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ECONOMIC RESEARCH DEPARTMENT

Editorial

Cautious optimism

The economic growth deceleration in emerging countries as a whole seems to have come to an end. Confidence indicators in the manufacturing sector have improved and external financing conditions have become very favourable. However, the recovery remains uneven and fragile. Beyond the fact that the Brazilian and Russian economies are expected to emerge from recession, the recovery will remain constrained by the structural slowdown in world trade and the very gradual deleveraging of corporates.

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Edito

Cautious optimism

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The horizon brightens…

Economic growth in emerging countries seems to have hit bottom in late 2015. In real terms, aggregate GDP growth for our selection of 26 countries held at 4.1% in H1 2016. Growth was bolstered by a mild acceleration in the BRIC countries (which alone account for 36% of the total), to 5.1% in Q2 2016, from 4.5% in Q4 2015. Nonetheless, this stabilisation is fragile. First, the BRIC rebound is largely due to a milder recession in Russia and Brazil. Chinese growth barely levelled off at 6.7%, while India's growth profile is still too jagged to talk yet of a turnaround. Second, many commodity exporting countries are still slowing (Andean countries; the Gulf countries) or have entered or are verging on recession (Saudi Arabia, Argentina, Nigeria and Angola). Lastly, growth is still solid in central Europe, but it has slowed since the strong acceleration of H2 2015, which was driven by the use of European structural funds.

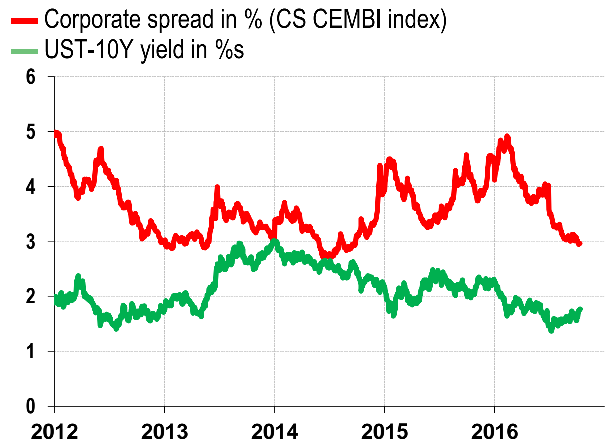
And yet the short-term horizon is getting brighter. Confidence indicators in the manufacturing sector as a whole are looking more upbeat. Industrial deflation in China is easing. Credit has even accelerated slightly in central Europe. With the return of non-resident portfolio investment and the consolidation of commodity prices, external financing conditions have become as favourable as they were before the US Fed's announcement of tapering in spring 2013 (see chart), while central banks' foreign reserves are not under as much pressure.

… but growth forecasts remain in the dark

Growth forecasts by the international institutions have yet to take into account these easing headwinds. In its interim report released in late September, the OECD even revised downwards its 2017 growth outlook for the non-OECD world excluding Brazil, China and India by 0.2 percentage points (pp). The IMF left its outlook unchanged, although it raised its growth forecast for India by 0.2 pp. The OECD and IMF took a more in-depth look at two major constraints hindering the acceleration of growth in the emerging countries (in addition to the automatic impact of the stabilisation of the situations in Brazil and Russia): external trade weakness and corporate deleveraging.

The institutions recently published two in-depth studies on the world trade slowdown since the 2008-2009 financial crisis. World trade growth in goods and services has basically been slashed in half, from 8.5% in the period 2003-2007 to 4% in 2011-2015.

External financing costs have become favourable again



Sources: Macrobond - Bloomberg

The slowdown even worsened in emerging countries in 2014-2015. The two institutions attempted to evaluate the contribution of cyclical and structural factors. Cyclical factors are still predominant (import demand for end goods, total or weighted by the component of demand in the IMF study; output gap, investment cycle and Chinese growth in the OECD study). But structural factors have also played a key role, notably the levelling off and decline in trade over the past two years linked to global value chains. This structural factor is clearly playing a primordial role in emerging Asia, based on the persistent sluggishness of the region's exports (-2.4% in January-July 2016 compared to January-July 2015).

The IMF also highlights corporate deleveraging since 2015, based on gearing ratios (debt/capital) calculated for a selection of companies. Yet deleveraging will be a gradual process, even in a scenario of accelerating growth and today's low refinancing costs, and some countries, like China and India, will continue to see a high share of debt-at-risk (i.e. the debt for which the coverage of interests by the EBITDA is less than 1). Corporate deleveraging might well be the second structural factor behind a milder recovery.

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Brazil

A crucial turning point ahead

Despite uncertainty over the new government's reform programme, the markets and investors reacted positively to the political changes of the past few months. The same cannot be said for the local population, who fears a shift towards liberalism and the hardships of reforms, after weathering the turmoil of the political and economic crisis over the past two years. Squeezed by a sluggish labour market, a decline in purchasing power eroded by inflation and a heavy debt burden, household consumption is unlikely to make a positive contribution to the economic recovery for several more months. Even so, the economy could benefit from a gradual rebound in private investment.

Eyes on reforms

After president Dilma Rousseff (PT) was officially ousted on 31 August, vice-president Michel Temer (PMDB), the interim president since 12 May, was sworn in with full powers as Brazil's new president. The collapse of the Workers' Party (PT), discredited by the Petrobras corruption scandal, was confirmed following the municipal elections of 2 October (runoffs will be held in certain cities on 30 October). The PT was relegated to 10th place among the political parties after losing 59% of the municipalities it has held since 2012. Although the people rejected the political class as a whole, the Brazilian Democratic Movement (PMDB) and Brazilian Social Democracy Party (PSDB) were the big winners of these local elections, which have taken on a national character in the current environment. Allies within the new government, the two parties seem to be heading for a confrontation in the 2018 general election.

