

BUDGETARY REVENUES AND OIL PRICES

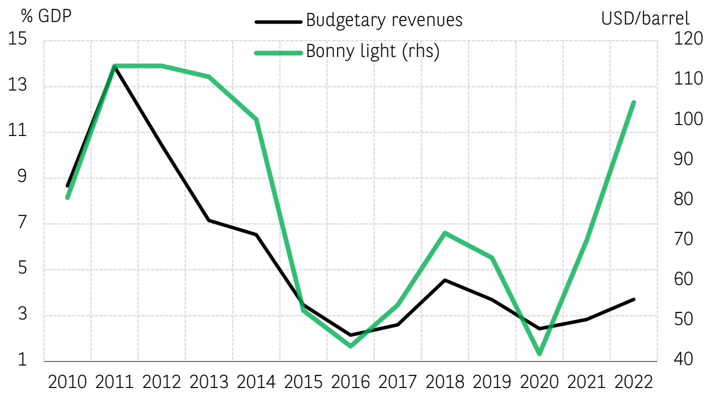

CHART 2 SOURCE: CENTRAL BANK, IMF, BNP PARIBAS

There are several reasons for this, starting with the poor performance of the oil sector. Falling to 1.5 million barrels per day (mb/d) in 2020 compared to 1.9 mb/d in 2019, crude oil production continued to contract to a historic low of 1.1 mb/d in 2022. The surge in energy subsidies also exerted a bit more pressure on the budgetary leeway already eroded by the debt burden, which has risen sharply since 2014, and the increase in the costs of financing. In 2022, the debt interest burden exceeded public investment and budget revenues barely returned to their 2019 level, despite 60% higher oil prices (Chart 2). The loss of financial attractiveness due to an artificially overvalued exchange rate has also led to a decorrelation between oil prices and foreign exchange reserves (Chart 3). At the end of 2022, these reserves amounted to only USD 5.6 billion compared to USD 36.7 billion in 2020, despite the IMF's SDR allocation in 2021 and the issuance of Eurobonds for a cumulative amount of more than USD 4 billion. The already significant restriction on access to the dollar has therefore been tightened. This has resulted in strong pressure on the parallel exchange rate which, combined with an overly accommodative monetary policy, has contributed to a surge in inflation already at work before the shock of the war in Ukraine.

An inflationary shock that will weigh on economic activity in 2023

Without a shift in economic policy, the macroeconomic situation was only going to get worse. Nevertheless, the measures taken by the new executive will affect growth in the short term.

In fact, the decision taken by the Central Bank at the end of 2022 to change the banknotes in circulation caused a liquidity crisis in Q1 2023. Launched on 15 December 2022, this policy to overhaul the naira was due to be completed by the end of January 2023. Poorly prepared, this policy led to a 60% drop in currency in circulation in January and February before the Central Bank reversed its position in March by allowing use of the old banknotes once again. Excluding agriculture and excluding the oil sector, growth slowed sharply as a result to 3.9% in Q1, compared to 6% on average in 2022. In 2023, with a contraction of 0.9% in agricultural GDP, the economy recorded a growth rate of only 2.3% y/y in Q1 (Chart 4), and weak economic activity in the oil sector once again dashed hopes of a rebound in Q2 (only 2.5%). At 1.1 mb/d on average between April and June, crude oil production reached a new low due to a strike affecting Exxon Mobil facilities in April. Oil production is expected to recover over the rest of the year and reach an average of 1.250 mb/d in 2023, provided there are no further incidents. However, this will be lower than the quota allocated to the country by OPEC but reduced to 1.380 mb/d compared to 1.750 mb/d previously (Chart 5). In any case, the recovery will be limited and the rest of the economy is struggling.

Non-oil and non-agricultural GDP recovered very slightly in Q2 (4.3%), largely driven by the good performance of the information and communication technology (ICT) sector and financial services and insurance (Chart 6); without these two drivers, it only rose 0.6% in Q2. In fact, whole swathes of the economy are at a standstill, particularly retail, with growth of less than 2% since the beginning of the year, compared to 5.1% in 2022 and 8.6% in 2021. Retail sluggish activity reflects weak consumer consumption due to strong inflationary pressures. However, the situation will not improve in the coming months due to the double shocks of the devaluation of the naira and the end of oil price subsidies, which has already a significant impact. In fact, the rise in the consumer price index (CPI) reached 24.1% in July and 25.8% in August (Chart 7), an almost 20-year record. On a monthly basis, growth was also unpre-

