

# ECO PERSPECTIVES

2<sup>nd</sup> quarter 2019 (completed on 17 April 2019)

## Editorial **Lingering concerns despite hopeful signs**

Recent data in China and the eurozone point towards a stabilisation of growth and have been met with relief. Although the US economy is slowing, growth should remain at a satisfactory level in the near term. Yet there are lingering concerns about the underlying strength of the global economy. The IMF has again scaled down its forecasts and only expects a modest growth pickup later this year. The flattening of the US yield curve fuels worries that growth will disappoint. The Fed insists it is confident about the outlook and patient in setting its policy. Markets have welcomed this accommodative message. Yet the signals sent by equity and bond markets about future growth are quite different. It only adds to the list of concerns.

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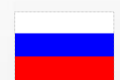
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ECONOMIC RESEARCH DEPARTMENT



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## Editorial

### Lingering concerns despite hopeful signs

Recent data in China and the eurozone point towards a stabilisation of growth and have been met with relief. Although the US economy is slowing, growth should remain at a satisfactory level in the near term. Yet there are lingering concerns about the underlying strength of the global economy. The IMF has again scaled down its forecasts and only expects a modest growth pickup later this year. The flattening of the US yield curve fuels worries that growth will disappoint. The Fed insists it is confident about the outlook and patient in setting its policy. Markets have welcomed this accommodative message. Yet the signals sent by equity and bond markets about future growth are quite different. It only adds to the list of concerns.

#### ■ Hopeful signs

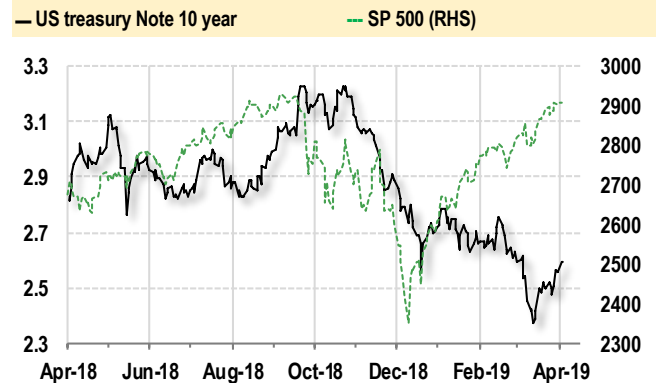
Following months of ever softer readings, recent indicators pointing towards some improvement have been met with relief. In China, the rebound of the purchasing manager indices for March, albeit to a level barely above the 50 mark, has been followed by a first quarter GDP growth of 6.4% y/y, unchanged from the previous quarter and slightly above expectations. This provides hope for Chinese trading partners and in particular Germany, where export assessments had dropped very significantly in recent months. German data have ticked up as well in services, trade and construction, but with the notable exception of manufacturing, which continues to suffer. The services purchasing manager index improved in March for the eurozone, as well as in Italy and Spain, whilst remaining stable and well above 50 in Germany. Data in France have also improved somewhat. In the US, the dismal job numbers of February have been followed by strong data for March.

#### ■ Lingering concerns

Despite the hopeful signs, concerns remain for a host of reasons. One is the flattening of the US yield curve. Its lead time with respect to the start of a recession is variable and years of expansionary monetary policy, including quantitative easing, have quite likely influenced the shape of the curve. Yet the historical record as a rather reliable leading indicator may end up influencing the real economy by instilling a more cautious mindset when deciding on corporate investment or bank lending. The April Duke University survey of CFOs of 469 US companies showed that 38% expect a recession by the first quarter of 2020, 67% by the third quarter of 2020, and 84% by the first quarter of 2021. There is also the question of whether the improvement in Chinese data will be self-sustained or require ongoing stimulus measures. A third question mark is the delayed effects of protracted uncertainty. The news on the US-China relations suggests that an agreement will be reached, but concrete implications remain to be seen (improved market access? Trade diversion?). In the meantime negotiations between the US and the EU have started, which may become a new source of uncertainty. In addition, the Brexit outcome remains unclear. The semantics of the IMF's April World Economic Outlook provide a sobering assessment (emphasis added):

*"The global growth forecast reflects a combination of waning cyclical forces and a return to lepid potential growth in advanced economies; a precarious recovery in emerging market and developing economies, driven to a great extent by economies currently experiencing severe macroeconomic distress; and complex factors that shape the prospects for potential growth in both groups."*

#### ■ US Treasury Note 10 year (%) vs SP 500



Source: Federal Reserve, Standard and Poor's, BNP Paribas

#### ■ Risk appetite fluctuates between monetary support and growth fears

As a consequence, the tone of central banks has evolved. Faced with a slowing economy and low inflation (core inflation at barely 0.8% in March in the euro area), the ECB will roll out another targeted long term refinancing operation (TLTRO). This should serve to stimulate credit growth against the background of softening credit demand from companies, as reflected in the latest bank lending survey. The Federal Reserve, benefitting from a combination of above trend growth and stable, close to target, inflation, has repeatedly insisted on its patience in contemplating a change of its policy rate. This monetary support has been instrumental in triggering a rebound in equity prices and the S&P500 index is now close to its record of end September 2018. 10 year US treasury yields on the other hand are still 70 basis points below the level of end September. When markets send conflicting signals on growth, there is reason to be vigilant.

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# United States

## Inversion, then recession?

Although losing steam, the economic activity in the US is seen keeping on a rather dynamic path in 2019. The International Monetary Fund still forecasts a 2.3% increase in GDP this year, while delivering an increasingly cautious message in the meantime. The IMF recently pointed out several risk factors, including the record high corporate debt ratio, the opacity and less stringent standards on the leveraged loan market, and stretched equity market valuations. Moreover, the inversion of the yield curve is virtually complete, which in the past has always been an early-warning sign of recession.

It has almost become a ritual. In the United States, the new year has seen disruptions in activity, as it began with a spell of abnormally hot and dry weather in the Southwest, and exceptionally humid and cold weather in the Northeast. A possible avatar for climate change, the adjustment for seasonal variations has become a major challenge for statisticians, and a source of risk when evaluating gross domestic product (GDP). After peaking at nearly 3% in 2018, GDP growth undoubtedly slowed in first-quarter 2019. The partial government shutdown and the trade war with China obviously didn't help.

Yet most observers of the US economy think it would be only a temporary slowdown. This is notably the position of the members of the Federal Reserve (Fed), who are forecasting a "solid rebound" in the economy in the second quarter<sup>1</sup>. Indeed, a few indicators such as world trade and employment have picked up after slumping during the winter months. The equity markets are also looking perky again.

But other trends have not really turned around yet. After the euphoria of tax cuts in 2018, corporate earnings growth continues to return to normal levels. Certain surveys, like the one by the Federal Reserve of Philadelphia, suggest that industrial leaders' expectations were more mixed in March. Known for its reliability, the OECD's leading economic indicator is still declining.

Thus we cannot be absolutely certain that the economic slowdown is over. Judging by the quasi inversion of the yield curve<sup>2</sup>, before things start getting better again, the US economy could be heading for worse in the months or quarters ahead. Yet for certain observers, this early-warning signal must be kept in perspective.

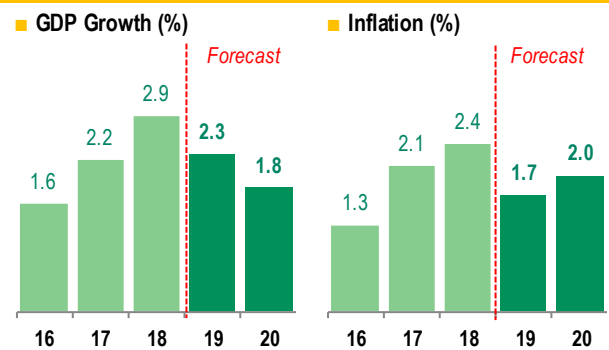
### ■ This time is different

The most common argument is that the yield curve, the distribution of US interest rates by maturity, is biased by the Fed's securities purchasing programme, also known as quantitative easing (QE). Without QE, long-term rates would be higher and the yield curve would not have inverted. To defend this point, they regularly cite a study by Bonis et al. (2017), which evaluates the impact of QE on

<sup>1</sup> Federal Open Market Committee (2019), Minutes of the meeting, 19-20 March 2019

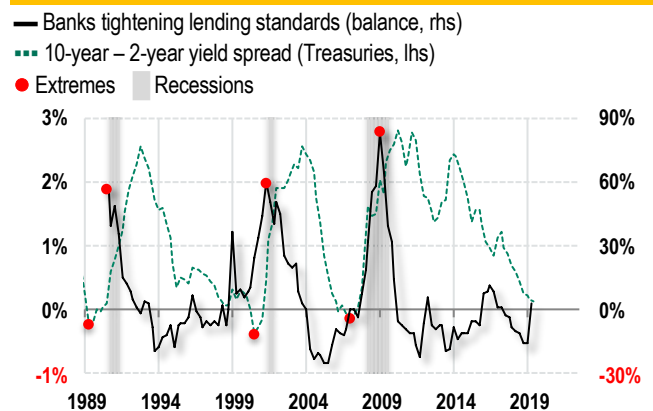
<sup>2</sup> At 12 April 2019, 2-year and 10-year US government bonds yields were nearly the same, at 2.4% and 2.5%, respectively. Moreover, they were lower than the interest rate on 3-month T-bonds.

### 1- Growth and inflation



Source: National accounts, BNP Paribas

### 2- What do yield curve inversions tell us?



Source: Federal Reserve, Refinitiv

the term premium of Treasuries at 100 basis points (bp)<sup>3</sup>. Since this effect cannot be observed directly, however, their estimate must be taken with caution, especially since it comes with a rather high margin of error (+/- 50 bp). Moreover, the Fed is disengaging from the programme. Since October 2017, it has reduced its securities holdings by roughly USD 500 bn, which means it is less directly weighing on the long end of the yield curve.

<sup>3</sup> Bonis B., Ihrig J., Wei M. (2017), *The Effect of the Federal Reserve's Securities Holding on Longer-term Interest Rates*, FEDS Notes, April

It is not so much the central bank's quantitative policy as its message to the markets that has pulled down bond yields in recent months, to the point that they are now lower than short-term rates. By acknowledging the deterioration of the economic outlook and announcing a pause in its monetary tightening, the Fed has facilitated, if not encouraged, the shift in expectations. At the recent meeting of the Federal Open Market Committee (FOMC), members seemed less worried, but market participants continue to give a 50% weighting to the probability of a key rate cut by the end of the year. This signals that in their eyes a further slowdown in economic activity and prices is still possible, and the 3-month forward rate in twelve month time continues to stand below the spot rate.

In the end, the inversion of the US yield curve in 2019 is no less significant than in 1989, 2000 or 2007. The regularity with which it predicts downturns in the economic and monetary cycles is sufficient proof that it should not be underestimated. An analysis by the Federal Reserve of Saint Louis even claims that inverted yield not only predict recessions but also have the power to cause them (Wheelock, 2018)<sup>4</sup>. By undermining transformation conditions, an inverted yield curve can lead to greater loan selectivity and curb activity (chart 2).

The risk of freezing up credit would not come as much from banks as from alternative market financing channels, one of the main vectors behind the swelling of US debt. Real Estate Investment Trusts (REITs), which use short-term borrowing on the repo market to make long-term investments in the MBS compartment, are among the shadow banking entities that seem to be most vulnerable to a flattening of the yield curve (IMF, 2013<sup>5</sup>).

Yet the segment that is currently drawing the most attention is leveraged lending activities. This market, which is also dominated by non-banking intermediaries - finance companies, Collateralized Loan Obligation (CLO) vehicles - has expanded very rapidly in recent years. Showing deeper internationalization and complexity, this market is also subject to greater risk taking: 80% of new operations are "covenant lite", which means they are exempt or nearly exempt from guarantees (see chart 3 and box 4). The IMF regularly devotes several pages of its Financial Stability Report to the leveraged loan market, often for underlining excesses<sup>6</sup>.

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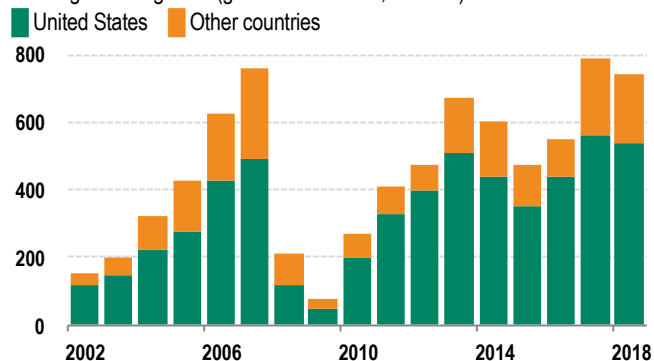
<sup>4</sup> Wheelock D. (2018), *Can an Inverted Yield Curve Cause a Recession?* Federal Reserve Bank of Saint Louis Blog, Dec. 27

<sup>5</sup> IMF (2013), *Transition challenges to stability*, Global Financial Stability Report, Ch. 1, October

<sup>6</sup> IMF (2019), *Vulnerabilities in a Maturing Credit Cycle*, Global Financial Stability Report, Ch.1, April

### 3- Leveraged loans stage a comeback

Leveraged loan growth (gross annual flows, USD bn)



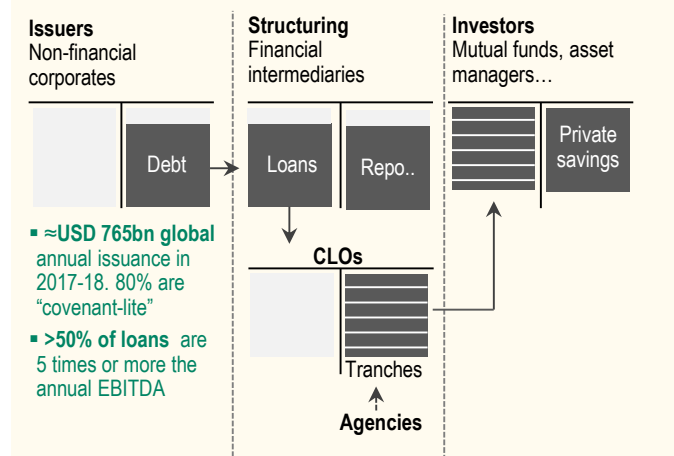
Source: IMF

### 4- Leveraged loans: how they work

Leveraged loans are designed for companies with limited equity resources, most of which are already in debt. They typically accompany corporate finance operations (capital investment, mergers & acquisitions, etc.).