With its legitimacy bolstered by the municipal elections, the Temer government now seems to be in a good position to launch its full reform programme – which is highly unpopular with the local population – at a time when public finances remain under pressure. The primary deficit continued to widen, to 2.8% of GDP in the 12 months to August, while the overall deficit has levelled off at 9.6% of GDP, thanks to profits generated by the central bank's currency swap operations against a backdrop of the real's appreciation. Gross public debt rose above 70% of GDP in August.

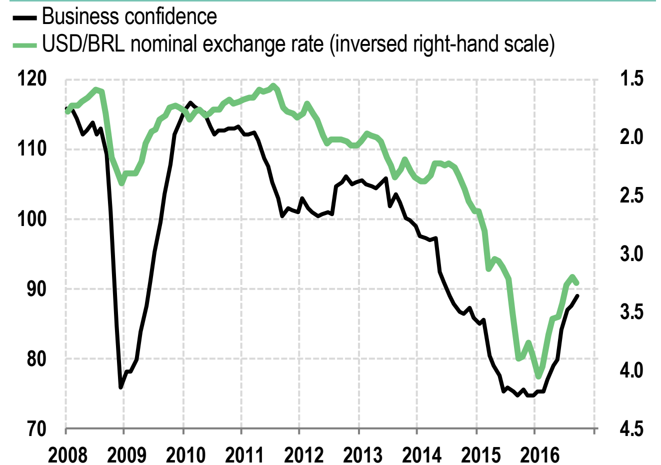
No major tax reform has been announced. The parliament is debating a proposal to place a ceiling on public spending increases (+6% a year in real terms since 2009) indexed to the previous year's inflation rate. The pension system, which has run up a deficit of 2% of GDP, has been weakened by an aging population (the over-60 age group is growing 4% a year), the low retirement age (less than 55 on average) and pension indexation. Pension reform could be adopted by mid-2017. A concession and privatisation programme has also been launched in the energy sector (hydrocarbons, electrical power) and in infrastructure (transport, water). The restructuring of Petrobras has been launched around four key points: major asset disposals (USD 14.4 bn in 2016, a very ambitious target), vital debt reduction (gross debt of USD 124 bn and a net debt/EBITDA ratio of 4.5 at mid-2016), a 50% decline in investment spending over 5 years to USD 100 bn, and regulatory changes in the hydrocarbon market (broader opening to private investors, elimination of the requirement for Petrobras to hold a 30% stake in joint ventures, end of its natural gas transport monopoly, etc.).

1- Forecasts

	2014	2015	2016f	2017f
Real GDP growth (%)	0.1	-3.8	-3.0	2.0
Inflation (CPI, year average, %)	6.3	9.0	8.8	5.0
Fiscal balance / GDP (%)	-6.2	-10.3	-10.1	-9.4
Gross public debt / GDP (%)	58.9	66.2	73.3	78.3
Current account balance / GDP (%)	-4.4	-3.3	-1.0	-1.5
External debt / GDP (%)	23.2	30.4	34.7	34.2
Forex reserves (USD bn)	355	349	350	355
Forex reserves, in months of imports	15.6	15.2	14.8	14.6
Exchange rate USD/BRL (year end)	2.5	3.9	3.2	3.0

f: BNP Paribas Group Economic Research estimates and forecasts

2- Business confidence and the exchange rate



Sources: Central bank, Fundação Getulio Vargas

A few positive economic and financial signals

Mired in a recessionary spiral for the past two years, the Brazilian economy reported its sixth consecutive quarterly decline, with Q2 2016 GDP down a seasonally-adjusted 0.6% q/q. Despite the upturn in household confidence since May, private consumption contracted again in Q2 (-0.7% q/q) and retail sales remained sluggish in July. Several factors are to blame: 1) a depressed labour market (see below), 2) a decline in purchasing power (squeezed by real wages eroded by high inflation – 8.6% in September) and 3) sluggish credit growth, undermined by high interest rates (Selic at 14.25%, and astronomical bank intermediation margins) and deleveraging by households, strapped with high debt servicing (21% of GDP).

Foreign trade made a negative contribution to Q2 GDP growth due to a big increase in imports of intermediate and capital goods.

Import growth reflects the uptick in investment (+0.4% q/q in Q2, ending a 10-quarter decline) and the rebound in monthly industrial output since March. Although these positive economic signals are still fragile (industrial output contracted in August), they nonetheless reflect the upturn in business confidence since March. The markets are clearly giving the green light again, bolstered by the very accommodating monetary policies maintained in the advanced economies. Since early 2016, the Brazilian real has appreciated 22% against the dollar and the IBOVESPA stock market index has gained 37%. The yield on 4-year Treasury notes (10.5%) and the premium on 5-year sovereign CDS (270 bp) contracted by 520 bp and 220bp, respectively. Brazil continued to attract foreign direct investment (USD 41 bn in the first 8 months of 2016), notably in a few key sectors, including light and heavy vehicles, hydrocarbon extraction, real estate and retailing. Net equity portfolio investment flows have amounted to USD 4.2 bn since the beginning of the year. The government easily refinanced its MLT global bonds (260% refinancing ratio), unlike the private sector (36% of refinancing), which increased its external debt in the short term. There is nothing really alarming about Brazil's external position considering that the current account deficit has still narrowed in recent months and the country still boasts very substantial foreign reserves.