FOREX RESERVES AND OIL PRICES

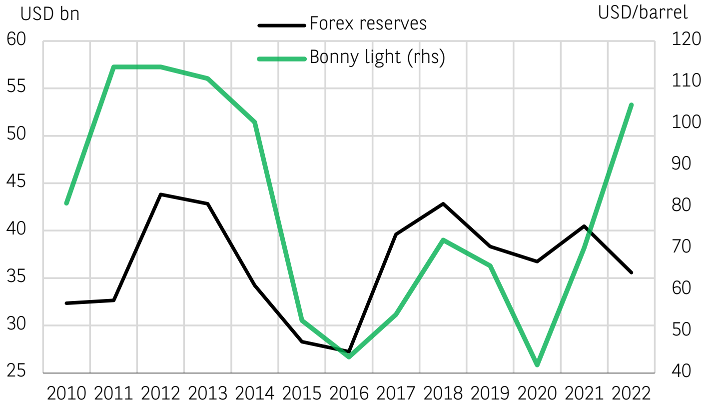

CHART 3 SOURCE: CENTRAL BANK, IMF, BNP PARIBAS

CONTRIBUTION TO REAL GDP GROWTH

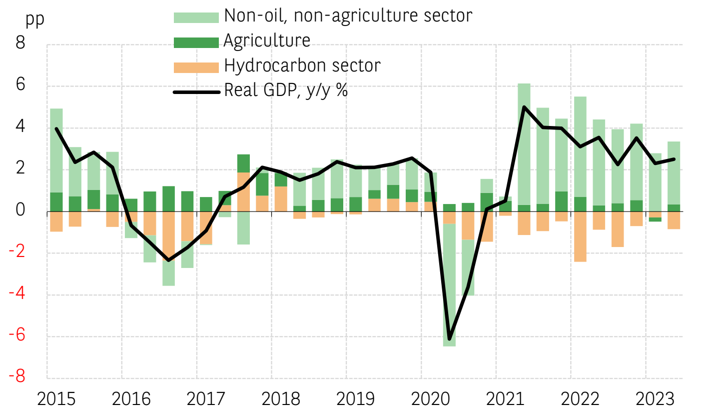

CHART 4 SOURCE: NBS, BNP PARIBAS

CRUDE OIL PRODUCTION AND QUOTA

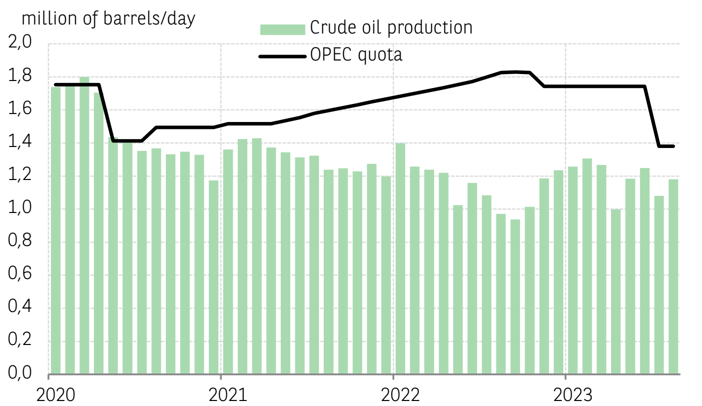

CHART 5 SOURCE: JODI, OPEC, BNP PARIBAS

cedented: +2.9% in July and +3.2% in August, i.e.1 point higher than the average recorded since the beginning of the year. Food inflation (+29.3%) was the main contributor, with food accounting for 51% of the consumer basket. But the rise in prices is widespread. Core inflation (excluding food and energy) stood at 21.5% y/y in August compared to 18.9% at the beginning of the year, and pressure will remain strong in H2 despite the decision to freeze petrol prices until the end of the year.

With this level of inflation (25% on an annual average and nearly 30% at the end of the year), economic growth is expected to slow down further this year. At 2.5%, real GDP growth would be once again lower than population growth. According to the World Bank, it could accelerate above 3% in 2024 and even top 4% from 2025 onwards, taking Nigeria closer to its average performance before 2014. Nevertheless, this presumes a strengthening of macroeconomic stability, which is still far from being achieved, particularly on the inflation front.

There is no indication at this stage whether the current price shock will be temporary given the high volatility of the exchange rate. Better coordination of fiscal and monetary policies will also be required to lower inflation durably. However, the signals sent by the monetary authorities are, for the time being, mixed. The key rate hike of just 25 bps in July remains a token gesture. This is the smallest movement since the Central Bank started the monetary tightening cycle (in May 2022). At 18.75%, the key rate also remains too low in view of the level of inflation (Chart 8). Further rate hikes are likely to be necessary. The Central Bank will probably also use other levers, such as the recently relaunched sterilisation operations. However, the size of the first security issued in early August by the Central Bank was considered too modest compared to the strong growth in the money supply (+20% on average since 2020 before the revaluation effect linked to the exchange rate adjustment in June); the latter was largely linked to the repeated monetisation of budget deficits. In addition, the increase in the Central Bank's limit on advances to the Treasury, from 5% to 15% of the previous year's revenue, suggests that the authorities are not prepared to give up on deficit monetisation. Its scale will depend largely on the dynamics of public finance. However, as long as there is so much money in circulation, the inflationary risk will remain high. The same applies to exchange rate risk, as demand for dollars remains unsatisfied at present.