Bearing high risk by nature, they offer attractive returns (interest rates). In 2017 and 2018, average annual production totalled USD 765 bn worldwide, surpassing the 2007 peak (see chart 2). Looking beyond the amounts at stake, the IMF is concerned that the most recent generation of leveraged loans has experienced a deterioration in underwriting standards and credit quality: 80% of operations are "covenant lite" which means they are nearly exempt from guarantees. In half of the cases, the amounts engaged match or exceed five years of operating income, which is also a record high.

The US dominates the market in terms of size (3/4 of total issuances). The main players are non-banking institutions such as finance companies or CLO-type vehicles (Collateralised Loan Obligations). Bolstered by a major leverage effect and with support from the rating agencies, the tranches issued by CLOs have been increasingly successful with investors. This distribution channel has become increasingly internationalised and complex, to the point that in March 2019, the Financial Stability Board (FSB) launched an in-depth investigation.



Source: Financial press, IMF



# Eurozone

## External dampers, internal hopes

*The eurozone's manufacturing sector has been hard hit by the decline in foreign trade and persistently high uncertainty. Very open internationally, the eurozone is sensitive to global cyclical slowdowns. Internal macroeconomic fundamentals are still solid, and the rally in the services sector is showing resilience. The ECB has taken note of the longer than expected slowdown, and has opted once again for longer-term refinancing operations (TLTRO). Numerous risks still cloud the forecast horizon, which could darken rather quickly if any of these risks were to materialise.*

In the first part of 2019, the eurozone is still showing signs of fragility after the sharp economic slowdown in late 2018. The industrial sector is on the front line when it comes to absorbing the downturn in external demand. Faced with this situation, the European Central Bank (ECB) is remaining vigilant and has reactivated its longer-term refinancing operations (TLTRO).

### ■ Foreign trade hampers growth

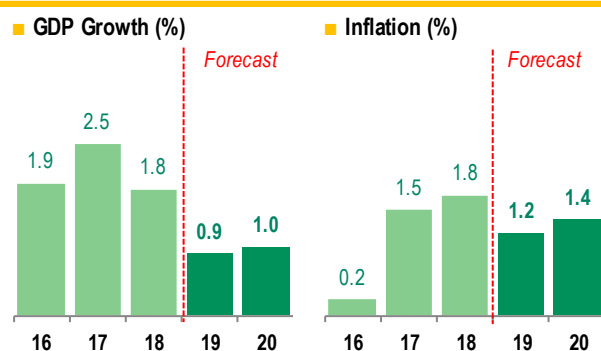
In 2018, foreign trade strained eurozone growth, which rose at an average annual rate of 1.8%. The industrial sector was hard hit by weak external demand, especially in Germany given its high international exposure. Activity slowed sharply compared to 2017, which reported an average annual growth rate of 2.5%. The slowdown worsened in the second semester of the year as Italy entered recession and Germany, hit by temporary domestic shocks, notably in the automobile sector, barely avoided one. Inversely, the French economy proved to be resilient despite social unrest at the end of the year, and Spain maintained a buoyant growth rate.

World trade has been sluggish since the beginning of the year, and there is still uncertainty about Chinese activity and whether stimulus measures will help stabilise the situation. In a rather lacklustre international environment, cyclical indicators in the manufacturing industry continue to trend downwards (see chart 2). Manufacturing Purchasing Managers' Index (PMI) hits a low of 47.5 in March 2019, undermined by the ongoing deterioration of Germany's industrial sector (where PMI dropped to 44.1 in March). More specifically, German industry has been hit by an unusually sharp decline in the "new export orders" component. These dynamics contrast with the eurozone's rebound in industrial output in January, which admittedly followed a particularly downbeat period in late 2018, notably in the transport equipment sector. Data for the entire first quarter of 2019 will provide a more complete picture. Far from the troubles of the industrial sector, the services sector is holding up well in the eurozone. The services PMI rose to a relatively comfortable 53.3 in March, suggesting that internal support factors are still in place.

All in all, eurozone growth is expected to slow sharply in both 2019 and 2020, with average annual growth rates of 0.9% and 1%, respectively. Germany will experience a sharp slowdown while growth in Italy will be nil in 2019 before accelerating slightly in 2020. France is expected to grow at its long-term potential rate, while Spanish growth will decline but remain dynamic.

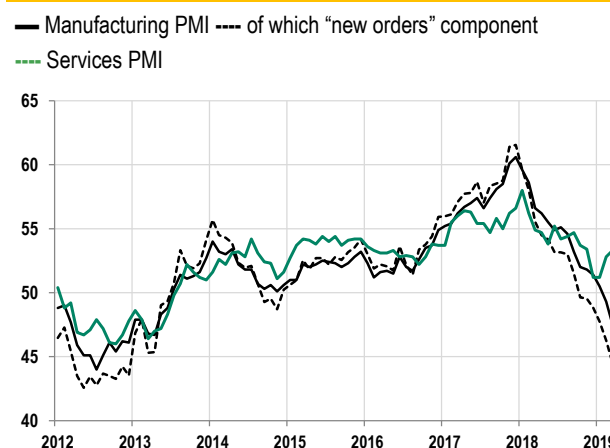
The eurozone economy will have to continue facing up to less vigorous world trade, in an environment of persistently high

### 1- Growth and inflation



Source: National accounts, BNP Paribas

### 2- Eurozone PMI



Source: Markit

uncertainty. The outcome of Brexit negotiations, trade tensions – including the possible introduction of tariffs on European automobiles – and the pace of the slowdown in China are all sources of uncertainty for the eurozone's economic agents. Yet the key components of domestic demand are still robust on the whole. Financing conditions are still favourable and corporate margins are comfortable, albeit in decline, which should bolster private investment. A buoyant labour market and wage acceleration will boost household consumption at a time when the jobless rate continues to fall.



The downside risks to our eurozone growth forecast could have a significantly negative impact if they were to materialise. Eurozone activity would be hard hit by a no-deal Brexit or by a more abrupt slowdown in the Chinese economy, especially in Germany with its very open economy<sup>1</sup>.

■ **Proactive monetary policy**

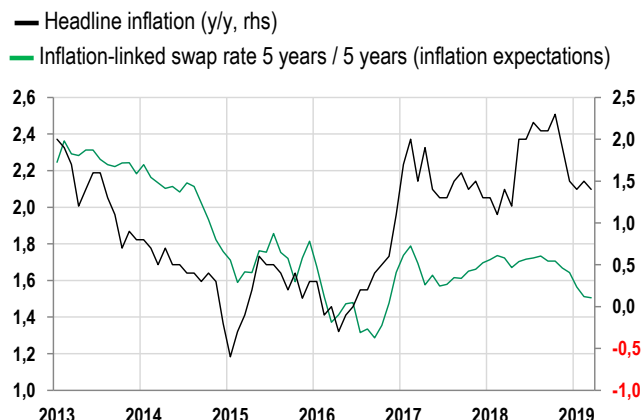
After a first wave in mid-2014, the President of the ECB announced, earlier than expected, that it would launch a new wave of long-term lending operations to eurozone banks (*TLTRO-III*) at its March 2019 monetary policy meeting. These operations, with a maturity of two years, will begin next September and run through March 2021. They will be indexed to the main refinancing rate (currently zero), which could thus vary<sup>2</sup>. These long-term loans will help prevent a negative liquidity shock, particularly with regard to bank regulatory ratios. They are also designed to facilitate monetary policy transmission and thus credit supply, which still seems to be going rather strong in general in the region.

The ECB also revised its forward guidance. Key rates will remain unchanged at least through the end of the year. They will also hold at current levels in 2020 according to our outlook. By terminating the programme at the end of the year, and not later, the Governing Council avoids tying the hands of Mario Draghi's successor, after his term ends next October. On the whole, key rates are expected to remain low for a long time. Long-term rates will remain low throughout our forecast horizon, as the ECB rolls over the securities on its balance sheet arriving at maturity, thereby maintaining the stock unchanged. The yield on 10-year German bonds recently slipped into negative territory as the current upsurge in uncertainty reinforces the attractiveness of German bunds, which investors see as a safe haven.

All of this is occurring in the midst of sluggish inflation: the core component is fluctuating around 1% since 2013, after dropping to only 0.8% year-on-year in March, according to preliminary estimates. Inflation expectations have also slipped, and have been trending downwards since mid-2018 (see chart 3). According to our scenario, annual inflation will hold well below the target rate of 2%, at +1.2% in 2019 and +1.4% in 2020.

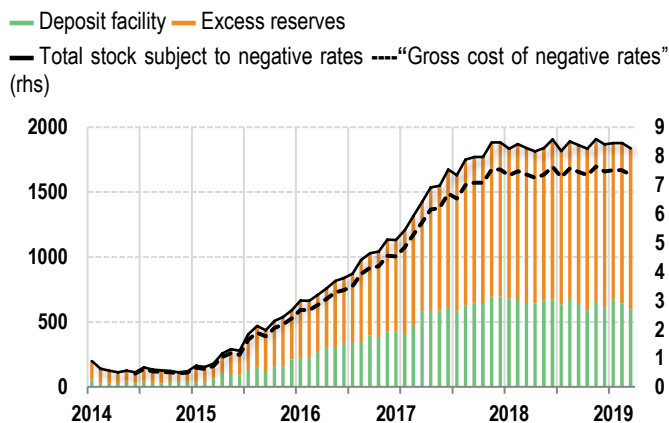
Since 2014, the ECB, like other central banks, has integrated negative interest rates in its policy instruments (the deposit facility rate was -0.4%). The protracted application of negative rates is straining the intermediation margin of eurozone banks, particularly those with major excess reserves (in Germany and France, in particular). Ideas are being explored to try to mitigate the impact on the banking system's profitability<sup>3</sup>. One solution would be to set up a "tiering" system<sup>4</sup>. If adopted, the effectiveness of this measure,

**3- Inflation and inflation expectations**



Source: ECB

**4- Estimated gross annual cost of negative rates (bn EUR)**



Source: ECB, BNP Paribas

notably in terms of the credit pulse, would depend on bank behaviour, especially with regard to the average rate applied to their entire stock of excess reserves.

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<sup>1</sup> F. Cornuet et al., *Evaluating the impact of Brexit on the activity of the UK's partners: trade channels*, note de Conjoncture, Insee, March 2019

<sup>2</sup> The indexation to the main refinancing operations rate allows the rate of TLTRO-III to move, as from the start of next year.

<sup>3</sup> ECB, *Account of the monetary policy meeting*, March 2019 (<https://www.ecb.europa.eu/press/accounts/2019/html/ecb.mq190404~edc605830b.en.html>)

<sup>4</sup> This system, implemented in Switzerland and Japan, allows for some excess reserves to be exonerated from negative rates.

# Germany

## Manufacturing woes

Since the middle of 2018, economic activity has virtually stagnated largely because of a slowdown in world trade. The most recent surveys and hard data confirm that weakness in the manufacturing sector continued in Q1 2019. Spearhead of the economy, the sector can become a source of vulnerability when world markets are less buoyant. However, Germany is able to support domestic demand. In 2019, the government will return to households and businesses a part of last year's record budget surplus (more than EUR 50 bn).

Since the middle of 2018, economic activity has virtually stagnated. Initially, this was largely blamed on temporary factors such as the introduction of new exhaust regulations for cars. In the second half of 2018, car production was 7.1% lower than in the preceding six months. Moreover, a long period of draught resulted in record-low water levels of the Rhine, which seriously hampered freight transport on Europe's busiest waterway. In particular, the chemical industry was impacted.

### ■ A slowdown based on more than anecdotal evidence

However, throughout the second half of the year, it became increasingly obvious that the slowdown could not be explained by only temporary factors. The manufacturing woes can largely be blamed on the slowdown in world trade, against the backdrop of US-Chinese trade tensions and Brexit uncertainties. In Q4, world trade volumes were 1% lower on the preceding quarter, in particular due to an important import contraction in the for Germany important Asian markets (-5.6%). German exports in declined by 0.1% in the second half of the year.

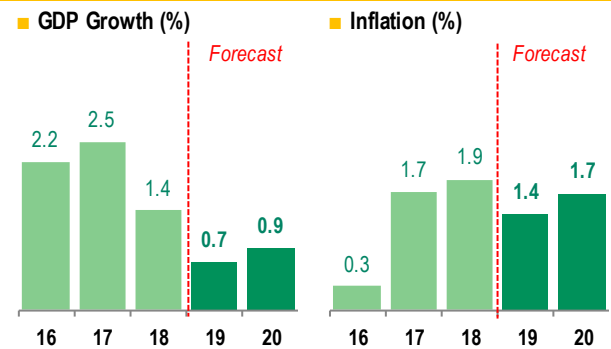
Also private consumption was more or less stagnant in the second half of 2018, despite strong wage developments, growing employment and high consumer confidence. A possible explanation is the increase in energy and food prices in Q4, which had a negative impact on purchasing power. Moreover, households may have postponed their car purchases, partly because of the production problems, but also because of increased tightening of exhaust regulations for diesel vehicles in several large German cities. As a consequence, the savings rate steadily increased during the year from 10% in Q1 2018 to 10.9% in Q4 2018, a highest since mid-2008.

Growth was mainly supported by government consumption and investment in buildings, both rising by 0.2% in H2 on the previous six months. Investment in equipment remained at around the same level as in H1. Nevertheless, it was 4.2% higher in 2018 on the previous year, a substantial increase compared with previous years.

The most recent surveys and hard data confirm that weakness in the manufacturing sector continued in Q1 2019. In March, the PMI manufacturing dropped to 44.1, a lowest since July 2012, as total order books and new business from abroad fell at the fastest rate since April 2009.

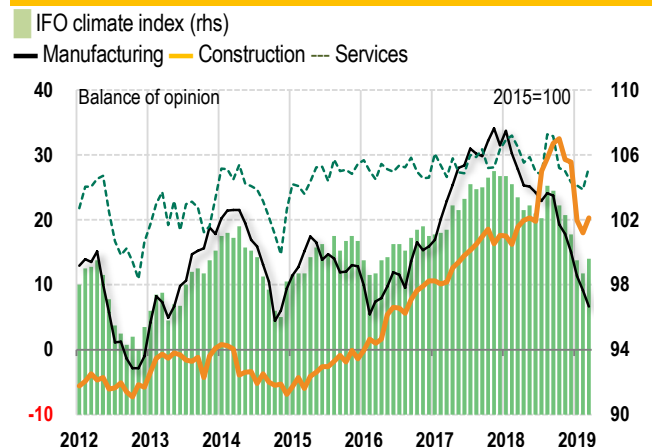
However, more positive signals came from the sectors mainly producing for the domestic market such as construction and services. The IFO climate index even strengthened in March after

### 1- Growth and Inflation



Source: National accounts, BNP Paribas

### 2- The Ifo climate index turned upwards in March



Source: IFO

six consecutive months of decline, despite a further deterioration of the manufacturing component. This also explains why labour market data remain well oriented. Employment continued to grow, although at a slower speed and the unemployment rate inched down to only 3.1% in February, whereas job vacancies reached a historical high (807 000 in March).