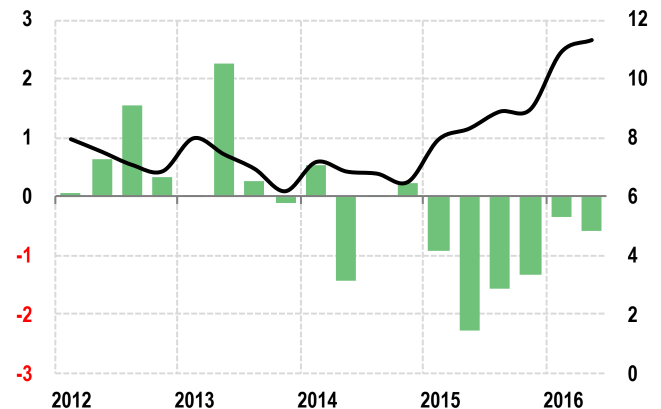
With the announcement of fiscal reforms, financial stabilisation, the dissipation of food price shocks and better anchorage of inflation expectations, the central bank could decide to launch a round of monetary easing in the very near future. Its (partial) transmission via the traditional bank lending channel would help loosen the stranglehold on companies and households and stimulate domestic demand.

A sluggish labour market hampers the recovery

Household consumption accounts for 66% of real GDP and contributed 60% of real GDP growth between 2004 and 2014. This growth engine has stalled over the past six quarters (-9% since year-end 2014), notably due to the sharp deterioration in labour market conditions.

With GDP growth averaging 3.7% a year between 2004 and 2014, the Brazilian economy managed to create 14.1 million net formal jobs (1.3 million a year), of which 70% were in retailing and services and only 16% in the manufacturing sector. The participation rate did not increase significantly over the period (61% at year-end 2014 according to the new IBGE methodology introduced in March 2016), and new entrants were easily absorbed in the labour market. The official unemployment rate declined by nearly seven points to 4.3% (6.5% according to the new methodology). The 2008-09 global crisis had only a mild impact on the Brazilian labour market in terms of its duration and intensity, with a slowdown in job creations and a short-lived rise in the unemployment rate. The external shock created by the global crisis did not halt the improvement in labour productivity observed since 2004, although it coincided with the moment working hours began trending downwards (-5% since 2008).

3- Economic growth and unemployment rate



Source: IBGE

The severe recession over the past two years ended up destroying 2.8 million net formal jobs (7% of total employment), including nearly 1 million jobs in the manufacturing sector (11% of sector employment), 800,000 construction jobs (-25%) and 600,000 service sector jobs (-4%). Although the general downturn in the labour market can be traced back to Q4 2014, the manufacturing sector began destroying jobs as early as mid-2013, while the services sector was more resilient until the end of Q1 2015. Initially, the very rapid upturn in the unemployment rate (to 11.8% non-adjusted for seasonal variations in August 2016) reflected the slowdown in gross hiring, which bottomed out in Q2 and Q3 2015. By H2 2015, this trend was overtaken by the acceleration in layoffs, while gross hiring began picking up again. Another negative impact of the crisis was that it halted the downward trend in the informal sector (to 38% in mid-2016): the switch from the formal to informal sector can serve as a potential transitory stage before workers left the labour market, and labour productivity declined 5% between 2013 and 2015.

According to the latest figures, the labour market continues to deteriorate. For the thirteenth consecutive month, formal employment declined by another 0.3% between July and August, bringing the annual contraction to 2.2%. Given the usual lag between an economic recovery and its repercussions on employment, the labour market is unlikely to show tangible signs of improvement before mid-2017. We are maintaining our scenario of a gradual rebound in private investment in the quarters ahead, while household consumption will remain in a slump for a few more quarters. We expect real GDP to level off in Q3 2016 before picking up very gradually as of Q4.

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Russia

A painful recovery

The Russian economy is getting a bit better. In the second quarter, GDP growth contracted by only 0.6% and manufacturing activity accelerated slightly. In addition, the business sector started to rebuild inventories and survey results have been positive. However, the recovery is fragile. Household consumption remains depressed by falling real wages and the government does not have sufficient fiscal rooms for manoeuvre to support the economy. The consolidation of public finances has become its priority. To achieve this, it is ready to freeze spending for the next three years. It hopes to reduce the budget deficit by 1 point of GDP per year, bringing it to no more than 1.2% of GDP in 2019.

A painful recovery

The Russian economy is slowly and painfully coming out of recession.

In the second quarter, growth contracted by only 0.6%, compared to the 4.5% contraction in the same period last year. The economy continues to be supported by a strong agricultural sector, which posted growth of 2% y/y in Q2 2016. Conversely, in construction, considered as the most fragile sector, activity continued to contract, falling 9.5% y/y. Signs of an economic recovery have, since June, been most visible in manufacturing. In Q2 2016, activity recovered by 0.3% y/y, after five consecutive quarters of contraction. This recovery nevertheless remains fragile, as shown by the fall in industrial production in July, which was followed by a fresh recovery in August.

In addition, companies have started to rebuild inventories and their prospects have improved, as shown by marked rallies in business confidence indices. On the other hand, consumer spending remains in the doldrums. In Q2 2016, it contracted for the sixth quarter in a row (down 5.2% y/y) and retail sales trends suggest little prospect of an improvement in the third quarter. Moreover, real wages contracted again in July and August, having recovered over the spring. The central bank estimates wage arrears at RUB 3,531 billion, the equivalent of 1% of total wages.

In order to encourage this painful recovery, in September the central cut its main policy rate for the second time this year to 10%. Nevertheless, despite the sharp fall in inflation (6.5% y/y in September, from 15.7% a year ago), it has already announced that it will not be making any further rate cuts this year.

The central bank and the Finance Minister have downgraded their growth forecasts, on the hypothesis that oil prices will average USD 40 over the next three years. Growth is now expected to be between 0.5% and 1% in 2017 and between 1.5% and 2.2% in 2019.

This said, despite these very modest growth prospects, the government is not planning to support the economy by boosting public spending. Its priority now is to consolidate the public finances.