EXTERNAL ACCOUNTS ARE STILL VERY FRAGILE

The nominal devaluation of the naira by more than 40% helped to correct the currency overvaluation accumulated since 2021. With a real effective exchange rate that has returned to its long-term average (Chart 9), the naira should, in theory, be close to equilibrium. However, the official exchange rate is still subject to high volatility, and the spread with the parallel market might even suggest that the authorities do not want any further currency adjustment for fear of boosting inflation. Either way, the 12-month forward rates (NGN/USD 998 versus NGN/USD 759 for the official rate) indicate that pressure is not about to ease. In fact, whether in terms of flows or stocks, Nigeria's external position remains fragile.

Problem with flows...

Despite the rebound in oil prices in 2022, Nigeria only posted a small current account surplus of 0.2% of GDP due to factors that are still largely prevalent today. One of these factors is low oil exports. The slight increase in oil production expected this year will not make up for the fall in the annual average Brent prices. At USD 50 billion, crude oil exports are below their 2018-2019 levels. In terms of imports, the

CONTRIBUTION TO NON-OIL, NON-AGRICULTURE REAL GDP GROWTH

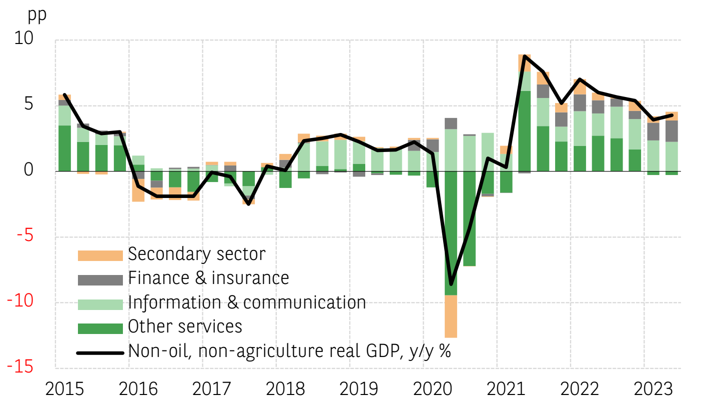

CHART 6

SOURCE: NBS, BNP PARIBAS

INFLATION

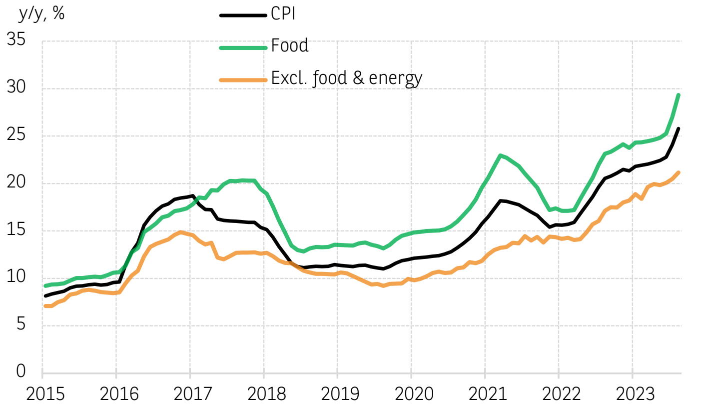

CHART 7

SOURCE: NBS, BNP PARIBAS

MONETARY ENVIRONMENT

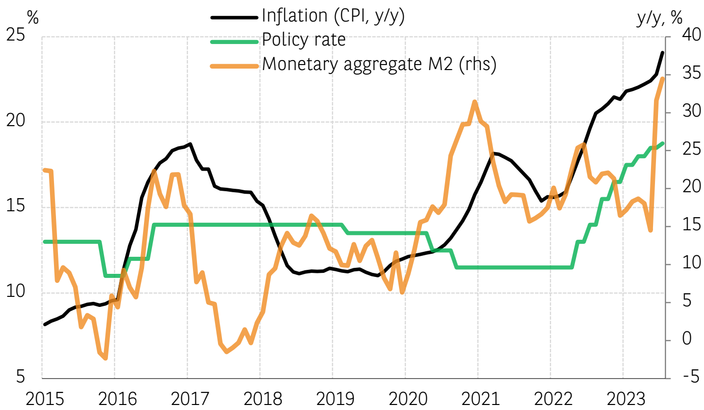

CHART 8

SOURCE: CENTRAL BANK, BNS, BNP PARIBAS

start-up of the Dangote mega-refinery is also supposed to give a boost to an economy that is currently dependent on other countries to provide supplies for its domestic market. In 2022, imports of refined oil surged, accounting for 35% of the country's total exports. But the refinery could take longer than expected to ramp up. The IMF expects production to be 100,000 barrels per day in 2024, 200,000 in 2025 and 300,000 in 2026-27. This is well below the 650,000 barrels per day announced by the end of 2024, i.e. levels sufficient to cover all of Nigeria's needs. In view of the repeated incidents affecting the hydrocarbon sector, caution remains necessary. More generally, uncertainties about oil production outlook are a a key risk. Assuming constant Brent prices, every 100,000-barrel increase per day could generate a gain of 0.8% of GDP oil exports over a full year.