### ■ The state coffers are bursting at the seams

Thanks to the rapidly incoming taxes in the context of robust consumption and wage growth, the government budget surplus reached 1.7% of GDP and public sector debt declined to 60.9% of



GDP in 2018. This would allow the government to pursue its expansionary policy as projected in the coalition agreement.

In 2019, discretionary fiscal measures will amount to 0.7% of GDP. They will include an improvement of pensions for mothers (*Mütterrente II*), and increased spending for defence, development aid, child care and investment. Moreover, the budget includes income tax reductions and research funding. For 2020, the stimulus plan will amount to 0.4% of GDP, in particular for health care and child benefits. Moreover, the basic tax-free allowance will be increased and the tax brackets raised. The budget surplus (in % of GDP) is projected to decline to 1.2% in 2019 and 1% in 2020. According to the German Council of Economic Experts (*Sachverständigenrat*), the structural deficit will decline from 1.7% in 2018 to 0.7% and 0.4% in 2019 and 2020, respectively.

Finance minister Olaf Scholz has already announced that he is prepared to use all the fiscal leeway available to stimulate the economy if a crisis hit. However, the government is unlikely to characterize the current slowdown as a crisis. Moreover, breaking open the government agreement might create new problems for the already fragile coalition.

### ■ Strong employment and productivity growth

Leading indicators and early hard data such as factory orders suggest that the slower momentum in growth is likely to continue in the first half of 2019. Growth could stabilise around the middle of the year, depending on the unwinding of tensions and uncertainties that are currently weighing on world trade. We expect the economy to recover gradually thereafter. GDP growth could gradually pick up from 0.7% in 2019 to 0.9% in 2020.

Compared to other industrialised countries, Germany has a relatively large manufacturing sector. The share of manufacturing in total gross value added amounted to 23% in 2017, compared with only 11% in France. That is the reason that the Germany economy is among those most affected by the current economic slowdown.

However, the large manufacturing sector has also brought major advantages for the economy. As the manufacturing sector has recorded much higher labour productivity increases than the services sector, Germany has outperformed most other advanced economies in terms of economic output per hour. In the period 2012-2017, productivity increased by 0.8% per annum in Germany, compared with 0.6% p.a. in France.

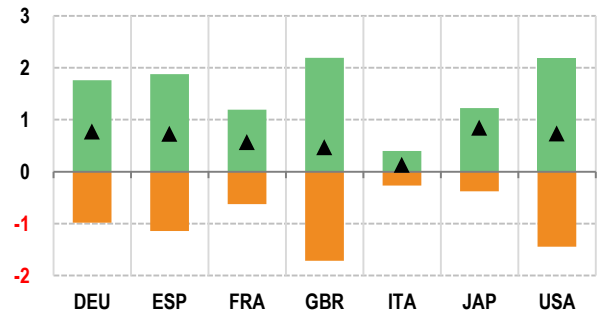
Moreover, Germany has succeeded in integrating many workers with low productivity into the labour force. They have found work mainly in the services sector. Between 2012 and 2017, total hours worked in the German economy increased by around 1% p.a., compared with only 0.6% p.a. in France.

It is true that many of the jobs that have been created in Germany were part-time jobs. Nevertheless, thanks to income support schemes, the number of working-poor has remained relatively low. The risk of poverty among employees, whose household equivalised disposable income is below 60% of the national median equivalised income, has actually declined from 10.4 in 2014 to 8.7%

### 3- Labour productivity and hours worked

Average per annum growth between 2012 and 2017

■ GDP ■ Decline in hours ▲ Productivity



Source: OECD, BNP Paribas

in 2017. Among the major EU countries only France, at 7.5% in 2017, did better. In Italy and Spain, these rates were 15.5% and 13.4%, respectively.

The turnaround of the German economy is generally attributed to the implementation of the labour market reforms, the so-called Hartz reforms, in 2003-05. Overall, these reforms have delivered good results in terms of access to the labour market and equity objectives. However, the model has not yet been tested in an economic environment in which jobs are less numerous. If the current economic slowdown were to morph into a long lasting recession, it might be hard for the German model to achieve its equity objectives without corrective measures.

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# France

## A glimpse of stability in an ocean of uncertainty

*Business confidence surveys are showing signs of levelling off. Hard data for January and February are rather positive. These factors are consistent with the economy keeping up growing at about 1.2%, which is our growth forecast for 2019. Although this is not very high, it is synonymous with the resilience the French economy is expected to show in an environment marked by uncertainties and downside risks. The main factor behind this resilience is the positive impetus of economic and fiscal policy, notably stimulus measures to boost household purchasing power, and the expected ensuing rebound in household consumption.*

Q4 2018 growth eventually held up a bit better than expected, with an 0.3% quarterly GDP gain vs expectations of 0.2%. Admittedly, this is a lacklustre growth rate, disappointing in absolute terms but, at least, it remained on the same pace as in Q3 and a little higher than the eurozone average (0.2% q/q in Q4 2018 after 0.1% in Q3). However, activity slowed significantly in year-on-year terms: growth dropped to only 1% y/y in Q4 2018, from 2.8% y/y in Q4 2017. The average annual growth rate slid to 1.6% from 2.3% in 2017.

### ■ Mixed growth

Although quarterly growth rates were similar, the GDP breakdown was not the same. Both quarters paint a mixed picture with growth hampered by a series of bumps and shocks<sup>1</sup>. Q3 growth was supported by a rebound in household consumption, an acceleration in corporate investment and a positive contribution of net exports, but it was pulled down by a decline in household investment, a stagnation of public investment and a negative contribution of changes in inventory. In Q4, changes in inventory made a smaller negative contribution to growth (-0.1 points, vs -0.5 points) but the positive contribution of final domestic demand also eroded (0.2 points, vs. 0.5 points). Household consumption was flat and corporate investment slowed down markedly while household investment continued to decline. Net exports made another positive contribution of 0.3 points, the same as in Q3, but it was based on a much stronger combination of exports and imports (up 2.2% q/q and 1.3% q/q, respectively, vs. +0.6% q/q and -0.2% q/q in Q3<sup>2</sup>).

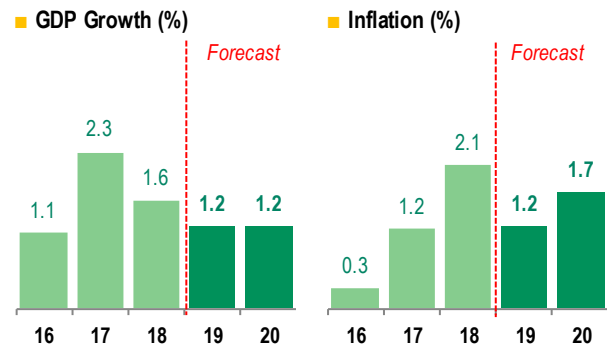
Growth prospects are still mixed in Q1 2019. The sense of a deteriorated cyclical environment is mainly derived from the PMIs for the manufacturing and services sectors. Last December, both abruptly dropped below the 50 threshold, which separates expansion from contraction, and have fluctuated around 49 ever since. Yet this negative signal is offset by a more positive signal from the Insee surveys (see chart 2). The Insee composite business climate index is holding above its benchmark average of 100<sup>3</sup>, i.e. in expansion territory (104 in March). Moreover, the index has increased since the beginning of the year, by one point a month. This improvement is fuelled by the construction and retail and wholesale trade sectors. In manufacturing and services, the business climate remained more or less flat, which is good news for

<sup>1</sup> France: 2019, another testing year, EcoPerspectives Q1 2019

<sup>2</sup> Exports contributed +0.7 points to growth in Q4 (vs +0.2 points in Q3) and imports contributed a negative 0.4 points (vs. +0.1 points in Q3).

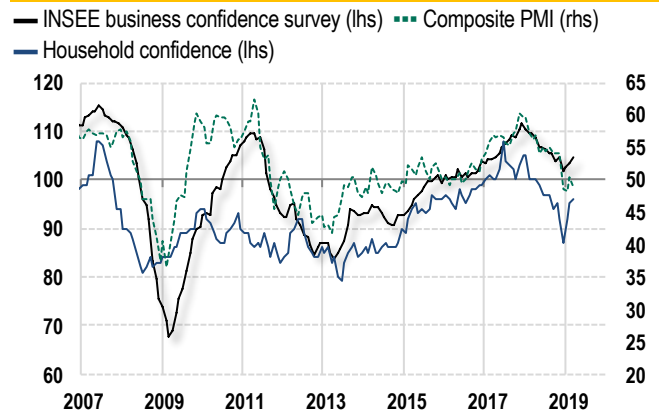
<sup>3</sup> Since 2000, 100 corresponds to average growth of 0.3% q/q.

### 1- Growth and inflation



Source: National accounts, BNP Paribas

### 2- Confidence surveys



Source: INSEE, Markit

industry but a source of concern for services. In each sector, the business confidence index was above the benchmark average of 100<sup>4</sup>.

Household confidence rebounded more strongly (+9 points between January and March), regaining the ground lost in November and December (-8 points). At 96, the composite index is nonetheless well below its benchmark average of 100.

<sup>4</sup> Specifically, the March index was 102 in industry, 103 in services, 112 in construction, 102 in retail trade and 107 in wholesale trade.



Between the mixed signals of surveys and the rather positive hard data (production, consumption and exports) in January and February, the most likely scenario seems to us to be that Q1 growth will stabilise at 0.3% q/q. This is the same as the Bank of France's estimate, while the Insee is expecting growth of 0.4%. Our Nowcast model based on hard data also shows growth of 0.4%, while the estimate based on survey data points to 0.2%.

Thereafter, we expect growth to hold to a quarterly pace of 0.3%. Though not very high, it is nonetheless synonymous with the resilience the French economy is expected to show in the face of the world economic slowdown. To be more precise, the French economy will not be sheltered from the global slowdown and from the European one in particular, but it will not be hit as hard either. According to our estimates, French growth will lose 0.4 percentage points to 1.2% in 2019, from 1.6% in 2018, while eurozone growth will decline by 0.9 points, to 0.9% from 1.8%. If this proves to be the case, then French growth will surpass that of the eurozone for the first time since 2013.

This resilience can be attributed to three factors. Two are specific to France and definite, although the extent of their buffering effect is open to debate: 1) the positive impetus of economic and fiscal policy and 2) the relatively low degree of openness<sup>5</sup>. The third factor is shared with the eurozone and cannot be taken for granted because it pertains to a forecast, although we do not see the degree of uncertainty as very high: the strength of the labour market which brings in its wake job creations, declining unemployment and wages acceleration. Additionally, monetary and financial conditions remain growth-supportive.

Looking at the components of growth, and considering the factors mentioned above, this resilience will depend on the household consumption rebound, which should get a boost from major purchasing power gains expected in 2019. In 2020, we do not foresee a further acceleration in consumption,<sup>6</sup> and unless other growth engines pick up the slack, growth is expected to remain stable at 1.2%. This forecast is slightly below that of the consensus and of the official institutions (ranging between 1.3% and 1.4%), a sign of the significant downside risks surrounding the economic outlook (recession fears, commercial tensions, Brexit).

■ **Core inflation: the great missing**

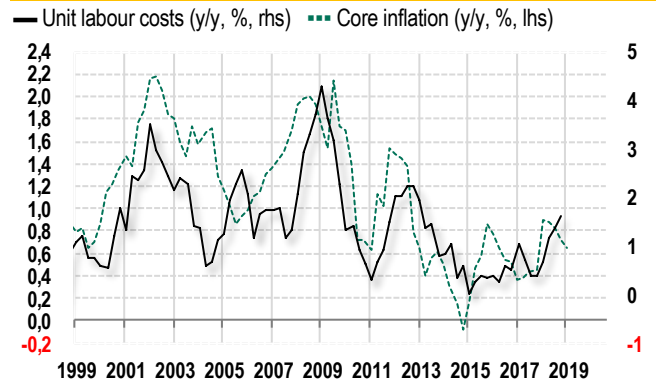
When we lose something, we know more or less where to look to find it, and the same can be said about core inflation: we should be able to find it in upstream prices, the closing of the output gap and wages acceleration. So far, however, it is nowhere to be seen.

To be more precise, core inflation has increased (from an average annual rate of 0.4% in 2017 to 0.8% in 2018) but its feeble scope raises doubts. This increase even seems to have nothing to do with the improvement in the economy and looks to be due solely to a statistical base effect: after jumping from 0.5% year-on-year in

<sup>5</sup> Nonetheless, France is indirectly exposed via Germany, its main trading partner.

<sup>6</sup> Although the measures to be taken in response to the Great National Debate are not known yet, the additional fiscal surplus that the government is prepared to inject would increase the chances of such an acceleration.

**3- Core inflation and unit labour costs**



Source: INSEE, OECD, BNP Paribas

December 2017 to 0.9% in January 2018, core inflation has returned to a slightly downward trend. In March 2019, it even fell back to 0.5%.

The disinflationary impact of the euro's appreciation between mid-2017 and mid-2018 might be one explanation for the limited upturn in core inflation. Sector-based factors have also weighed in, such as the repercussions of the reduction in housing benefits for low-income rental rates and another sharp decline in the prices of telecommunications services. The second-round effects of the sharp rise in oil prices through October 2018 have not kicked in yet either (especially in terms of airline prices).

From a more fundamental perspective, low core inflation can also be blamed on corporate efforts on margins, which have been sustainable so far because unit labour costs have only begun to rise very recently and mildly so (see chart 3). Yet if unit labour costs accelerate over the forecast horizon as we expect, they would increase pressure on margins, resulting in a stronger upturn in core inflation.

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## Italy

### Recession in the short term, demographic challenge in the long term

The Italian economy entered the third recession in the last ten years. In 2018, value added in the manufacturing sector recorded four consecutive contractions. Domestic demand disappointed, as both households and firms remained extremely cautious. Given the deterioration of the overall scenario, in the 2019 Economic and Financial Document recently approved, the Italian Government has lowered from 1% to 0.2% the GDP growth expected in 2019, with public deficit at 2.4% and the debt to GDP ratio at 132.6%. The structural deficit would worsen by 0.1%, to 1.5%. A progressive ageing of the population makes the scenario even more complicated.