A widening deficit

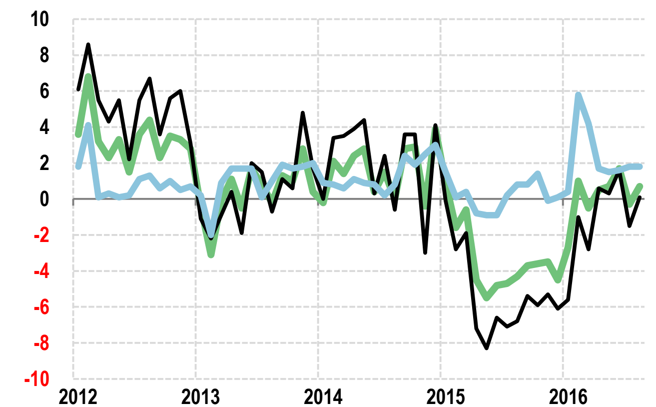
Over the first eight months of 2016 the government's budget deficit hit RUB 1,518 billion, equal to 3% of GDP, putting it 67% higher than in the previous financial year. This increase was due to falling receipts (-9%), particularly those from oil (-25%), and came despite the exceptional income generated from the sale of Alrosa shares (estimated at USD 800 million).

1- Forecasts

	2014	2015	2016f	2017f
Real GDP growth (%)	0.7	-3.7	0.0	2.2
Inflation (CPI, year average, %)	7.8	15.6	7.1	5.4
Federal Gov. balance / GDP (%)	-0.2	-2.4	-3.4	-2.2
Public debt / GDP (%)	13.2	13.6	13.5	13.7
Current account balance / GDP (%)	2.9	5.2	2.8	3.5
External debt / GDP (%)	29.5	38.9	39.2	37.0
International reserves (USD bn)	385	368	402	431
International reserves, in months of impo	7.5	10.8	11.0	10.3
Exchange rate RUB/USD (year end)	60.7	72.5	66.0	69.4

f: BNP Paribas Group Economic Research estimates and forecasts

2- Industrial production
Economic activity indicators (y/y, %)



Source: RosStat

At the same time, cuts in government spending, have been extremely modest, at just 2%. Higher pension costs and debt servicing costs (up 13% and 21% respectively) offset the sharp cut in military spending (down 27%). In order to control the budget deficit, the government sold its holdings in Bashneft (EUR 4.7 billion) and should sale its stakes in Rosneft between now and the end of the year, or at the latest early next year if market conditions are not favourable beforehand. In this context, the government revised upward its initial target for the 2016 fiscal deficit to 3.7% of GDP from 3% of GDP.

Over the first eight months of the current year, the deficit has mainly been funded from the reserve fund, which had been reduced to just

USD 32 billion by the end of August, USD 38 billion lower than a year before. In order to stem the bleeding from this fund, the government made two debt issues, one in May the other in September, for a total of USD 3 billion. Given that its bonds trade freely on the secondary market, the government could make greater use of this means of financing its deficit.

The 2017 budget was officially presented on 13 October and will be submitted to the Duma on 28 October, alongside the revised 2016 budget. The headline items have already been announced.

The government has decided to introduce a program of fiscal consolidation over the next three years[1] (2017 to 2019). Returning to this approach (which had been abandoned in the previous two budgets) will encourage greater transparency, as the financing of the deficit remains the main problem.

The Finance Minister's aim is to decrease the fiscal deficit from 3.2% of GDP in 2017 to 1.2% in 2019, requiring a one-point reduction each year.

Two thirds of this consolidation will come from a freeze on spending (in nominal terms) at RUB 15.8 trillion over the period 2016 to 2019. As a percentage of GDP, this means that public spending will fall from 19% of GDP this year to just 15.7% in 2019. As the details have not yet been announced, it is hard to assess the feasibility of such a programme. The government has still not announced whether or not it will freeze public sector pay for the third year running. However, it is likely to allow an increase in pensions of between 5% and 6%. In order to offset this increase, it will probably have to make further cuts to education and health spending, which will have the effect of reducing potential growth.

Meanwhile, over the period from 2017 to 2019, the government is expecting only a modest increase in receipts, driven by a return to growth and an increase in dividends and the proceeds of privatisation. This said, and given that its hypothesis of USD 40/barrel is particularly conservative, it is possible that receipts will be higher than predicted.

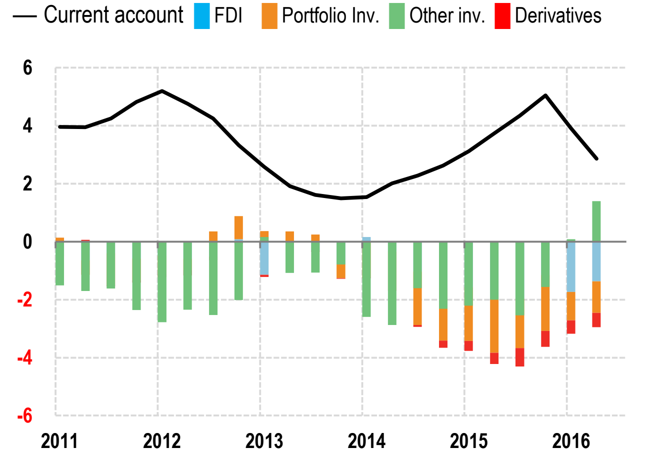
Over the longer term, from 2020, the Finance Ministry expects to introduce a new fiscal rule ensuring that the primary budget will be balanced.

Consolidation of the balance of payments

In the first half of 2016, the current account surplus shrank by more than 70% relative to last year to 2.3% of GDP from 9% a year ago. This sharp fall was due to a collapse in exports caused by tumbling commodity prices in the first quarter of 2016. Even though oil and gas prices have since recovered, they remain low, and Russia's current account surplus is unlikely to exceed 3% to 3.5% of GDP over the next two years according to the IMF.