Moreover, the rebalancing of external accounts thanks to exchange rate adjustment is expected to be modest. In the past, this strategy had worked quite well. But the current situation is different, due to the already low level of non-oil imports: 7.5% of GDP in 2022 compared to 10.5% in 2019-2020. Further compression of demand for imported goods could therefore cause the economy to fall into recession. The fact that 90% of exports are made up of oil or gas also limits the potential gain of exchange rate competitiveness.

With an expected current surplus of around 0.5 points of GDP for 2023 and 2024 (Chart 10), external liquidity pressures are likely to persist. For three years now, net financing flows have been low, or even in negative territory in 2020, despite the success of Eurobond issues in 2021 and 2022. However, Nigeria tapping the international financial markets again seems difficult to envisage in the short term. Although risk premiums on government bonds in US dollars have fallen significantly since June, they are still above 700 bps. Moreover, the effects of the exchange rate reform remain uncertain. In principle, the measure should increase the country's attractiveness. However, for the time being, a wait-and-see attitude is prevailing among foreign investors due to the lack of visibility on the direction of economic policy and interest rates deemed too low. Against this backdrop, the consultation around the potential reclassification of the MSCI Nigeria index will be closely monitored. The decision was rescheduled for the end of October in order to take recent developments in the foreign exchange market into account. If external liquidity improves, Nigeria will maintain its frontier market status. Nevertheless, the scope of such a decision must be nuanced, as it only concerns the stock exchange, i.e. less than 10% of portfolio investment inflows since 2019. The very high level of the "errors and omissions" item is also a source of weakeness (Chart 11). In 2022, this item was negative by USD 7.5 billion, i.e. more than the current surplus and net capital flows cumulated. However, by definition, there is no visibility on changes to this item.

... and stock

Hard currency inflows are no longer enough to cope with outflows. Over the first eight months of the year, foreign exchange reserves continued to contract by almost USD 3 billion, after falling by USD 5 billion in 2022. The level they have reached is also a problem.

The coverage ratio is apparently comfortable. At the end of 2022, foreign exchange reserves still reached 5.5 months of imports of goods and services. But this ratio does not show the whole picture. In particular, it is inflated by the compression of imports due to difficulties in accessing the dollar for economic operators, and due to capital control measures or the Central Bank's rationing. Officially, there is around USD 7 billion in pending demand, the equivalent of 0.4 months' imports of goods and services.

REAL EFFECTIVE EXCHANGE RATE

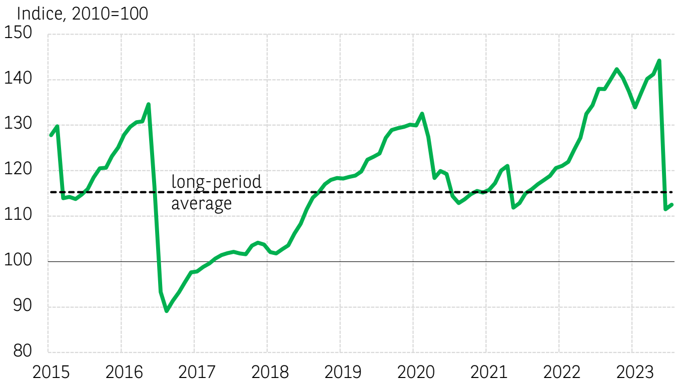

CHART 9 SOURCE: IMF, BNP PARIBAS

CURRENT ACCOUNT

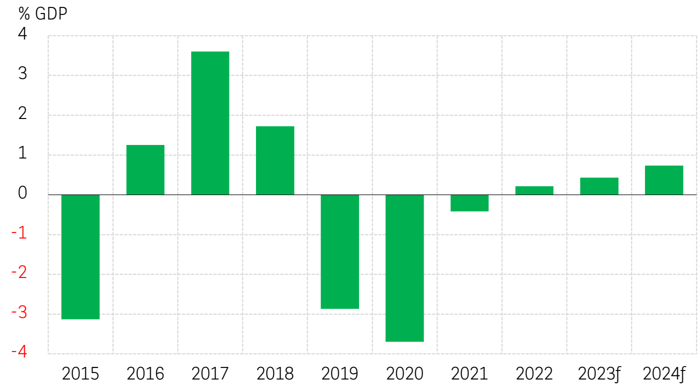

CHART 10 SOURCE: CENTRAL BANK, BNP PARIBAS

NET FINANCIAL FLOWS AND 'ERRORS & OMISSIONS'