In the second half of 2018, the Italian economy entered the third recession in the last ten years. Real GDP declined by 0.1% q/q in Q3 and in Q4. The annual growth rate was nil, from 1.7% a year before. The contraction reflected the negative contribution of stocks (-0.4% in Q4) and the feeble evolution of domestic demand, while net exports sustained GDP increase, as exports rose more than imports, adding 0.4% to the overall growth in the second half of the year.

#### ■ A new recession, amid feeble consumption and disappointing investment

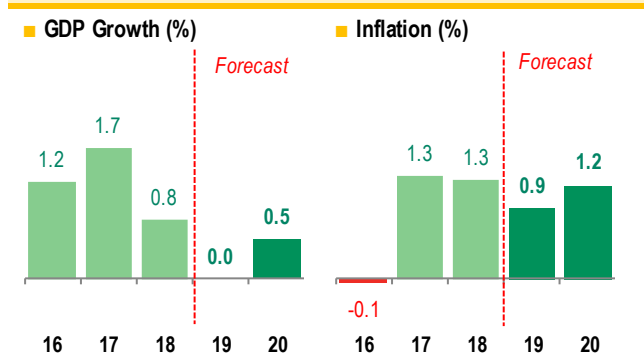
The slowdown mainly interested sectors which had supported the previous recovery. In 2018, while services and construction continued to slightly recover, value added in the manufacturing sector recorded four consecutive contractions, with the annual growth rate falling from +5% in Q3 2017 to -1.1% in Q4 2018. Production of automobiles declined by more than 15% from July to December.

The overall conditions in the labour market further deteriorated. The unemployment rate increased to more than 10.5%, with that referred to people aged 15-24 stable at 33%. The recovery of employment has come to a halt, with the number of persons in work virtually unchanged around 23.2 million. The feeble evolution of income, together with a slightly stronger increase of consumer prices, negatively impacted households' purchasing power, which declined by 0.7% in the second half of 2018. Trying to offset this disappointing evolution, Italian households have continued to reduce their propensity to save, which fell to 7.6% in Q4 2018.

From January to September 2018, households' financial wealth fell by EUR 12 bn, to EUR 4.100 bn, with a per capita loss of almost EUR 2.000. Italian consumers became extremely cautious in their spending decisions, with consumption stagnating in the last three quarters of 2018, as well as in their investment decisions, increasing the share of wealth invested on deposits, pension and insurance products.

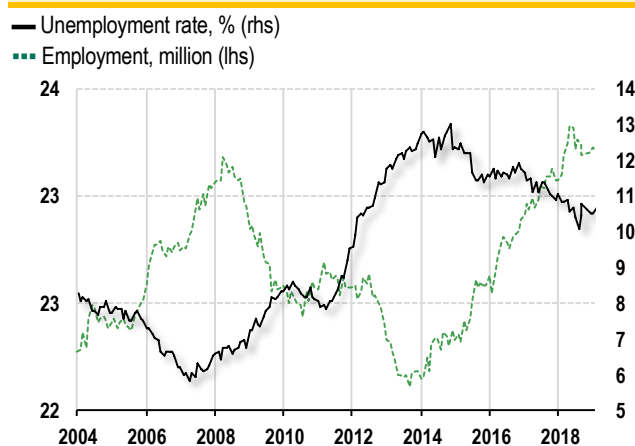
During the second half of 2018, economic and financial conditions of Italian firms slightly worsened, with profitability newly declining. Despite value added of non-financial corporations rose above EUR 800 billion, the highest value in the last twenty years, the gross operating surplus to value added ratio fell below 42%. The persisting uncertainty surrounding the overall economic scenario negatively impacted on business confidence, which has been

#### 1- GDP growth and inflation



Source: National accounts, BNP Paribas

#### 2- Labour market



Source: Istat

declining for the last one year and a half, falling to the lowest level since the beginning of 2015. Investment continued to suffer a disappointing evolution, remaining almost 20 percentage points below the 2008 level.

#### ■ A challenging fiscal balance

The Italian Government has approved the 2019 Economic and Financial Document. Higher public investment, the new income support scheme, the revision of the pension system and all the other measures approved or under discussion are estimated to have an

overall positive effect on the economy, with an additional growth of 0.1%. In 2019, real GDP would grow by 0.2%, from +1% expected in the December 2018 Budget Law, while employment would decline by 0.2% and the unemployment rate would increase to 11%. The structural deficit is estimated to rise to 1.5%, from 1.4% in 2018, and the debt to GDP ratio would reach 132.6%.

### ■ The population is declining...

The financial crisis and the global recession that hit the world economy more than ten years now have produced long-lasting economic and demographic damages, through their impact on fertility and migration. The high levels of unemployment, which in many countries have characterized the years after 2008, have brought many couples to postpone pregnancies, so causing a higher than expected slowdown in the fertility rates. In Europe the effect of the global recession on fertility was particularly evident in Spain, Greece and Italy.

According to Istat, at the beginning of 2019, 60.4 million people were resident in Italy, a value that went down for the fourth consecutive year. Today the number of children per woman in Italy stands at 1.32, with values higher than the average in the Northern regions (around 1.37) and lower in the Southern ones (1.29 on average, with the lowest values in Basilicata, Molise and Sardinia, where the number of children per woman is close to unity). The decline in fertility has been accompanied by a decline in mortality, which has led to a significant increase in the life expectancy at birth, from 66.5 years in 1950-55 to 83.26 in 2015-20, one of the highest values in the world, after those of Japan (84,0 years), Switzerland (83.56), Spain (83.36).

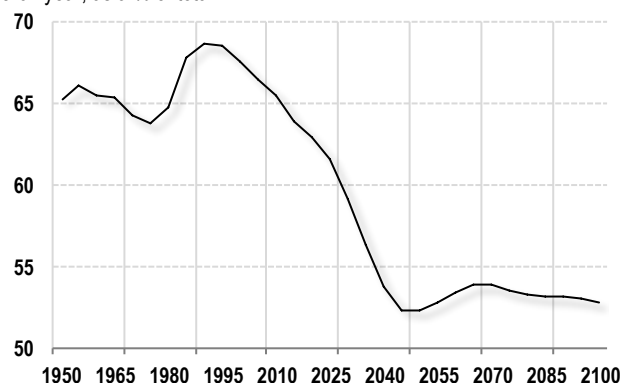
### ■ ... while life expectancy is growing

In turn, the increase in life expectancy has led to a significant increase in the proportion of the elderly people: the over-65 years old, in particular, that represented just 8.1% of the total Italian population in 1950, in 2019 cover up to 22.8%. In the same period, the weight of the 0-14-year-old class declined from 26.7 to 13.2%. According to some estimates by Istat and the Bank of Italy the old age dependency ratio (i.e. the ratio between the over-65s and the population between 20-64 years old) increased from 14.3% in 1950 to 37.8% in 2015 (last year available for international comparisons), the highest value in the world after that of Japan (46.2%). During the same period, the share of the working age population out of total, after having reached the maximum of 70% in the early 1980s, began to shrink, and according to recent forecasts it is expected to fall to a record low of 52.3% in 2050.

Due to these trends, the contribution of demography to Italian economic growth over the past 25 years has been negative. This can be seen by breaking down the per capita income into the product of three factors; product per person employed, employment rate and ratio between population in working age and total population. According to an estimate based on long time series between 1861 and 2016, in Italy, the most significant stimulus to the growth of per capita income came from productivity, especially during the 1950s and 1960s. The contribution of this variable became less relevant – and basically zeroed – since the beginning

## 3- Working age population

15-64 year, as a % of total



Source: Istat

of the 2000s. The impact of the employment rate on growth was positive especially in the second half of the twentieth century, while the so-called “demographic dividend” (population in working age on the total), after having contributed in an important way to growth during the 1980s, since the early 1990s has become irrelevant.

### ■ A complicated future

According to recent Istat forecasts, Italy will see a gradual reduction in the number of “fertile age” cohorts (14-50) in the coming years, and an increase in elderly cohorts (over 65) which would lead to an increase in life expectancy at birth of male and female to 86.1 and 90.2 years respectively by 2065. By 2025 the population should remain stable, while it will suffer a substantial decline by 2045, when there would be 59 million residents, which would drop by a further 4.5 million (to 54.1) in 2065.

By 2025 the population in working age in Italy would fall to 63.2% of the total, from 64% in 2019. A drastic drop is expected by 2045 when working age population would be little more than half of the total (54.5%); the average age at that point would be close to 50 years. About one out of three residents in Italy in 2045 will be over 65 years old.

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# Spain

## Resilient growth

*In a morose economic environment, Spanish growth stands out as one of the most resilient in the eurozone, and it seems to have entered the year at a very similar pace to the one in H2 2018. The main factors behind this resilience can be found on the household front, where the savings rate has dropped back to the low point of 2008. With only a few days to go before the 28 April general elections, the electoral landscape is still highly fragmented. Regardless of the outcome, the winning party will find it hard to form a sustainable majority coalition.*

### ■ A solid start in 2019

In spring 2019, Spain is still one of the most resilient economies of the eurozone heavyweights. After a very vigorous 3-year recovery, with GDP growth averaging more than 3% a year in 2015-2017, economic activity clearly slowed last year. Nonetheless, Spain continues to stand up well in Europe, with GDP growth of 2.6%, compared to a eurozone average of 1.8% (see chart 2).

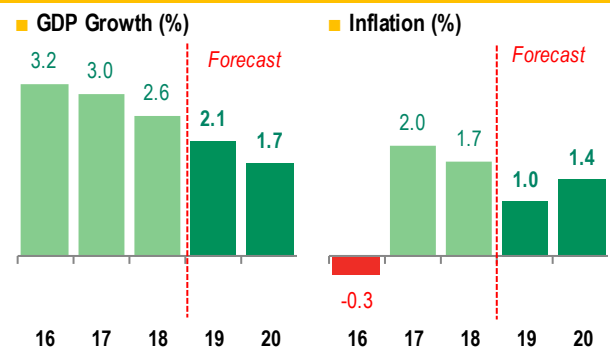
That does not mean that the economy is sheltered from the downturn in the international environment and the slowdown in world trade. To the contrary, merchandise exports have slowed continuously over the past two years and contracted in late 2018 and early 2019 (-2.4% y/y in volume in January). These developments ended up straining productive investment (excluding construction), which stabilised and then contracted in H2 2018.

Other factors have contributed to the resilience of Spanish growth, foremost of which is domestic demand, and household demand in particular. From a sector perspective, another key factor was services, which grew 3% y/y in volume at the end of 2018 (vs -0.5 y/y in the manufacturing sector). The most recent economic statistics and survey data confirm this trend. In manufacturing, production contracted slightly between late 2018 and early 2019. The purchasing managers' index (PMI) verged on 50 in February and March, the threshold that signals a contraction. In services, in contrast, survey data have picked up after briefly stalling last fall, and prospects are looking upbeat (chart 3).

On the whole, these factors reveal that economic growth has levelled off for the moment at a relatively high level, buoyed by stronger domestic demand, and despite the slowdown in foreign trade. At this stage, the most recent estimates by the Bank of Spain and Airef, the independent authority for fiscal responsibility, suggest that quarterly growth trends in Q1 2019 were in line with those reported in 2018 (0.6% q/q). Even if growth were to dip somewhat in the quarters ahead, annual GDP growth would still slightly exceed 2% in 2019.

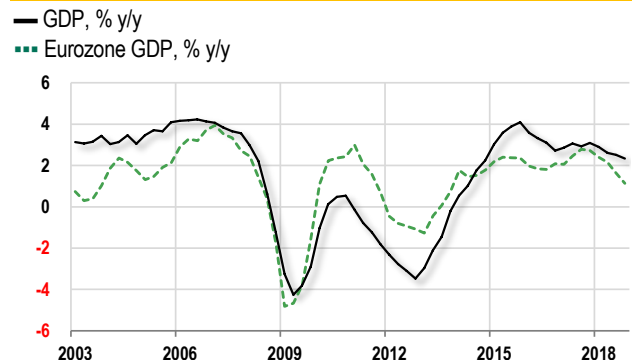
The outcome of the Brexit crisis obviously creates a downside risk, which would materialise "accidentally" in case of a no-deal Brexit, triggering short-term disruptions in trade and accentuating the slowdown in European commerce. After the initial impact, however,

### 1- Growth and inflation



Source: National accounts, BNP Paribas

### 2- One of the most dynamic economies



Source: Eurostat

it is worth keeping in mind that in terms of foreign trade, Spain does not rank among the countries with the highest exposure to Brexit.<sup>1</sup>

### ■ Household confidence is (excessively?) strong

Several factors are supporting the dynamic momentum of domestic demand. Job creations, an obvious support factor, are continuing to rise at a rapid pace (+2.3% y/y in Q4 2018), even though nearly 2.3 million people have joined the work force since the market tanked in 2013. In early 2019, the jobless rate fell below 14% of the active

<sup>1</sup> Evaluating the impact of Brexit on the activity of the UK's partners: trade channels, INSEE, note de Conjoncture, March 2019, pp33 to 51. For Spain, the estimated impact is slightly less than for France, at between 0.2 pp. of GDP (soft Brexit) and 0.5 pp. (hard Brexit).

population, and will continue to decline over the course of the year. Another support factor is low inflation, which has shed a point since October, to 1.3% in March 2019, thanks to falling energy prices. Core inflation has held at roughly 1% for nearly the past 18 months, without showing any signs of accelerating. Lastly, fiscal policy remains slightly expansionist, particularly towards households, while at the same time ensuring a nominal reduction in the fiscal deficit, given the economy's strong growth. As a result, after the minimum wage increase at the beginning of the year, and with the approach of legislative elections, Pedro Sanchez's minority government is seeking to beef up its social welfare policy (extension of paternity leave, improvement in unemployment benefits for seniors) in areas where he can act by decree. As things currently stand, and while waiting to know the budget choices of the next government, the Bank of Spain estimates the fiscal deficit at about 2.5% of GDP this year, slightly lower than the 2.7% reported in 2018.

Spanish households are taking full advantage of this rather buoyant environment, and it is surely regrettable that they are not allocating some of the increase in disposable income (+1.3% in real terms last year) to rebuild their savings. Much to the contrary, the dynamic momentum of consumer spending is also being fuelled by a decline in the savings rate, which dropped below the 2008 low to 5% at year-end 2018. Given the exuberance of the housing market<sup>2</sup>, household savings no longer suffice to cover the new residential investment flows of households. If these trends continue, the household debt ratio, which has narrowed sharply in recent years, could end up levelling off near the eurozone average.