Nevertheless, despite the fall in the current account surplus, Russia's balance of payments has consolidated. Over the first eight months of the year, outflows of private capital fell significantly and reached only USD 9.9 billion, a fifth of their level a year ago. Meanwhile, direct foreign investment gathered pace in the second quarter. As a result the deficit on the financial account was only USD 6 billion in the first half, from more than USD 55 billion a year earlier. Foreign exchange reserves increased by 4% y/y to USD 320 billion by end-August.

3- Balance of Payments (4 quarters moving sum % of GDP)



Source : CBR

The consolidation of the balance of payments is likely to continue, to the extent that repayments of external debt will fall still further. Over 2017 as a whole, the central bank estimates repayments of USD 70 billion, from more than USD 91 billion this year.

Substantial victory in parliamentary elections

In September's elections the ruling United Russia party won 343 of the 450 seats, on 54.2% of the votes. By way of comparison, United Russia received 'only' 49.3% of the votes in 2011.

A victory on this scale gives President Putin full scope to conduct his economic and diplomatic policy as he wishes. However, it is likely that he will wait until after the 2018 presidential before introducing certain particularly unpopular reforms, such as measures on pensions.

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[1]The budget has been drawn up assuming oil at USD 40/barrel and a RUB/USD exchange rate of 69.1 on average over the next three years. Moreover, the government assumes that international sanctions will be held until 2019.

India

A major advance

Two years after taking power, the Narendra Modi government managed to pass a unified VAT bill. Even though it will take a few years to feel the positive effects of this reform, the bill is a major advance. The government estimates the gains in terms of potential growth at between 0.9 and 1.7 points. Even though the country still faces enormous structural weaknesses, the business climate is improving. According to the latest competitiveness report, India gained 16 ranks last year and is now ahead of Indonesia. The rating agencies have turned a blind eye to these changes so far. A high public debt continues to block any improvement in India's sovereign rating.

Economic slowdown

In the first quarter of the current fiscal year, GDP growth in India slowed slightly to 7.1%, from 7.5% in the year-earlier period. However, India's GDP growth remains one of the strongest in Asia. Household consumption remains robust (+6.7% y/y) and exports swung back into positive territory after a 5-quarter decline. Net exports made a positive contribution for the first time in two years. Inversely, investment continued to contract for the second consecutive quarter (-3.1% y/y), reflecting the financial troubles of banks and companies.

India's economic growth prospects continue to look upbeat. Dynamic private consumption will continue to support economic activity, thanks to a big increase in public sector wages (effective 1 August). The recovery of both public and private investment is more problematic. The government has much less fiscal manoeuvring room than it did last year, and it is likely to remain in a tight spot throughout the transition period following the introduction of the new VAT system. Meanwhile, companies are still pursuing debt reduction strategies.

Budget overruns

In the first quarter of the current fiscal year, the government deficit hit 61% of the full-year target, which is much higher than in the past (the average for the past five years was 46%). Consequently, the deficit could reach the equivalent of an annualised 4.8% of GDP, surpassing the finance minister's deficit target of 3.5% of GDP. This overrun can be explained in part by the increase in expenditures (notably the 53% increase in subsidy outlays), but above all by the shortfall in revenues compared to the authorities' targets. Although revenues increased by more than 18% compared to the year-earlier period, they amounted to only 19% of the full-year target in the first four months of fiscal 2016/17.

These budget overruns are not particularly alarming since the government usually corrects any shortfalls in the year-end period. The decline in investment spending, in contrast, which fell more than 22% y/y in the first four months of the fiscal year, is much more unsettling. Once again, this type of spending will very likely serve as the budget's adjustment variable, especially since increased spending due to higher public sector wages will not be reported until fiscal Q2 (with seven months of back payments).

This means the government will not be able to increase public investment in order to offset the decline in private investment, unless privatisation proceeds prove to be much higher than expected. The government is not ready to ease up yet on its fiscal consolidation policy, even in the name of infrastructure development.

1- Forecasts

	2014	2015	2016f	2017f
Real GDP growth[1] (%)	6.6	7.2	7.6	8.2
Real GDP growth[2] (%)	7.0	7.2	7.9	8.3
Inflation [2] (CPI, year average, %)	6.6	4.9	5.4	5.0
Central Gov. Balance[1] / GDP (%)	-4.5	-4.1	-3.9	-3.5
Central Gov. Debt[1]/ GDP (%)	47.1	46.4	47.6	46.1
Current account balance[1] / GDP (%)	-1.7	-1.3	-1.1	-1.3
External debt[1]/ GDP (%)	23.6	23.0	23.2	21.3
Forex reserves[1] (USD bn)	283	322	336	332
Forex reserves[1], in months of imports	5.9	6.7	7.8	7.5
Exchange rate INR/USD (year end)	63.0	66.2	68.2	70.0

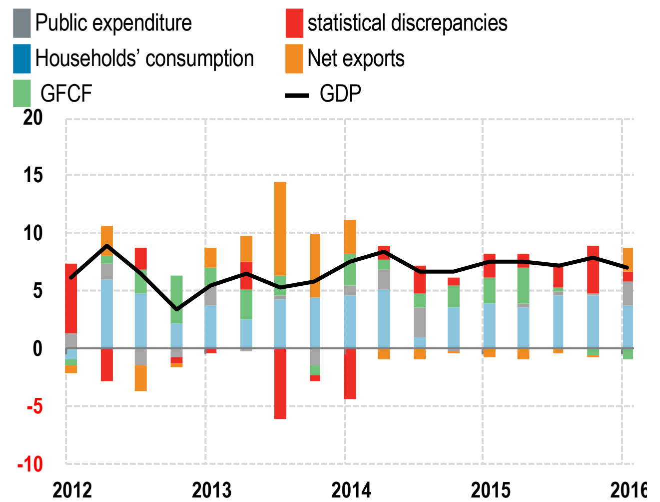
(1): fiscal year from 1 April of year n-1 to 31 March of year n

(2): Calendar year

f: BNP Paribas Group Economic Research estimates and forecasts

2- Economic growth decelerated

GDP growth (yoy) and components (percentage points)



Sources : CEIC

Indeed, India's high public debt is still one of the factors preventing the rating agencies from upgrading its sovereign rating.