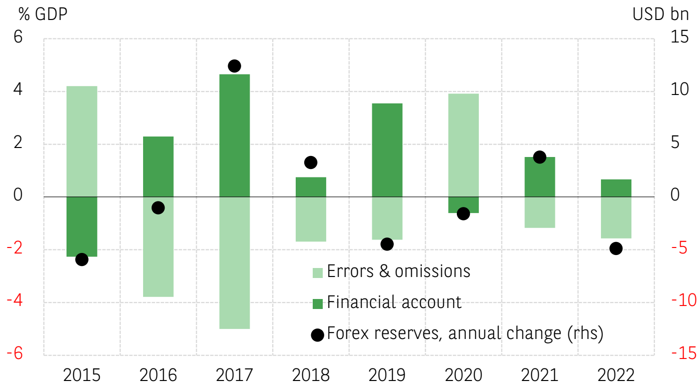

CHART 11 SOURCE: CENTRAL BANK, BNP PARIBAS

In addition, a significant proportion of the Central Bank's foreign exchange reserves is not fully available. The recent publication of the Central Bank's audited financial accounts for the period 2016-2022 have revealed significant foreign-currency liabilities of USD 14.3 billion, including USD 6.9 billion in forward currency contracts and USD 7.5 billion in securities loans. Details of the exact nature of these commitments are not provided, but it would seem that they were contracted on short maturities with the aim of bolstering foreign exchange reserves. As a result, net foreign exchange reserves were USD 21.3 billion at the end of 2022, or enough to cover only 3.3 months of imports of goods and services. More troubling, an off-balance sheet item points to higher commitments (USD 31.7 billion at the end of 2022) by including OTC futures and swap transactions. Again, it is impossible to determine with whom these contracts were concluded (local or foreign investors), or even their use. According to the various IMF reports, currency swaps could reach USD 10 to 12 billion, of which a large proportion is with domestic banks, which would reduce external liquidity risk somewhat. The Central Bank's currency supply capacity is nevertheless dependent on the renewal of swap transactions.

In addition, potential capital outflows should also be taken into account to assess the external vulnerability of a country. Yet, the shock of hot money (stock of portfolio investments in equity and short-term debt) remained significant at USD 28.3 billion at the end of 2022, i.e. the equivalent of 80% of gross foreign exchange reserves (Chart 12) and 133% of net reserves. Nigeria is therefore also fragile in this respect.

PUBLIC FINANCE: STRUCTURAL PROBLEMS REMAIN

Reduced budget flexibility

The situation of public finance is another major concern. Despite the decision to end energy subsidies and the increase in oil revenues generated by the depreciation of the exchange rate, the budget deficit is still expected to reach 5% of GDP in 2023 and 4.7% in 2024, compared to 5.7% in 2022 (Chart 13).

In fact, Nigeria's very low tax base is jeopardising the prospect of rapid fiscal consolidation. Government revenues, which had fallen to a low of 5.6% of GDP in 2016, have somewhat recovered since then, but have not returned to their pre-2014 levels or caught up ground lost compared to peer countries (Chart 14). At 8.6% of GDP in 2022, they remained 9 points lower than the average in sub-Saharan Africa, and 12.7 points lower than other oil producers on the sub-continent. However, this poor performance cannot be explained solely by the poor performance of oil revenues. Despite some progress in recent years, non-oil revenues still did not reach 5% of GDP in 2022. Consequently, Nigeria is not only posting a

structurally low level of public spending (Chart 15), but budgetary flexibility has also been significantly reduced. Almost one third of government resources were used to pay debt interest in 2022, compared to less than 10% in 2014. At federal government level, the situation is even worse. For the first time, in 2022, interest surpassed total resources, pushing the federal government to cut drastically capital spending, which fell below 1% of GDP.

The room for manoeuvre generated by the energy subsidy reform and the exchange rate system reform is, however, significant: this is expected to reach 1.7 points of GDP in 2023 alone, and probably double that figure in 2024. With regard to energy subsidies, they represented only 1.4% of GDP from January to June 2023, compared to 2.2% of GDP in 2022. However, the government was forced to implement some mitigating measures to absorb the inflationary shock. The authorities