### ■ Seeking a majority

It was Parliament's rejection of the 2019 budget proposal earlier this year that led Pedro Sanchez to call early general elections, which will be held on 28 April.

At this point, the Spanish Socialist Party (PSOE) is leading in the polls, although the number of voting intentions is lower than the votes received by the Popular Party in the 2016 general elections (33%). The second striking feature of the current electoral momentum is the surge in Vox, the extreme right party and the latest arrival on Spain's political scene. Vox currently has about 10% of voting intentions. Lastly, in Spain as in other countries, the breakthrough of the extreme parties is hardening the positions of the traditional parties.

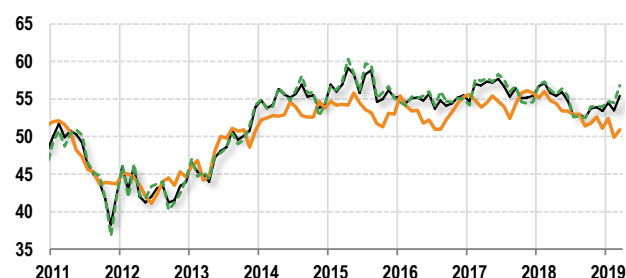
All in all, the fragmentation of Spain's political landscape clearly has not diminished since 2016, much to the contrary. Under the current situation, even if his party wins the elections, Pedro Sanchez will have a very hard time forming a coalition capable of leading the government for any length of time. The big question is whether, in addition to Podemos, he can count on the support of the pro-independence parties, while the Catalan question remains a major source of division in the country. So far, his proposal for in-depth discussions on Catalan autonomy within a constitutional framework has fallen on deaf ears. As to the Popular Party (PP) and its new leader Pablo Casado, the big question is whether he can convince

<sup>2</sup> Prices, which have risen by more than 6% y/y for the past 18 months and more, are now only 20% below the 2007 peak, compared to 37% at the low of year-end 2013.

### 3- Manufacturing slows

Purchasing Managers Indices

— composite ; ■■ services ; — manufacturing

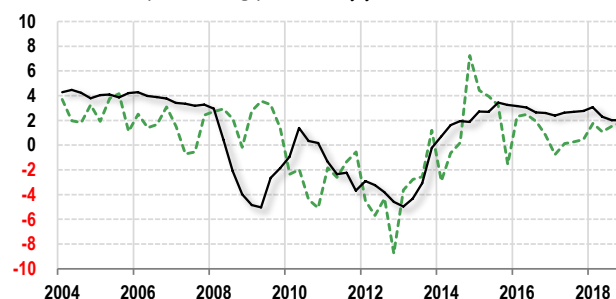


Source : Markit

### 4- Households' revenues and consumption

— real private consumption, % y/y

--- households purchasing power, % y/y



Source : INE, Eurostat

Vox and Ciudadanos to replicate at the national level the alliance they formed last December to win control of Andalusia. Even though none of the parties are currently envisioning such a plan, observers do not rule out the possibility of a PSOE-Ciudadanos alliance.

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# China

## What lies behind the rise in corporate defaults?

*Industrial enterprises were squeezed by tighter financing conditions in 2017 and early 2018, and then hit by a slowdown in production and revenue growth last year. These troubles have contributed to the deterioration of their payment capacity, resulting in a surge in defaults in the local bond market. The increase in defaults is an indicator of the financial fragility of corporates, and also seems to be going hand-in-hand with greater differentiation of credit risks by lenders and a certain clean-up of the financial sector. These trends are expected to continue in the short term as the authorities conduct a targeted easing of monetary policy. However, the persistence of the debt excess in the corporate sector will maintain high credit risks in the medium term.*

Chinese corporates operated in a tough environment in 2018, squeezed first by tighter financing conditions and then by the slowdown in activity. As a result, their payment capacity has deteriorated while their debt burden has remained excessively high. In recent months, in response to the worsening economic growth slowdown, the authorities have introduced fiscal measures to stimulate demand and eased monetary policy. This accommodative policy stance is likely to be maintained in the short term, and economic growth is projected to slow only moderately in 2019. In this environment, how will corporate credit risks evolve?

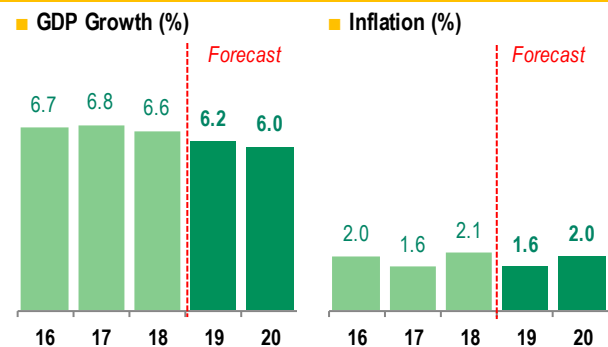
### ■ A complex environment for industrial enterprises

Since the end of 2016, corporates have found it harder to access credit. The authorities tightened monetary policy from late 2016 to early 2018 and then have only cautiously loosened it since Q2 2018. In the meantime, they have also considerably strengthened the financial sector's regulatory framework. As a result, growth in total credit to the economy (social financing) has slowed gradually, before picking up slightly again in Q1 2019 (see chart 2). The weighted average bank lending rate increased from 5.3% at year-end 2016 to 6% in mid-2018, before easing again to 5.6% at year-end 2018.

The deterioration in global economic conditions has only compounded the impact of tighter credit conditions on Chinese growth. Corporates in the industrial sector have been hit hardest by the slowdown in activity resulting from the weakening in both internal and external demand. Industrial production growth dropped to a low of 5.3% y/y in January-February 2019, compared to a monthly average of 5.7% in September-December 2018 and 6.5% in January-August 2018. While global demand has been cooling, China's export manufacturing sector has been hard hit by US tariff hikes. The latest round of tariff increases (10% in September) had a severe impact: total exports contracted by 0.1% y/y in November-December 2018 and by 5.2% in January-February 2019 (although they rebounded again in March).

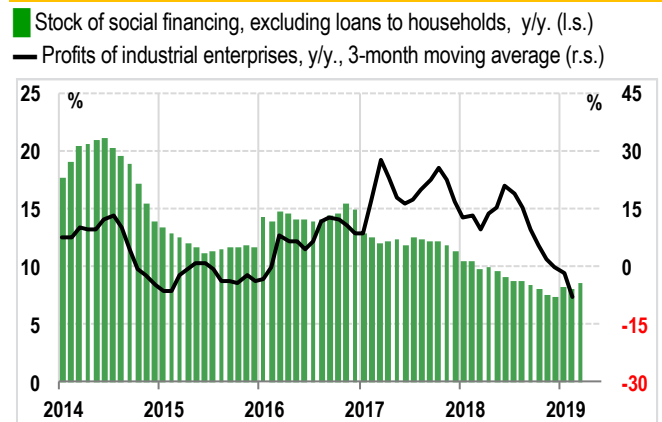
Industrial enterprises geared towards the domestic market have continued to be squeezed by the decline in real estate market transactions (which rose only 1.3% in 2018 and contracted 3.6% y/y in January-February 2019) and the slowdown in retail sales, especially in the durable goods and automobile sectors (vehicle purchases were down 3.1% in 2018 before plunging 15% in the first two months of 2019).

### 1- Growth and inflation



Sources: National accounts, BNP Paribas

### 2- Less credit, fewer profits



Sources: PBOC, NBS

Weaker demand, lower production capacity utilisation rates in 2018 (after two years of improvement) and the decline in energy prices in the year-end period triggered rapid disinflation in the producer price index (+0.2% y/y in Q1 2019 vs. 3.7% in Q1 2018). In the past, corporate revenues have been very closely correlated with this index. As a matter of fact, profits of industrial enterprises have slowed since mid-2018 and then fell by 14% y/y in the first two months of 2019.



### ■ Increasing number of defaults

In this environment, the payment capacity of corporates has deteriorated. Supplier payment periods have lengthened and the number of late payments has soared, which has helped spread these difficulties throughout the economy. According to Coface data, the average duration of late payments increased in the majority of sectors, with transport and construction reporting the longest durations, at more than 100 days. Worse, there has been an increase in the number of ultra-long late payments (80% of which are never repaid), which has eroded the cash position of many corporates, notably in construction, automobiles, textiles, information & communications technology and transport.

As to the repayment of debt, commercial banks reported a slight increase in non-performing loan ratios last year (to 1.83% from 1.74% at year-end 2017). The number of defaults in the local bond market increased more spectacularly, from less than 20 per year in 2015-2017 to about 40 in 2018 and 10 in Q1 2019. Several sectors were hit, and the energy sector in particular. The amount of defaulted debt is still limited (USD 16 bn in 2018, less than 0.5% of outstanding corporate bonds). Yet the surge in defaults indicates not only a deterioration in the corporate financial situation, but also a change in behaviour in the Chinese market (the first bond default did not occur until 2014). Moreover, not only private corporates are defaulting, but also a few state-owned enterprises, which signals that government support can no longer be taken completely for granted.

Therefore, while the rise in default risks is an alarming indicator of corporate fragility, it also seems to be accompanied by healthier lending practices. Moreover, other sources of vulnerability and risks of financial-sector instability have eased over the past two years, in response to the tightening of monetary policy and the strengthening of the regulatory framework. The decline in interbank financing has reduced the interconnections between financial institutions (banking and non-banking) and enabled them to deleverage. Shadow banking activities have also declined<sup>1</sup> (see chart 3). Meanwhile, the corporate sector began to report a slight decline in the debt-to-GDP ratio (estimated at 133% at year-end 2018, down from 137% at year-end 2017)<sup>2</sup>. However, this later trend is expected to be reversed in 2019.

### ■ An improvement in credit risk assessment?

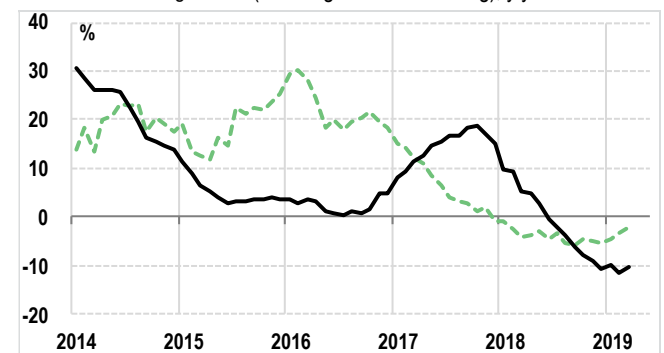
Between economic growth and deleveraging, the Chinese authorities have switched priorities over the past few months: the current policy mix primarily aims to stimulate activity in the short

<sup>1</sup> The financing offered by shadow banking institutions is not monitored and supervised as closely as bank loans. Some of this financing is reported in official statistics of "social financing", for example trust funds and entrusted loans (intercompany loans intermediated by banks). Other shadow banking activities are excluded from these statistics (such as assets financed by wealth management products, loans by financing companies, microloans, online lending between individuals, etc.). All forms of shadow banking have contracted over the past two years.

<sup>2</sup> Debt of the corporate sector excluding local governments and their financing vehicles.

### 3- Attenuation of financial-sector instability risks

--- Interbank lending (claims on banks & non-bank financial institutions), y/y  
— Shadow banking credits (including in social financing), y/y



Sources : PBOC, NBS

term. Growth in bank loans and bond issuance has accelerated slightly again since Q4 2018, and investment in public infrastructure has also been picking up. Moreover, fiscal stimulus measures introduced since early 2019 should also help economic growth to recover slightly, after bottoming out in the first part of the year. The easing of credit conditions should also help improve the cash position of corporates. Even so, default risks are still high, simply because of the persistence of corporates' debt excess. The number of defaults on the local bond market is likely to increase even further since the amount of debt reaching maturity for non-financial corporates will hit a record high in 2019 (USD 459 bn according to the Institute of International Finance).

At the same time, there should also be greater differentiation between different categories of borrowers. Firstly, the authorities are proceeding with a targeted easing of monetary policy: banks are notably encouraged (via directives or targeted financing facilities) to increase lending to private enterprises, SMEs and the healthiest companies. In addition, the increase in defaults seems to be prompting greater risk aversion and a better assessment of risks by creditors. As a result, financing conditions should continue to deteriorate for the most fragile companies. Lastly, reducing the risks of instability in the financial sector is still a key objective for Beijing, and the authorities are expected to maintain efforts to improve financial regulation and strengthen state-owned enterprises. The relative performances of financial institutions should continue to diverge as the big banks remain relatively solid and the others (small banks and non-banks) are hit by higher non-performing loans and the deterioration of their liquidity and capital adequacy ratios. Here too, even though the difficulties of certain institutions may well expose China to bouts of stress and volatility, they might also signal a move towards a healthier financing system.

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# India

## Economic track record on the eve of elections

After nearly five years in power, Narendra Modi's track record is generally positive, even though the last year of his mandate was tough, with a slowdown in growth in Q3-2018/19. The main growth engines are household consumption, and more recently, private investment, thanks to a healthier corporate financial situation, with the exception of certain sectors. In full-year 2018, external accounts deteriorated slightly as a swelling current account deficit was not offset by foreign direct investment. A big challenge for the next government will be to create a more conducive environment for domestic and non-resident investment.

### ■ Robust growth in 2018 despite a slowdown in Q3-FY2018/19

In the third quarter of fiscal year 2018/2019 (October-December 2018), economic growth slowed to 6.6% year-on-year (y/y). This was in part due to a slowdown in government spending, while household consumption and investment continued going strong. Activity slowed in the primary sector but remained robust in the industry and the services sector. To stimulate growth, the Central Bank lowered its policy rates twice (in February and April 2019), taking advantage of mild inflationary pressures (+2.6% y/y in February 2019) and the end of US monetary policy tightening.

In calendar year 2018, economic growth rose to 7.4% (vs 6.9% in 2017), one of the highest growth rates in Asia. In comparison, growth was 5.2% in Indonesia, 6.2% in the Philippines, 6.6% in China and 7.1% in Vietnam. Despite India's solid performance, however, per capita income is still low at USD 2016.

### ■ Consolidation of corporate's financial situation

The situation of private non-financial companies has improved significantly. They are now in a more solid position than in 2011, when the corporate situation began to deteriorate.