The new unified VAT bill: a major turning point

Last August, Narendra Modi's government managed to get the upper chamber of parliament to approve a bill introducing a unified goods and services value-added tax (GST). Sixteen of the 31 States and Union Territories ratified GST. By 1 April 2017, the law aims to replace the seventeen indirect taxes levied by the government and

states with a single unified tax (collected in part by the government and the states).

Even though the government is unlikely to meet its self-imposed timetable, passing the law is already a significant step forward for the country, because all states will apply the same unified VAT rate.

So far, it is hard to quantify the impact of this reform, because it has not been finalised yet. An ad-hoc council comprised of the central and state governments will meet to determine the VAT rate and tax base. Each proposal must be validated by at least 75% of the Council's members (the central government has 33% of the vote, and the states and union territories the remaining 67%). Once finalised, the upper house of parliament must approve the bill again (apparently during the next parliamentary session in December), after which each state must ratify the bill by 31 March 2017. For the government, the most difficult task will be to hammer out a financial agreement with each state to offset any financial losses engendered by the change in the tax rate and base. It was on this condition that the government managed to win over their approval for GST.

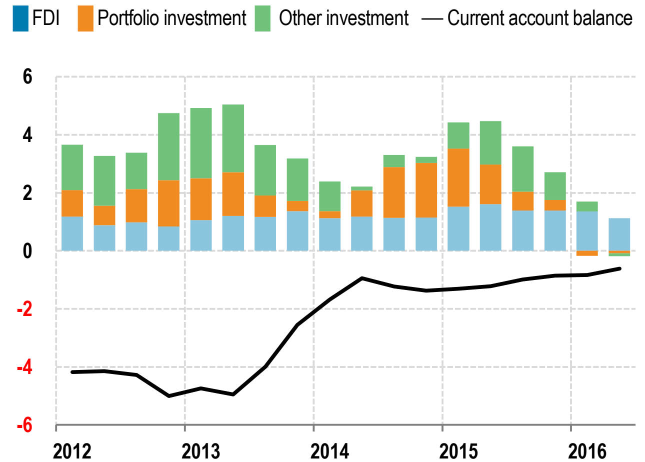
Although the draft bill has not been completely finalised, the broad outlines were drawn up last June. The VAT rate is likely to be around 18%, considering that the average tax rate is currently about 15% on services and about 25% on goods (all taxes combined). The government would also like to reduce the number of exemptions to 90 (from more than 300 today). By reforming the fiscal system, the government's medium-term goal is to boost revenues, but above all to stimulate growth by improving corporate competitiveness.

India is one of the countries with the lowest tax base. During the fiscal year 2015/16, government and state revenues collected through indirect taxes amounted to only 5.2% and 5.8% of GDP, respectively.

In the short term, VAT reform is likely to have a negative overall effect. Adopting a unified tax for all states will create extra costs for the central government due to the financial compensation it will have to pay to the states (during the first 5 years). GST is also expected to generate inflation of between 20bp and 50bp. In the longer term, the measure should be very profitable for the country as a whole. The government estimates the gain in potential growth at between 0.9 and 1.7 points of GDP.

A unified VAT system will eliminate tax differences between states, which should give trade within the country a considerable boost. The various taxes levied today place a real damper on trade. The World Bank estimates that logistical costs could be reduced by 30% to 40% and transport times could be shortened by 20% to 30%. This measure should generate major competitiveness and productivity gains. Prices of capital goods are expected to decline by an estimated 12% to 14%, which would automatically boost investment.

3- Balance of Payments (4-quarter moving average, % of GDP)



Source : CEIC

Lastly, in the medium term, higher government revenues (generated by stronger growth and a more efficient tax collection system) would increase the government's fiscal leeway and enable it to make the infrastructure investments necessary for the country's development.

External vulnerability has declined

In the first six months of the year, the current account deficit declined by 90% compared to the same period last year, to only 0.1% of GDP. Even though the deficit is expected to rise again in the second half, the country's external vulnerability is nothing like what it was three years ago. For the full-year, the current account deficit should near 1% of GDP, down from nearly 5% in 2013.

The structure of the balance of payments has also strengthened. Although FDI slowed in Q2, it is still much higher than portfolio investment. In 2016, FDI is expected to fully fund the current account deficit.

Consequently, even though USD 25 bn in non-resident deposits will reach maturity in Q3 2016, and even if all of it were to be repatriated abroad, the country's balance of payments equilibrium would not be threatened.

Foreign reserves covered 1.6 times the country's short-term financing needs in Q2. This is still higher than the "adequate" level suggested by IMF. The monetary authorities thus have sufficient resources on hand to stabilise the currency in case the US were to raise its key rates.

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China

Credit risks still rising

The slowdown in China's economic growth has paused since the second quarter of 2016 thanks to stimulus policy measures. The stabilisation in industrial production growth, the upturn in the real estate market and monetary loosening could help reduce pressures on corporates and local governments by easing their liquidity constraints in the very short term. However, their solvency is not improving, their debt levels have become even more excessive over the last year and their capacity to service their debt remains weak. In this context, credit risks in the financial sector continue to increase and the performance of commercial banks deteriorates gradually.