INDICATOR OF EXTERNAL VULNERABILITY

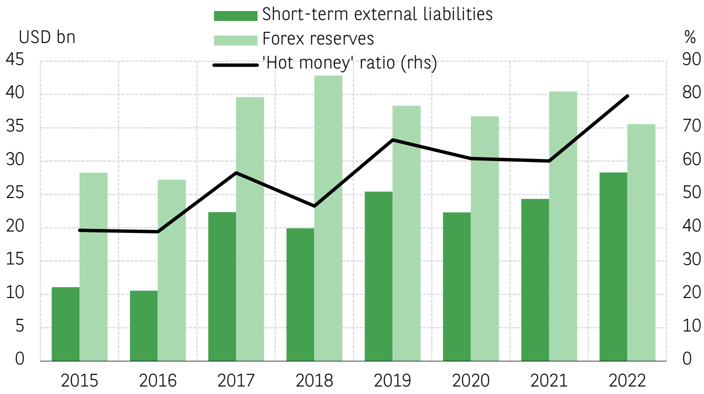

CHART 12 SOURCE: CENTRAL BANK, BNP PARIBAS

BUDGET BALANCE

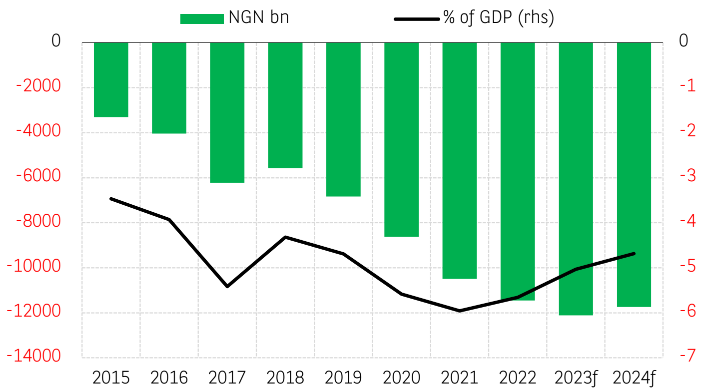

CHART 13 SOURCE: IMF, BNP PARIBAS

BUDGETARY REVENUES

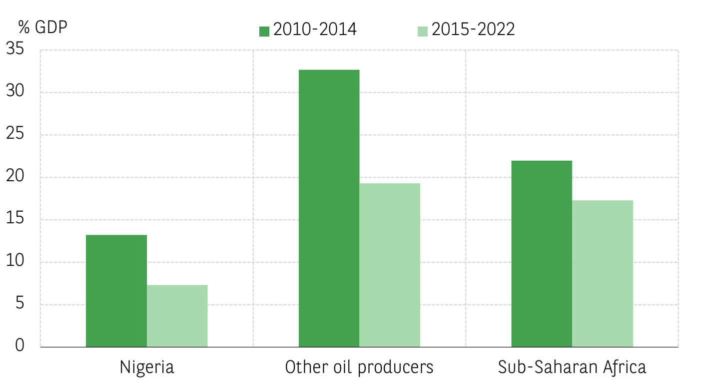

CHART 14 SOURCE: IMF, BNP PARIBAS

are already planning to use a concessional loan of USD 800 million from the World Bank to make direct transfers to the most vulnerable households. This represents less than 10% of the amount of subsidies, but other measures should be put in place. In addition, reducing public investment is still possible, but this is not desirable. According to the World Bank, it would take 300 years for Nigeria to fill its infrastructure gap at the current pace.

High cost of financing

Reduced budgetary leeway is largely due to the authorities' difficulty in improving tax collection. Another explanation is the high cost of financing. In recent years, the government has called heavily on the Central Bank to cover its budget deficits. Limited, in principle, and temporary in nature to offset a drop in revenues, the Central Bank's direct advances have largely replaced traditional sources of financing. In 2022, advances covered nearly 60% of government requirements. In terms of stock, they now represent 1/3rd of debt compared to 6% in 2015 (Chart 16). However, this financing strategy is not only inflationary, but also very costly for public finance. The interest rate on advances is 21.75% (Central Bank's key rate plus 3%), while interest rates on local market issues have not exceeded 16% since the beginning of the year.

A restructuring agreement was signed at the beginning of the year by the Ministry of Finance. This agreement covers almost all of the stock of debt contracted with the Central Bank at the end of 2022. It provides for conversion of short-term advances into debt securities with a maturity of 40 years, at an interest rate of 9%, accompanied by a three-year grace period on payment of the principal. According to estimates, the transaction is expected to reduce the government interest burden by almost 1 point of GDP. Obviously, this does not apply to transactions completed after signature of this agreement. Yet, the financing constraint remains significant. The absorption capacity of banks is limited. As the external financing conditions deteriorate, the government is therefore at risk of still making massive use of the Central Bank's advances.

All in all, given the expected high budget deficits, the interest debt burden should stabilise over the next two years, at best.

Public debt has risen sharply since 2015, from 14.1% of GDP to 36% at the end of 2022. It is expected to rise by 3 points of GDP to 39% in 2023 before starting to stabilise from 2024 onwards. The impact of the exchange rate shock on government debt will be contained. Only 1/4 of the public debt stock is denominated in FX currencies, and the proportion of official creditors in the government's external debt remains significant (61% at the end of 2022), albeit decreasing sharply (85% in 2015). The next repayment of the Eurobond debt will be made in 2025 and will total USD 1.1 billion, an amount that is expected to be largely covered by foreign exchange reserves. Beyond 2025, debt amortization schedule is smooth, with similar amounts.

However, debt stabilisation should be put into perspective. Debt is now more than four times higher than budget revenues, making Nigeria one of the most indebted African countries in this respect (Chart 18).