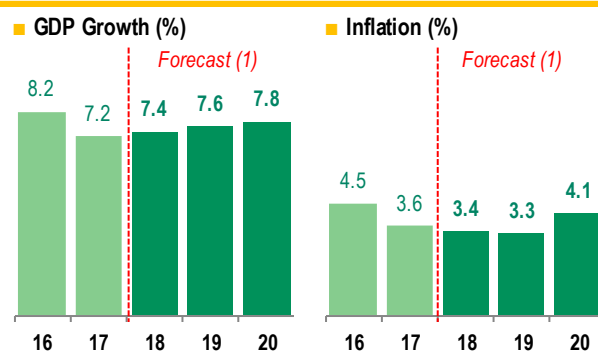
Since 2014, Indian companies as a whole have been undergoing financial consolidation. The debt-to-GDP ratio fell by 5 percentage points to 57% in Q3 2018. According to central bank data, the interest charges of private listed non-financial companies have declined. They accounted for 22.3% of profits before tax in Q4 2018, down from more than 35% in 2014. Sales revenue growth has also accelerated strongly since year-end 2017, generating an increase in net earnings of nearly 25% in Q4 2018, despite an upturn in the total wage bill. As a result, profits before tax covered interest charges 4.5 times in Q4 2018, compared with only 2.8 times in 2014.

Yet in certain sectors the situation is still very fragile, notably in telecommunications and energy. According to *Crédit Suisse*<sup>1</sup>, interest charges were higher than profits before tax for 96% of companies in the telecommunications sector and 58% of those in energy. The iron and steel sector had the highest concentration of loans at risk at the end of September 2018<sup>2</sup> (34.2% of loans outstanding according to the central bank), but companies have managed to consolidate significantly their financial situation thanks

<sup>1</sup> *India Corporate Health Tracker*, February 2019.

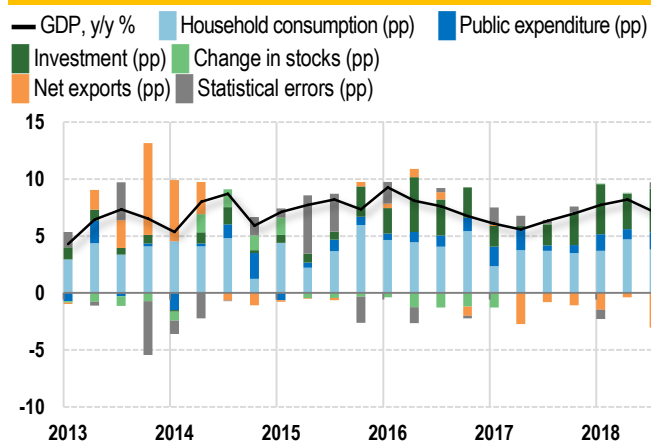
<sup>2</sup> Sum of non-performing loans and restructured loans.

### 1- Growth and inflation



Source: National accounts, BNP Paribas

### 2- Economic growth slowdown in Q3-FY2018/19



Source: CEIC

to sales revenue growth and deleveraging. Profits before tax covered interest charges 11.7 times in Q3 2018, compared to 4.3 times in 2014.

### ■ Insufficient foreign direct investment

In 2018, for the first time since 2013, the balance of payments showed a deficit estimated at 0.2% of GDP (excluding changes in foreign exchange reserves). It can be attributed to a sharp increase in the current account deficit coupled with a decline in net capital inflows.



The current account deficit rose to 2.4% of GDP in 2018, a 0.9 point increase compared with 2017. The deterioration reflects the strong rise in the trade deficit, which rose 1.1 percentage points to 6.9% of GDP. Exports rose only 5.9% over the full year, while imports increased 12.1%, reflecting an upturn in investment and the oil bill.

At the same time, net capital inflows declined to only 2.2% of GDP in 2018 (from 3% of GDP in 2017). Net foreign direct investment (FDI) declined compared with the 2015-2016 peak, and represented 1.2% of GDP in 2018; this did no longer cover the current account deficit. As a result, the country is dependent on portfolio investment and thus exposed to international financial market volatility. Yet net portfolio investment outflows reached the equivalent of 0.4% of GDP in 2018. As net capital inflows were inadequate to cover the increase in the current account deficit, foreign exchange reserves declined by USD 20 bn and the rupee depreciated by 9% against the dollar in full-year 2018. Even so, foreign exchange reserves are still sufficient to cover the country's short-term external financing needs (1.3 times). Compared with 2013/14, corporates are also slightly less exposed to a revaluation of their debt thanks to the rupee's depreciation against the US dollar. The share of external debt denominated in USD accounted for only 45.9% of total debt at the end of 2018, compared with more than 63% five years earlier.

In Q1 2019, the balance of payments seemed to be healthier given the positive shift in the rupee and foreign reserves. In the first two months of the year, the trade deficit narrowed slightly thanks to the decline in imports.

One of the future government's objectives will be to stimulate further FDI in order to boost economic growth and reduce the country's dependence on volatile capital flows. Although the business climate has improved significantly during the Modi mandate, FDI flows are still mild and the stock of FDI accounted for only 14.3% of India's GDP at year-end 2018 (compared with 22.5% of GDP in Indonesia and 21.7% of GDP in China).

### ■ End of preferential tariffs with the United States?

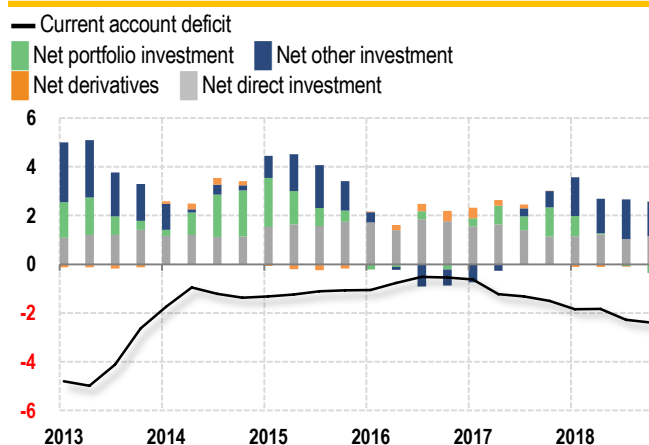
Since 1974, India has benefited from preferential tariffs for certain products exported to the United States under the framework of the Generalised System of Preferences (GSP), which aims to facilitate the development of emerging countries. President Trump announced that he might eliminate this advantage because sales of American products in India were heavily restricted, especially for medicines and basic necessities, such as milk.

Such a move would have only a moderate impact on India's economy. According to the US International Trade Commission, Indian exports to the United States as part of GSP amounted to USD 6.2 bn, 11.5% of exports to the United States, and the equivalent of 0.23% of GDP. These products include mechanical engineering, vehicles, iron and steel, chemicals and consumer goods.

### ■ Major challenges for the next government?

Between 11 April and 19 May, general elections will be held for the entire lower house of Parliament, and a new Prime Minister will be elected for the next five years.

### 3- Balance of payments (4-quarter sum, % of GDP)



Source: RBI

Although the Narendra Modi government's track record is generally positive, thanks notably to the introduction of the Goods and Services Tax (GST), the biometric coverage of the population (Aadhaar project) and a new corporate bankruptcy law, the next government will face several major challenges. Although per capita income has increased strongly in real terms (+6.8% a year on average over the past five years) and the poverty rate has declined, productive employment is still insufficient and informal employment is too high (81% of total employment according to the International Labour Organisation) to increase significantly the country's development.

The next government will have to create a more conducive environment for domestic and non-resident investment. These efforts must cover education (for all) and the labour market, by making it easier for women to find jobs, reducing hiring restrictions and lowering corporate costs in case of layoffs.

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# Brazil

## Delayed recovery

The hopes of seeing economic activity pick up following the election of Jair Bolsonaro have fallen. Some indicators point to a possible contraction in economic activity in Q1 2019 at a time where confidence indicators were seemingly improving. Meanwhile, the reform of the pension system – a cornerstone of President Bolsonaro’s economic program – was presented to Congress in February where it is currently under discussion. Negotiations will likely be more protracted and be more difficult than originally expected. Indeed, since taking office, the popularity of the Brazilian president has sharply declined and relations between the executive and the legislature have strained.

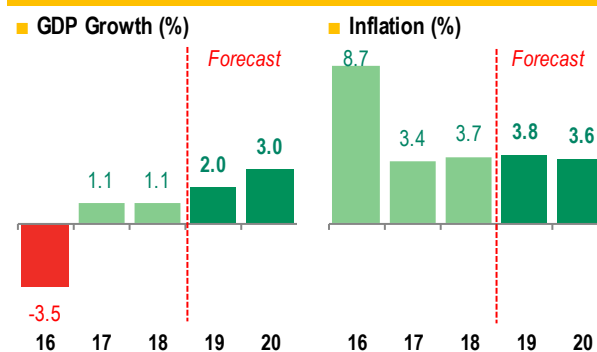
### ■ A lethargic start to the year

In 2018, the economy grew at the same pace as in 2017, at an annual average rate of 1.1%. The year’s growth performance was largely tainted by the truckers’ strike and the general elections. Household consumption remained the main driver of growth thanks in particular to a rise in consumer credit, which spearheaded the recovery in credit growth (+5% in 2018) after two years of contraction in 2016 and 2017. Investment recovered some lost ground (+4.1% y/y) after declining for four years. Nonetheless, investment as a share of GDP remains well below its 2013 peak (17.4% versus 22.8% of GDP). Meanwhile, the contribution of net exports was negative (-0.5 pp) for the first time since 2013. The current account deficit (USD 14.5 bn) was contained (0.8% of GDP) and was largely covered by net FDI flows (USD 74.3 bn, or 4.1% of GDP). Due to the very slow pace of economic activity in Q4 (+0.1% q/q) the statistical carry-over for 2019 is weak.

Despite the upswing in confidence witnessed post-election, economic indicators have largely disappointed since the onset of the year. Industrial production remained flat over the first two months of the year (-0.8% m/m, in seasonally adjusted terms in January followed by + 0.7% m/m in February). Mining production fell sharply (-15% in February) following the break-up of the Brumadinho dam in late January. Idle capacities in industry remain high, which partly explains—alongside the drop in subsidized credit—why corporate credit growth is recovering only very slowly (+ 2% y/y in February). More surprisingly, retail sales have remained largely erratic despite the rise in real wages since November and the strong growth in consumer credit (+ 9% y/y in February). Against this backdrop, the labor market deteriorated (unemployment rose to +12.4% at the end of February against 11.6% in December). Finally, activity in the services sector has also slowed since January. More importantly, the central bank’s leading indicator of economic activity (IBC-BR)—a monthly proxy for GDP—declined both in January and February (-0.3% and -0.7% m/m, sa), raising concerns about a potential contraction in GDP in Q1.

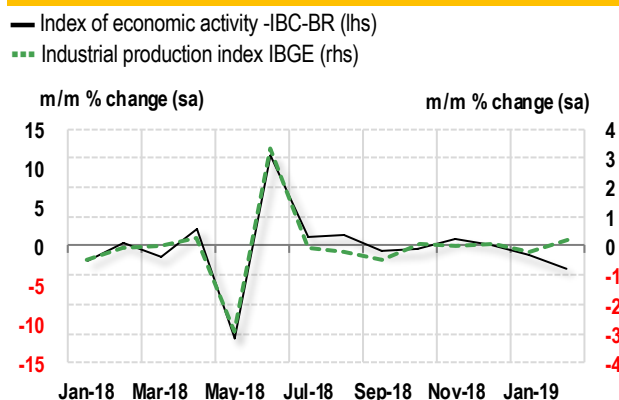
For now, financial markets have not yet adversely reacted to the weak performance of the economy. The stock market—which broke 100,000 points in March for the first time in its history—continues to perform well despite the sluggish business cycle. The risk premiums on sovereign debt remain around 250 basis points (bps) after dropping by nearly 100 bps since early September 2018. Meanwhile, the BRL which gained some ground against the US during Bolsonaro’s first month in office (+ 6% in early February) has since

### 1- Growth and inflation



Source: National accounts, BNP Paribas

### 2- Monthly proxy for GDP (IBC-BR) has contracted



Source: Central Bank of Brazil, IBGE, BNP Paribas

returned to its level at the beginning of January. The currency however remains down 12% compared to a year ago.

At this point, hopes of seeing economic activity accelerate strongly are limited. Fiscal consolidation leaves no room for increased public spending, while the climate of watchfulness resulting from the fiscal reform will likely hold back investment decisions. External factors are not also particularly supportive: in addition to the slowdown in the global economy the shortfall resulting from the recession in Argentina is weighing on exports of capital goods, particularly in the automotive industry. On the flipside, loose financial conditions and the process of disinflation remain favorable to private consumption and credit growth. The benchmark rate has been at a historical low



(6.5%) for a year now. Meanwhile, inflation should remain contained below the Central Bank's target in 2019.

■ **A peak at the state of public finances...**

Brazil's fiscal accounts have largely deteriorated since 2014 when the primary balance (excluding interest payments on government debt) turned negative after 10 years in surplus. Over period 2014-2018, the central government's fiscal deficit averaged 6.8% while the primary deficit averaged 1.7%.

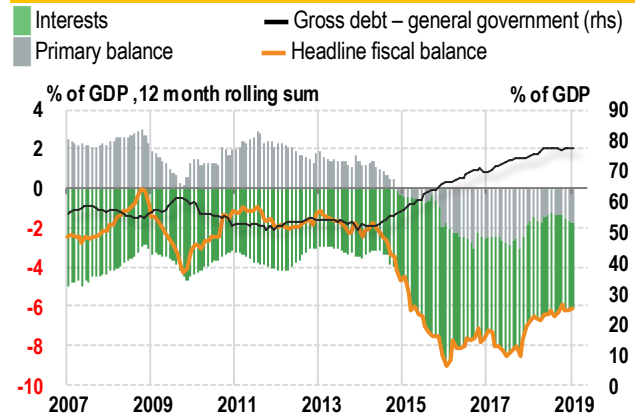
The deteriorating trajectory of the fiscal balance owes to cyclical factors (meagre recovery, revenues collapsing during the recession in 2015, 2016) but is mostly symptomatic of large structural imbalances which have led spending to grow 3 times as fast as GDP in the past 10 years. Spending has remained rigid owing to the incompressibility of mandatory social spending in particular social security and pension benefits which entitlements are protected under the constitution. The wage bill has also grown rapidly. Central government payroll has increased by 8% on average over period 2010-2017 accounting for about 4% of GDP. Costly indirect or direct subsidies are also to blame and have yet to be phased out. While the offering of subsidized credit through BNDES is being gradually phased out, the concurrent reduction of energy subsidies has remained politically sensitive. Subsidies associated with the truckers' strike (May 2018) is estimated to have cost the equivalent of 0.2% of GDP in 2018.