Corporates breathing a little easier

Signs of economic growth stabilisation that appeared in March 2016 have continued during the summer. After bottoming out in January and February, industrial production growth has remained above 6% in year-on-year terms (see chart). Although this remains very low, the improvement has been accompanied by a slight upturn in the average performance of manufacturing corporates. Their aggregate profits have started rising again (+8.4% y/y in the first eight months of 2016) after falling throughout 2015 (-2.3%). Demand for industrial goods has been boosted by monetary and fiscal stimulus measures (which have especially helped infrastructure projects, the real estate market and the auto sectors). Commodity prices have rebounded since the start of the year, and producer price deflation has become gradually less severe (-0.8% y/y in August vs. -5.9% in December 2015) and eventually turned slightly positive in September.

However, the situation in the industry remains very fragile, and there are wide variations between different sectors and different types of corporates. In particular, state-owned industrial enterprises are much less profitable than their private-sector peers, and their profits continued to fall in the first eight months of 2016 (-2.1% year-on-year vs. -21.9% in 2015) because of their lower productivity, higher indebtedness and greater exposure to sectors suffering from large production excess capacities. These difficulties, along with the durable weakening in China's export prospects, have continued to constrain growth in manufacturing investment (to 3.1% y/y in nominal terms in the first nine months of 2016, after reaching an all-time low of 2.8% in Jan.-August 2016).

In the real estate sector, similarly, the situation has improved but remains fragile. After the authorities loosened monetary policy and macroprudential rules on real estate transactions and lending, growth in sales volumes has accelerated (+25.5% y/y in the first eight months of 2016 vs. 6.5% in 2015) and house prices have rebounded in a growing number of cities. The average increase in house prices in China's 70 largest cities was 7.3% y/y in August 2016 vs. 0.2% in December 2015. Of those 70 cities, only six showed a year-on-year decline in August 2016, vs. 48 in December 2015. In fact, major regional variations weigh on the sector's prospects. Signs of a property bubble have already emerged in several large cities, prompting the authorities to tighten macroprudential rules, while smaller cities are seeing very moderate price growth and some even still have a stockpile of unsold homes. In the short term, however, the upturn in activity and prices in the property market should give corporates operating in the sector some breathing space, and support real estate investment (+6% y/y in the first eight months of 2016 vs. +2.4% in 2015).

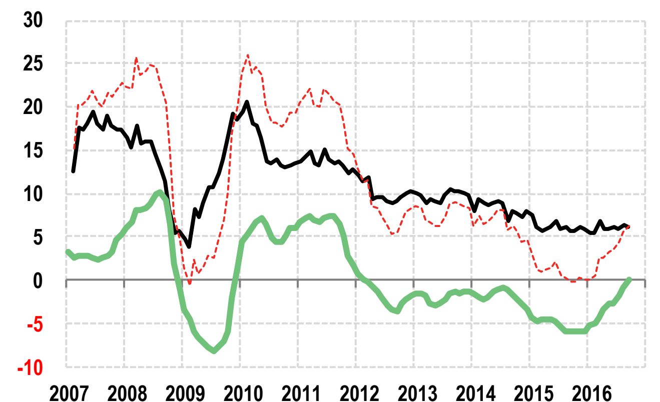
1- Forecasts

	2014	2015	2016e	2017e
Real GDP growth (%)	7.3	6.9	6.6	6.3
Inflation (CPI, year average, %)	2.0	1.4	2.0	2.2
Official budget balance / GDP (%)	-2.1	-2.4	-3.0	-3.2
Central Gov. debt / GDP (%)	14.8	15.3	17.0	18.9
Current account balance / GDP (%)	2.6	3.1	2.6	1.9
External debt / GDP (%)	9.1	5.4	4.6	3.9
Forex reserves (USD bn)	3 843	3 330	3 069	2 812
Forex reserves, in months of imports	20.4	19.5	19.0	16.5
Exchange rate CNY/USD (year end)	6.21	6.49	6.82	7.07

e: BNP Paribas Group Economic Research estimates and forecasts

2- Stabilisation in the industry

Year-on-year % change



Sources: NBS, BNP Paribas

The market rebound has also benefited local government finances, as their proceeds from land sales increased by 14% y/y in the first eight months of 2016 after collapsing in 2015. The upturn in tax revenue from the real estate sector has also partly offset the weaker performance in other sources of tax receipts. In addition, local governments also continued their debt swap programs in H1 2016, increasing bond issues in the local market in order to refinance bank loans at lower interest rates and longer maturities.

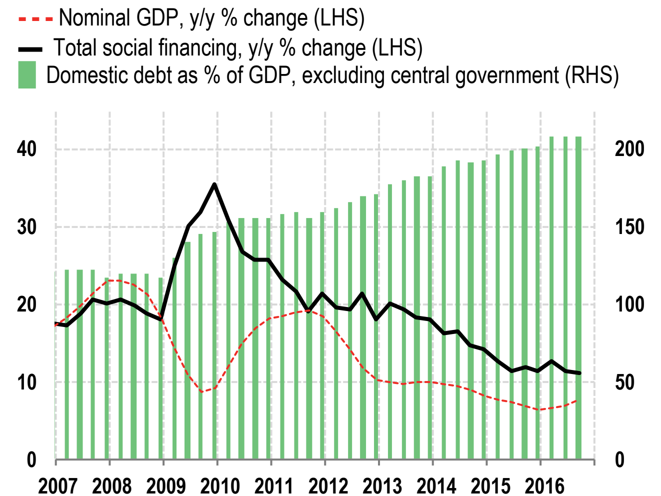
However, credit risks continue to increase

The recent stabilisation in economic growth and the upturn in the real estate market, along with monetary loosening (with the weighted average interest rate on loans falling from 5.9% in 2015 to 5.3% in H1 2016), should give corporates and local governments some respite by reducing their liquidity constraints in the very short term. However, their solvency is not improving. Their debt levels have become even more excessive, with domestic credit growth accelerating again since mid-2015. This rebound has remained moderate, and credit growth even slowed in Q2 2016, showing that the monetary authorities and creditors are more cautious given the excess debt of borrowers and loan quality deterioration. However, credit outstanding still grows much faster than nominal GDP (see chart). This means that the domestic debt-to-GDP ratio has continued to rise; it was estimated at 210% at the end of Q3 2016 vs. 202% at end-2015. The debt ratio includes the private sector, local governments and their financing vehicles, but excludes the central government. Within that total ratio, household debt accounts for only 40% of GDP.