BANKING SECTOR: BETTER PREPARED TO DEAL WITH THE ECONOMIC DOWNTURN

Nigeria's banking sector is exposed to many cyclical factors due to i its high exposure on the oil sector (1/4 of outstanding loans) and its commitments in FX currency. In 2016, the materialisation of these two risks (currency and credit) exerted pressure on banks. As a result, the ratio

BUDGETARY EXPENDITURES

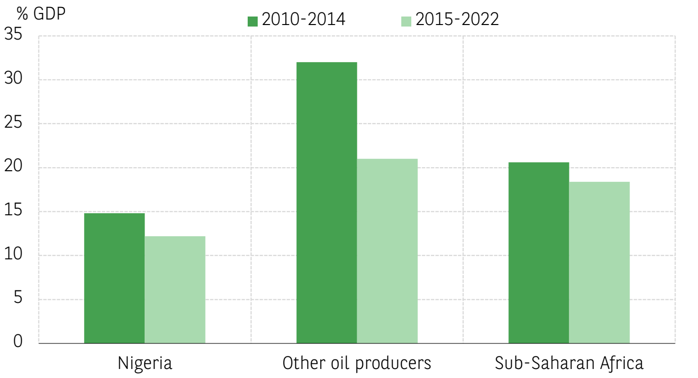

CHART 15

SOURCE: IMF, BNP PARIBAS

GOVERNMENT DEBT

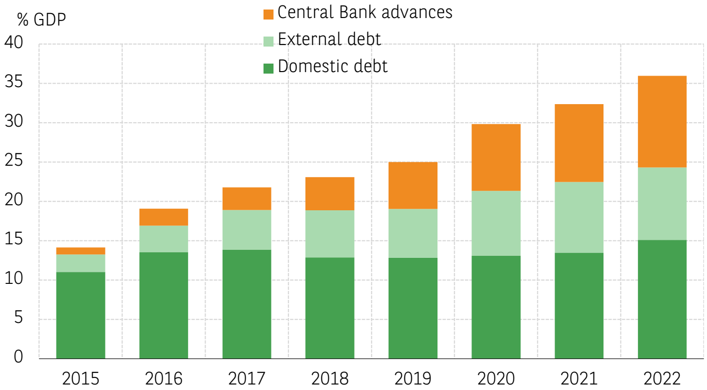

CHART 16

SOURCE: CENTRAL BANK, MINEFI, BNP PARIBAS

EUROBONDS AMORTIZATION

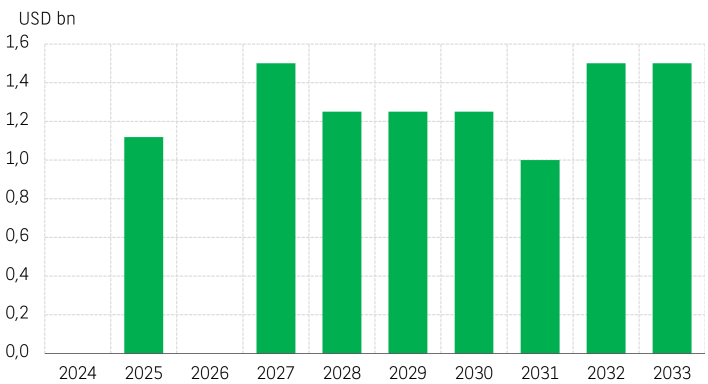

CHART 17

SOURCE: BLOOMBERG, BNP PARIBAS

of non-performing loans rose from 4.8% at the end of 2015 to 12.8% at the end of 2016, before reaching a high of 15% in Q3 2017, before falling again. Solvency and liquidity ratios also deteriorated sharply, without ever falling below prudential standards. The current situation is different, because the oil sector is benefiting from a rather favourable context. Better control of exchange rate risk by banks could also limit the consequences of the depreciation of the exchange rate on balance sheets.

About one third of corporate loans are denominated in foreign currencies. However, due to restrictions on access to dollars for households and businesses in recent years, banks have become more selective about the type of borrowers and the nature of transactions. For example, most banks require a customer to have forward currency contracts with the Central Bank before opening a letter of credit. In addition, the banking sector had a long position in foreign currencies. At the Central Bank's request, exchange rate gains generated by the depreciation of the naira were set aside in order to cope with any future adverse movements in the exchange rate. Moreover, the ratio of non-performing loans is only 4.2% (Chart 19) and capitalisation ratio (13.8% at the end of 2022) is, in principle, solid enough to absorb an increase in credit risk generated by the surge in inflation and the exchange rate shock.

The stability of the financial system therefore does not seem to be under threat at this stage. But the economic downturn is likely to unbalance the allocation of bank lending to the economy. Since Q3 2022, the growth in credit to the private sector has been negative in real terms (see Chart 20), so that the ratio of coverage of outstanding loans by deposits is only 57%. On the other hand, loans and securities to the govervenement rose 19% year-on-year in real terms last April. This is more a strategy of allocation in investments deemed safer and more rewarding against a backdrop of monetary tightening. Exposure of banks to the government is moderate (22.6% of total loans in April 2023) but has risen sharply, which has helped to restore profitability levels to pre-pandemic levels. In the current context, this crowding-out effect is therefore likely to worsen, while the low level of financial inclusion remains a structural problem. At the end of 2022, outstanding bank credit to the private sector was only 12.9% of GDP.