Despite the adoption of the spending cap<sup>1</sup> in 2016, the inability to alter the course of mandatory spending (social spending and pensions in particular) has meant that limited progress in terms of fiscal consolidation has been made. Given Brazil's structurally high interest burden (~ 5% of GDP), recurrent primary deficits have led to a sharp increase in public debt (+25 pp of GDP since 2013 to 77% in 2018).

The public debt burden is high but its financing does not currently pose a problem. Moreover, the profile of the debt has improved over time (longer maturities, low foreign-currency debt, better amortization profile, gradual replacement of floating rate instruments with fixed ones). The government also enjoys good coverage of its large financing needs thanks to the presence of a liquid domestic capital market. 96% of the public debt is domestic debt and is mostly held locally with ~11% held by non-residents at end 2018. Non-residents have continuously reduced their sovereign exposure since May 2015 when holdings reached a high of ~21%. Meanwhile, the monthly average borrowing costs of the central government on its domestic debt have eased (17.5 % in 2015 vs 10.6% in 2018) enabled by disinflation and the drop in the benchmark SELIC rate.

<sup>1</sup> According to the law, the non interest part of central government expenditure (ie primary spending) cannot grow faster than inflation for a period of 20 years. Penalties for not complying with the cap include the prohibition to grant adjustments to civil servants' wages, hire new personnel or generate additional expenditure.

**3- Overview of public finances**



Source: Central Bank of Brazil, National Treasury, BNP Paribas

■ **....as the pension reform bill is examined**

The pension reform bill - introduced by the government in February is currently under discussion in Congress. The reform<sup>2</sup> projects fiscal saving in the range of USD 300 bn over 10 years (around 1.5% of GDP per year). A recent Datafolha survey reveals that popular support for the reform has improved (51% rejection vs. 71% in April 2017).

In all likelihood, the size of the fiscal savings will be revised downwards by at least one-third after negotiations in Congress. Recent tensions between the executive and Congress however have cast doubts about the government's ability to find the necessary support to approve the reform. To make things worse, President Bolsonaro's popularity - the main lever for pushing a fragmented Congress to form a qualified majority (3/5) - has been significantly challenged. A poll conducted by Ibope in March reports a drop in the President's approval ratings from 49% in January to 34% in March.

At best, the reform should help reduce the primary deficit by 0.7 to 1 pp of GDP, which on its own will be insufficient to stabilize the public debt.

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<sup>2</sup> The new pension system which seeks to narrow the gap between workers in the public and private sectors would be rolled out over a 12 year transition period. The current proposal would (i) set the minimum retirement age at 65 for men and 62 for women for both public and private sector workers (ii) increase the length of contribution to social security, (iii) make important changes to how retirement benefits are calculated, (iv) align the rules applied to federal government civil servants with those of states and municipalities (v) eliminate certain discrepancies across professions (ie. teachers, police, military for instance benefit from early retirement rules).

# Russia

## Economic growth faces headwinds

Economic growth slowed in the first months of 2019, and is now close to its potential growth rate of 1.5% according to the central bank. A 2-point VAT increase on 1 January has strained real wage growth and sapped household consumption. Inflation (5.2% year-on-year in February) is still below the central bank's expectations, and the key policy rate was maintained at 7.75% following the March meeting of the monetary policy committee. In the first two months of 2019, investors were attracted by high yields on Russian government bonds, despite the risk of further tightening of US sanctions. The rouble also gained 5% against the US dollar in Q1 2019.

### ■ Growth acceleration in 2018 is not what it seems

Economic growth accelerated to 2.3% in full-year 2018 from 1.6% in 2017. Yet this strong performance must be kept in perspective. The acceleration can be attributed primarily to a slowdown in imports, which reflects slowing investment as well as household consumption, albeit to a more limited extent. As a result, net exports made a very positive contribution to growth in 2018 (+0.8 percentage points) after a negative contribution in 2017. All other growth components slowed. The slowdown in investment growth (+0.2% y/y in Q4 2018 vs +4.5% in the first three quarters) was partially due to less favourable monetary conditions. Corporate lending rates rose slightly (+60 basis points) as monetary policy was tightened.

Faced, on the one hand, with downward pressure on the rouble due to the risk of tighter US sanctions and, on the other hand, with higher inflation expectations following the VAT increase on 1 January 2019, the Central Bank of Russia raised its key policy rate by 25 basis points on two occasions, in September and December 2018, to 7.75%.

Economic growth is expected to slow in 2019. In the first two months of the year, economic indicators point to slowing growth. Industrial output slowed to 2.3% in the first two months of the year from 2.7% in Q4 2018, according to central bank estimates. It is nonetheless resilient thanks to the increase in natural gas and metal output. In contrast, oil production continued to slow in compliance with OPEC agreements.

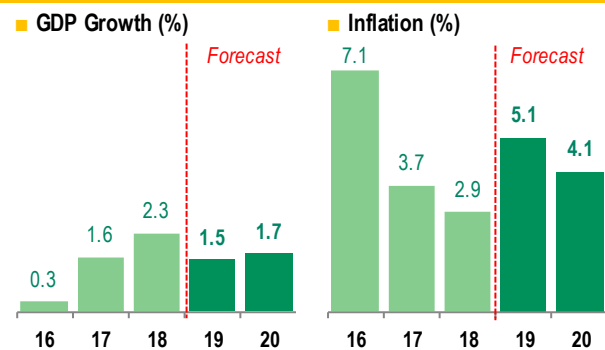
Production of capital goods and consumer goods (excluding food products) slowed in keeping with a net slowdown in retail sales and the drop-off in automobile sales. The slowdown in household consumption is mainly due to the 2-point increase in VAT, which has strained real wage growth (+0.7% year-on-year in February 2019, compared to a 2018 average of +7%).

Even so, confidence indicators in industry are still looking upbeat. Survey results suggest that domestic orders accelerated in March while export orders continued to sag. According to the Central Bank of Russia, economic growth is now close to its long-term potential rate of 1.5%.

### ■ Inflationary pressure rises

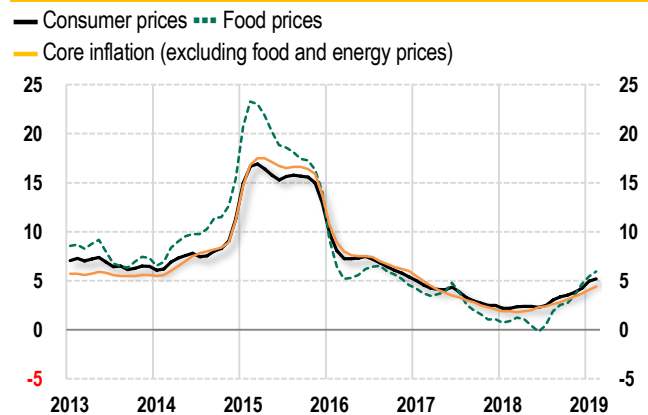
Consumer prices began to accelerate as of July, reflecting the rouble's depreciation, price increases for certain commodities (agricultural products and oil) and an unfavourable base effect

### 1- Growth and inflation



Source: National accounts, BNP Paribas

### 2- Inflation (year-on-year, %)



Source: CBR

(notably for food prices). In December 2018, prices were up 4.3% year-on-year, compared to only 2.5% y/y in the year-earlier period. All products (food and non-food) were hit by this acceleration. Since the end of the year, price increases have accelerated (+1.2 percentage points to 5.2% year-on-year in February) due to the VAT increase, which accounted for nearly half of the recent price acceleration according to the central bank.

### ■ Non-resident investors return in first part of the year

In 2018, the current account surplus swelled to 6.9% of GDP, up from 2.1% of GDP in 2017. Buoyed by increases in international oil and gas prices, the trade surplus rose 4.5 points to 11.8% of GDP.



At the same time, imports declined slightly (-0.1% of GDP). The current account surplus covered the financial account deficit, which amounted to about 5% of GDP.

As a result, in full-year 2018, Russia's net external position increased by nearly USD 100 bn to the equivalent of 22.4% of GDP (compared with 17.3% the previous year). This change has reflected major capital outflows following the tightening of US sanctions in April 2018: stocks of foreign direct investment and portfolio investment declined by 6.2% and 9.5%, respectively. The improvement in the external position also reflects the contraction of loans (down 13%). Russia's external debt continued to decline in 2018 (by USD 64 bn) and shrank to only 27.4% of GDP (100% of exports) at year-end 2018, compared with more than 41% of GDP (157% of exports) in Q2 2016.

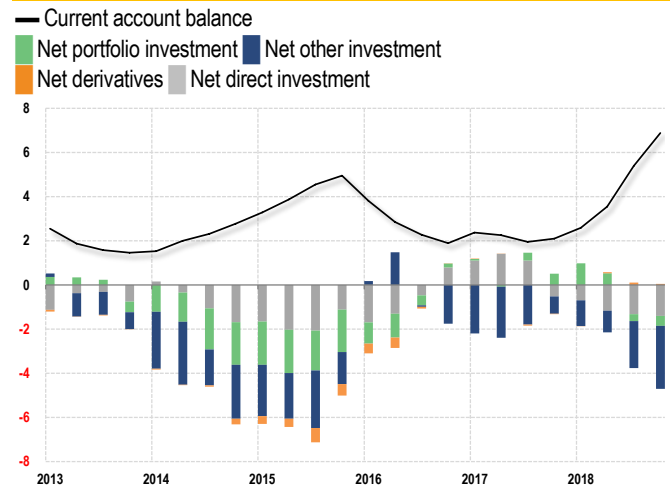
In the first two months of 2019, the current account surplus seems to have increased slightly due to the decline in imports, according to the central bank's preliminary estimates. Capital inflows accelerated despite the risk of tighter US sanctions. Government bonds held by non-resident investors increased for the second consecutive month, although they are still lower than in the previous year. In early March, non-resident investors held nearly 26% of government bonds issued in roubles. Non-resident investors were attracted by high yields on Russian government bonds at a time when interest rates are extremely low in Europe, and to a lesser extent, in the United States.

With the increase in oil prices since the beginning of the year and the decline in financial market pressures, the monetary authorities have begun purchasing foreign currencies again, which did not prevent the rouble from gaining 5% against the US dollar in Q1 2019. Foreign exchange reserves increased by USD 9 bn to more than USD 390 bn at the end of February, five times the amount of debt servicing from a 1-year horizon.

### ■ Risk of tighter US sanctions

In August 2018, Democrat and Republic senators Chris Van Hollen and Marco Rubio presented Congress with a bipartisan bill, Defending Elections from Threats by Establishing Redlines Act, also known as the Deter Act, which aims to sanction the Russian authorities suspected of US election interference in 2016. After the bill was rejected, the two senators submitted a new version on 3 April 2019 that was extremely similar to the previous one. The draft bill aims to sanction any country that influences US election results in any manner (based on the findings of an investigation by the Director of National Intelligence). If the law is adopted and Russia is found guilty of interference, US persons would be totally prohibited from purchasing Russian government bonds as well as bonds from companies owned or controlled by the Russian government. Sanctions would also be imposed on companies in the finance, energy and defence industries. Sberbank, VTB bank, Gazprombank, Vnesheconombank and Rosselkhozbank would be prohibited from making transactions with the United States. In the energy sector, any new investment by American entities would be prohibited. Lastly, any politicians or oligarchs implicated in US election interference would be prohibited from entering US soil and would be banned from making transactions with US persons.

### 3- Balance of payments (4-quarter sum, % of GDP)



To date, there is strong dissension in Congress about the best measures to take against Russia, and President Trump is still opposed to them.

Even if legislation is adopted, over a 1-year horizon, it would not endanger the Russian government's external financing needs, which are estimated at a little under USD 80 bn.

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# Japan

## Pale horizons

*Economic activity in Japan remains in a slump, and the slowdown observed in 2018 seems set to last. Manufacturing activity deteriorated in the first quarter. In the short and medium term, Japan will continue to be hard hit by the slowdown in China, its main trading partner. Demographics are still a major problem in a country where the over-65 age group continues to swell and now accounts for more than a quarter of Japan's total population. It serves as a constant incentive to boost productivity gains through large-scale structural reforms in the goods and services markets as well as in the labour market.*

Japan is one of the OECD economies with the highest exposure to the emerging markets of Asia. Already confronted with numerous structural challenges, Japan is also on the front line when it comes to the risk of a Chinese slowdown.

### ■ A sluggish economic situation

Economic activity slowed sharply in Japan in 2018 as GDP rose only 0.8%, compared to 1.9% in 2017. The growth profile was jagged. The country was hard hit by a typhoon in Q3 2018 that hit domestic demand particularly hard, especially investment. The fourth-quarter rebound was not as strong as expected as foreign trade once again curbed growth.

In Q1 2019, cyclical indicators are still mixed. According to the Bank of Japan's Tankan survey, a good indicator of business confidence, the index levelled off in the non-manufacturing sector but deteriorated in the manufacturing sector, possibly suggesting a decline in Asian orders, essentially from China. The purchasing managers index (PMI) for the manufacturing sector dropped from 52.6 in December 2018, to 49.2 in March 2019, which seems to corroborate this observation. Although the Japanese economy is not very open (exports in value account for less than 20% of the country's total value added), the weighting of the manufacturing sector is relatively high compared to the OECD average. It has even followed a slightly upward trend since 2013<sup>1</sup>. Given the structure of Japan's productive fabric and external trade (more than half of Japanese exports are shipped to Asia, and about 20% to China alone), the economy could be vulnerable to the current global cyclical downturn and the sluggish momentum of international trade.

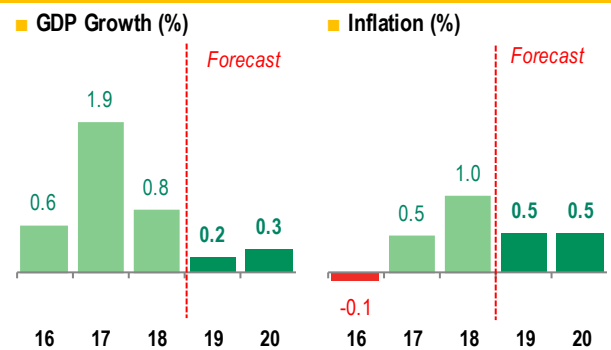
All in all, Japanese growth is falling sharply and is likely to near zero in 2019 and 2020, at +0.2% and +0.3%, respectively. The downturn in the investment cycle is likely to erode activity, as industrial companies take a wait-and-see approach to the slowdown in external demand.

There are numerous risks associated with this growth scenario. In case of a more abrupt slowdown in Chinese demand, for example, Japan would be one of the hardest hit economies, notably in the short term<sup>2</sup>.

<sup>1</sup> Source: OECD

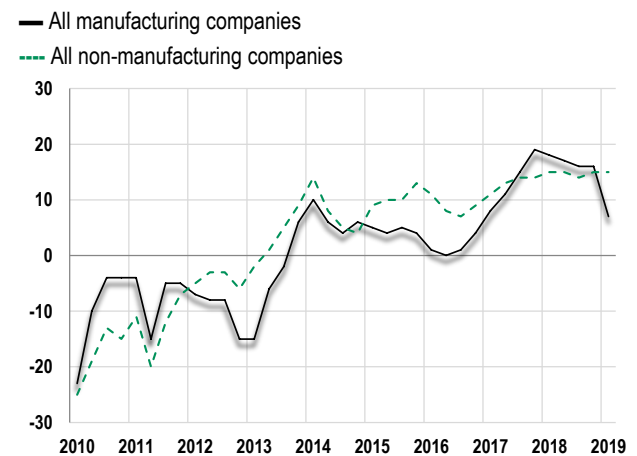
<sup>2</sup> *Global growth weakening as some risks materialize*, OECD Interim Economic Outlook, March 2019

### 1- Growth and inflation



Source: National accounts, BNP Paribas

### 2- Tankan indicator



Source: Bank of Japan

### ■ Questions about the effectiveness of monetary policy

The Bank of Japan's balance sheet has swelled rapidly since 2013 and now accounts for 100% of the country's GDP. At a time when the Fed's balance sheet is shrinking and the ECB's has stagnated, the Bank of Japan's balance sheet continues to swell, albeit at a slower pace since 2017. Meanwhile, a negative interest rate policy and yield curve controls have maintained the long end at roughly zero. This very expansionist monetary policy may have had a beneficial impact on growth, financing costs and inflation. However, price momentum is still very mild, with annual year-on-year inflation



of 0.2% in February 2019, the same as in January 2019. For the full year, inflation is expected to remain low at an average annual rate of 0.5%, due notably to the slowdown in activity. Inflation is expected to level off in 2020.

In general, Japan's extended period of low interest rates and its demographic trends (an aging population and a decline in the working age population), which reduce credit demand, pose major challenges for the local financial system. Net interest margins for the regional banks have been trending downwards since the mid-2000s. This environment encourages regional banks to take more risks, particularly in terms of their loan policy with regard to small and medium-sized enterprises (SME) (IMF, 2018)<sup>3</sup>.

### ■ Limiting the economic impact of aging population

The third arrow of Abenomics, launched in 2012, focused on so-called structural reforms. This segmented programme covers several aspects of the Japanese economy. In addition to boosting innovation and openness to trade, as illustrated by the recent trade agreement signed with the European Union, the reforms aim to limit the negative impact on the economy of 1) declining demographics and 2) labour market duality between regular and irregular workers.

Today Japan is the country with the world's oldest population, with the over-65 age group accounting for more than a quarter of the total population (see chart 4). An aging population accompanied by a decline in the share of the working age population poses a major economic challenge. It can have a negative impact on the potential growth rate by reducing the volume of work available. In terms of public finances, the decline in labour reduces fiscal revenues and leads to an automatic increase in public spending, driven up by the needs of the elderly. One solution is to integrate more women into the work force. The labour participation rate of women has increased rapidly in recent years, to 70% in 2018 from about 60% in 2012. Even so, it is still significantly lower than for men, by about 15 percentage points.

There is also the question of the labour market's structure, given its highly ingrained duality. The share of irregular workers has increased rapidly, reducing labour productivity<sup>4</sup>. Irregular contracts are relatively less expensive since they pay less than regular contracts and offer fewer job protections, training and career opportunities. In the early 2000s, regular workers accounted for 70% of total employment, but this figure has now fallen to just above 60%.

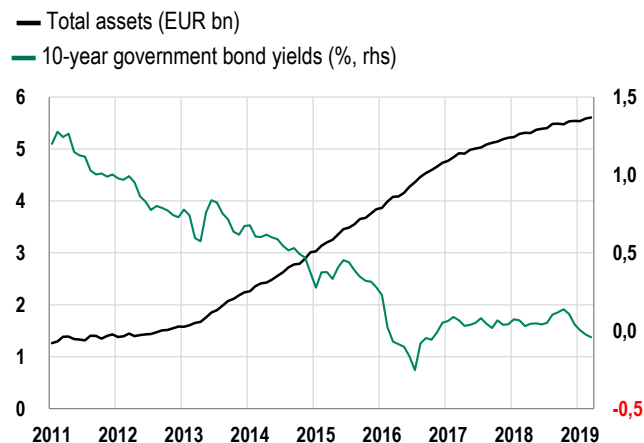
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<sup>3</sup> Article IV Consultation with Japan, IMF, November 2018

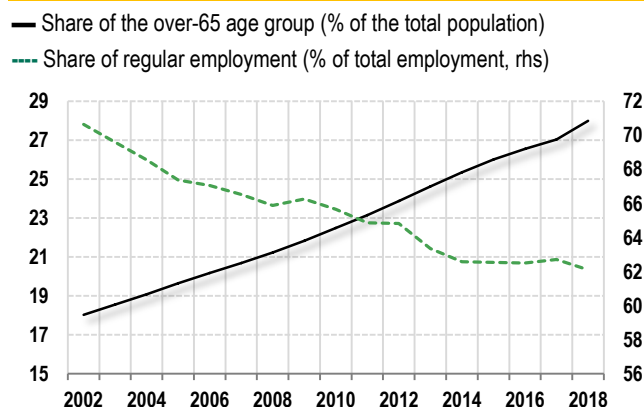
<sup>4</sup> M. Colacelli, "Macroeconomic effects of Japan's demographics: Can structural reforms reverse them?", IMF Working Papers, November 2018

### 3- Asset prices rise, while rates fall to the zero lower bound



Source: Bank of Japan

### 4- Major demographic challenges



Source: Statistics Bureau of Japan, World Bank, INED, BNP Paribas





# United Kingdom

## False start

By opting to leave the European Union (EU) without any exit plan, the United Kingdom has come face to face with an impossible choice. Week after week, the Brexit impasse has revealed the British Parliament's incapacity to make decision, starting with the ratification of the divorce terms, the fruit of 2-years of negotiations by Prime Minister Theresa May. In the end, the Brexit was simply postponed. First set for 29 March, then 12 April, the deadline for exiting the EU has now been extended to 31 October (a Halloween treat?). This date could be moved forward if the UK finally manages to ratify the withdrawal agreement, which it has rejected time and again. But the most probable scenario is that the UK will extend its participation to the EU, at least for a while...

Three years after voting by referendum to exit the European Union (EU) and after a 2-year divorce procedure, the United Kingdom has finally decided... to decide nothing. After failing three times to get the House of Commons to ratify the withdrawal agreement negotiated with the UK's 27 European partners, Prime Minister Theresa May had no other choice but to request a longer delay to trigger Brexit.

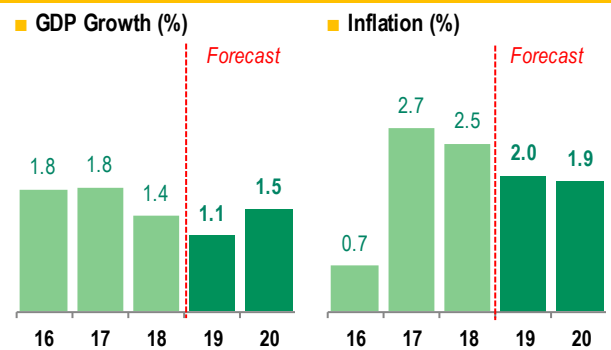
The European 27 granted extensions on two occasions. The deadline for the UK to exit the EU was first pushed back to 12 April, and has now been set for 31 October 2019, which is not only Halloween, but also the official end of the Juncker Commission's mandate. Between now and then, the field of possibilities is vast (see flowchart).

Although the European Council rules out any moves to reopen the withdrawal agreement, it has offered the House of Commons the possibility of ratifying it anytime between now and 31 October 2019, with Brexit taking effect on the first day of the following month. To avoid participating in European elections, however, the UK would have to ratify the agreement before midnight on 22 May (for an effective exit on 1 June). Since the alternative is "no-deal" Brexit after 31 May, it is more than likely that the UK will step into EU elections and prolong its participation to European institutions. This means that the UK will have to be reattributed 73 seats in the European Parliament, which would then be eliminated after 31 October, or redistributed according to the plan that has already been adopted (France would recover 5 seats, for example).

Of course, this sort of temporary solution is a first, and the Council wants to arm itself against any institutional blockage by instructing the UK to "abstain from any measures likely to endanger the realisation of the Union's objectives, especially when participating in the decision-making process..." Clearly, the Brexit question will continue to pop up in the middle of debates. Without being nil, there is very little probability that the UK Parliament will end up ratifying the withdrawal agreement. According to the indicative votes in the House of Commons, remaining in a customs union through a kind of "soft" Brexit seems to be the solution best positioned to win a majority vote. Although it is theoretically possible to hold a vote on a withdrawal agreement based on this option<sup>1</sup>, it would have to be a bi-partisan proposal. For Prime Minister May's already fragile majority, this solution would be very hard to resist. European elections and/or the calling of early general elections could also be

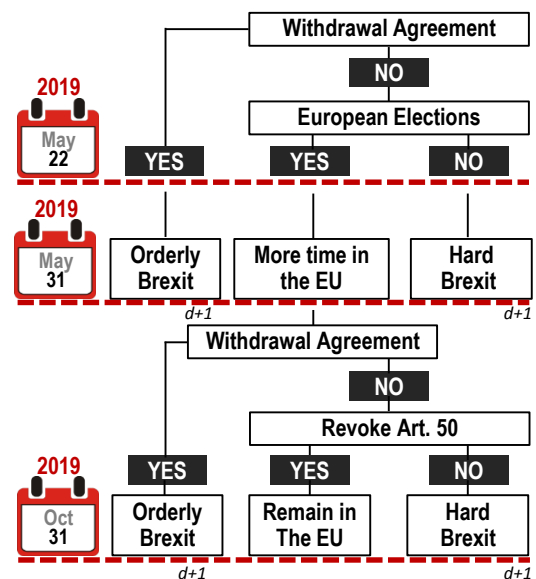
<sup>1</sup> The political declaration would undoubtedly have to be adjusted somewhat.

### 1- Growth and inflation



Source: National accounts, BNP Paribas

### 2- Non-exhaustive flowchart of possibilities



Source: European Council

the occasion to re-examine the Brexit question again. Unless of course the UK, still stuck in an impasse, decides to request another extension for Brexit, beyond 31 October.

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## Economic forecasts

%	GDP Growth			Inflation		
	2018	2019 e	2020 e	2018	2019 e	2020 e
<b>Advanced</b>	<b>2.2</b>	<b>1.5</b>	<b>1.3</b>	<b>2.0</b>	<b>1.4</b>	<b>1.6</b>
United-States	2.9	2.3	1.8	2.4	1.7	2.0
Japan	0.8	0.2	0.3	1.0	0.5	0.5
United-Kingdom	1.4	1.1	1.5	2.5	2.0	1.9
<b>Euro Area</b>	<b>1.8</b>	<b>0.9</b>	<b>1.0</b>	<b>1.8</b>	<b>1.2</b>	<b>1.4</b>
Germany	1.4	0.7	0.9	1.9	1.4	1.7
France	1.6	1.2	1.2	2.1	1.2	1.7
Italy	0.8	0.0	0.5	1.3	0.9	1.2
Spain	2.6	2.1	1.7	1.7	1.0	1.4
<b>Emerging</b>	<b>4.5</b>	<b>4.4</b>	<b>4.7</b>	<b>4.8</b>	<b>4.6</b>	<b>4.2</b>
China	6.6	6.2	6.0	2.1	1.6	2.0
India*	7.4	7.6	7.8	3.4	3.3	4.1
Brazil	1.1	2.0	3.0	3.7	3.8	3.6
Russia	2.3	1.5	1.7	2.9	5.1	4.1

Source : BNP Paribas Group Economic Research (e: Estimates & forecasts)

\* Fiscal year from April 1st of year n to March 31st of year n+1

## Financial forecast

Interest rates, %		2019				2018	2019e	2020e
End of period		Q1	Q2e	Q3e	Q4e			
<b>US</b>	Fed Funds	2.50	2.50	2.50	2.50	2.50	2.50	2.50
	Libor 3m \$	2.60	2.60	2.60	2.60	2.81	2.60	2.50
	T-Notes 10y	2.42	2.80	2.75	2.70	2.69	2.70	2.50
<b>Ezone</b>	ECB Refi	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	Euribor 3m	-0.31	-0.30	-0.30	-0.30	-0.31	-0.30	-0.30
	Bund 10y	-0.07	0.30	0.30	0.30	0.25	0.30	0.40
	OAT 10y	0.26	0.65	0.65	0.60	0.71	0.60	0.70
<b>UK</b>	Base rate	0.75	1.00	1.00	1.25	0.75	1.25	1.25
	Gilts 10y	1.00	1.85	2.00	2.10	1.27	2.10	2.10
<b>Japan</b>	BoJ Rate	-0.06	-0.10	-0.10	-0.10	-0.07	-0.10	-0.20
	JGB 10y	-0.09	-0.03	-0.05	-0.05	0.00	-0.05	-0.20

Source : BNP Paribas GlobalMarkets (e: Forecasts)

Exchange Rates		2019				2018	2019e	2020e
End of period		Q1	Q2e	Q3e	Q4e			
USD	EUR / USD	1.12	1.17	1.18	1.20	1.14	1.20	1.25
	USD / JPY	111.0	108.0	105.0	100.0	110.0	100.0	90.0
	GBP / USD	1.30	1.38	1.40	1.45	1.27	1.45	1.51
	USD / CHF	1.00	0.97	0.97	0.97	0.99	0.97	0.93
EUR	EUR / GBP	0.85	0.85	0.84	0.83	0.90	0.83	0.83
	EUR / CHF	1.12	1.14	1.15	1.16	1.13	1.16	1.16
	EUR / JPY	124.0	126.0	124.0	120.0	125.0	120.0	113.0

Source : BNP Paribas GlobalMarkets (e: Forecasts)



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