CONCLUSION

By putting an end to energy subsidies and by reforming the exchange rate system, the new Nigerian executive has taken strong but necessary decisions to restore an economy weakened by a decade of misperformances. However, this strategy is risky. In the short term, Nigeria will face an inflationary shock that will have a major impact on the economy and the population. The reaction of the authorities will therefore be closely monitored. Such measures had already been implemented in the past, before being promptly abandoned. Remaining on course will therefore be crucial to restore investor confidence. Reforms will also need to be accelerated to remedy the many shortcomings of the Nigerian economy: currency shortfall, insufficient budgetary resources, inability to restore its oil production potential.

Article completed on 10 October 2023

Stéphane Alby

PUBLIC DEBT IN SUB-SAHARAN AFRICA

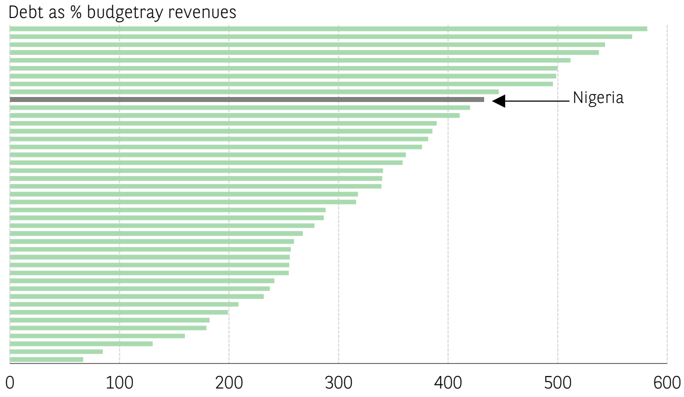

CHART 18 SOURCE: IMF, BNP PARIBAS

SOUNDNESS INDICATORS OF THE BANKING SYSTEM

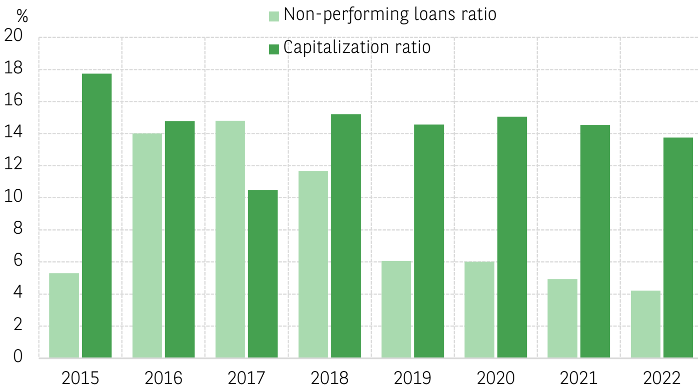

CHART 19 SOURCE: CENTRAL BANK, IMF, BNP PARIBAS

BANKING LOANS TO THE PRIVATE SECTOR

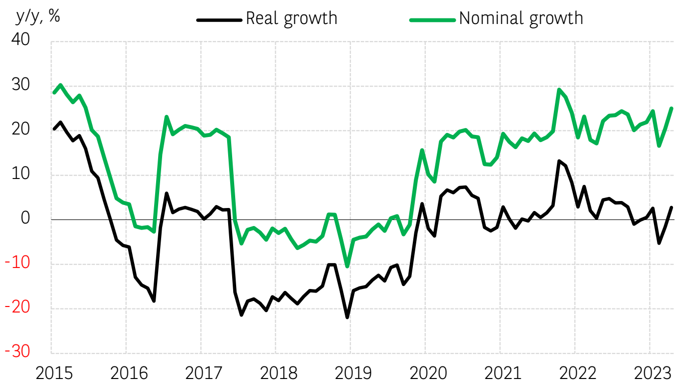

CHART 20 SOURCE: IMF, BNP PARIBAS

GROUP ECONOMIC RESEARCH

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

OECD ECONOMIES AND STATISTICS

Hélène Baudchon Deputy chief economist, Head - United States	+33 1 58 16 03 63	helene.baudchon@bnpparibas.com
Stéphane Colliac France, Germany	+33 1 42 98 43 86	stephane.colliac@bnpparibas.com
Guillaume Derrien Eurozone, Southern Europe, Japan, United Kingdom - Global trade	+33 1 55 77 71 89	guillaume.a.derrien@bnpparibas.com
Veary Bou, Tarik Rharrab Statistics		

ECONOMIC PROJECTIONS, RELATIONSHIP WITH THE FRENCH NETWORK

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

BANKING ECONOMICS

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

EMERGING ECONOMIES AND COUNTRY RISK

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

CONTACT MEDIA

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

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