In addition, the local government and corporate sectors still have deep-seated structural weaknesses (production excess capacity, distortions in the real estate market, inefficient SOEs, governance problems, for instance) while certain reforms that are vital to shift the economy to a more balanced and less credit-dependent growth model (such as the strengthening of governance or the effective implementation of fiscal reforms) have been delayed this year as the authorities have given priority to stimulus policy measures.

With debt levels worsening and profitability still hampered by structural weaknesses, corporates' capacity to service their debt remains weak (even though their cash positions could improve in the very short term). It has weakened sharply since 2010. On the basis of calculations made by the IMF on a sample of listed companies, the median debt/EBITDA (earnings before interest, taxes, depreciation and amortization) ratio more than doubled between 2010 and 2015. The real estate, mining and steel sectors are the most fragile, showing both the highest median debt/EBITDA ratios and the highest proportions of debt owed by loss-making companies. The IMF estimates that "debt at risk" (i.e. debt held by companies that lack sufficient revenues to cover debt interest payments, i.e. with an EBITDA/interest expense ratio of less than 1) accounted for 14% of total debt (for a sample of firms) in 2015, compared to 4% in 2010. Against this background, corporates have had growing difficulties to pay their suppliers, payables days have increased (transmitting stress across the economy), non-performing loans have grown in bank balance sheets and default risks have spread to non-bank financial institutions and to the bond markets. Equity markets are obviously also affected by the deterioration in listed companies' average solvency and the rise in credit risk (for example through the rise in share-collateralized lending).

3- Continued rise in debt ratios



Sources: PBOC, BNP Paribas

The banking sector's performance is deteriorating

The official Non-Performing Loan (NPL) ratio for commercial banks was 1.75% in June 2016. It is still very low, but it has risen steadily since June 2012, and the total stock of NPLs has more than tripled since that date (increasing by 51% in 2015 and 32% in H1 2016). In addition, the official NPL ratio only partly reflects the true state of banks' asset quality. For example, the ratio rises to 5.5% if "special-mention loans" are included. Moreover, banks have taken a whole series of measures to stop it worsening further (refinancing, write-offs, transfers to asset management companies and, recently, NPL securitization). Finally, official NPL figures do not take into account the credit activities of "shadow banking" institutions, which equal at least a fifth of commercial banks' "formal" loans and post a lower quality on average.

The deterioration in asset quality and the rise in credit costs in the banking sector will continue. Banks' profitability is under pressure and their liquidity and solvency ratios are worsening gradually. However, these ratios remain solid. Although the risk of systemic problems spreading across the entire financial sector is higher today than it was five years ago, it is sharply mitigated by two key factors that still currently persist: firstly, the banking system still has a very comfortable liquidity position (large customer and deposit base, low loan/deposit ratios, little reliance on external financing), and secondly, the central government still provides very strong support to the main state-owned commercial banks (which account for around 60% of total bank assets).

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Taiwan

New reality

The DPP's victory in the presidential and general elections last January rode on a wave of dissatisfaction with the poor economic performances of recent years, even though growth is expected to rebound in the short term thanks to the recovery in the global electronics cycle and the stabilisation of Chinese growth. The election results also reflect the people's resistance to an overly close alignment with China. Yet tensions with its neighbouring giant could make it harder for the government to negotiate trade agreements with new partners, and even risks slowing the development of very high value-added sectors, at a time when Taiwan must deal with its decelerating growth potential and reduce its dependence on Chinese demand.

High stakes for the new government

For the first time in its history, the Democratic Progressive Party (DPP) won both the presidency and parliamentary control during the general elections of January 2016. The DPP's clear-cut victory and the major setback for the Kuomintang (KMT), the party in power from 2008 to 2016, reflects the Taiwanese population's resistance to an overly close alignment with China (a pillar of the previous government's platform) as well as far-reaching divisions within the KMT. The election also rode on a wave of dissatisfaction with the poor economic performances and rising social inequality of recent years.

The new president, Tsai Ing-wen, was inaugurated in May 2016. With an absolute majority in Parliament (68 out of 113 seats), the new government should benefit from comfortable manoeuvring room to pursue its economic policies and introduce structural reforms, at least during an initial honeymoon period. The stakes – and the people's expectations – are very high, not only concerning economic and political issues, but also on societal questions like nuclear power and justice. In the short term, a top priority is to reform the pension system, the viability of which is threatened by a rapidly ageing population. The authorities also plan to define a "new development model" for Taiwan to diversify its economic ties with trading partners other than China, and above all, to foster a sustainable increase in its long-term growth potential (see next section).

Managing relations with China is another major challenge for the new government. Tensions have been on the rise since the DPP's victory, a party advocating greater independence, and Tsai's election. After her denial of the "1992 consensus", which recognises the "one China principle", Beijing has suspended all official communications with the island since June 2016. The president will have to maintain a cautious attitude towards Beijing, if for no other reason than to minimise the trade and economic consequences of cross-strait tensions. But she must not deviate either from her position on Taiwan being a separate identity, which is currently supported by the majority of the local population. Relations between Beijing and Taipei are bound to be ambiguous in the years ahead, which risks fuelling periods of stress and China's aggravation of economic pressures.

A slight growth rebound in the short term

Economic growth slowed sharply in 2015, dropping from 4% y/y in Q1 to -0.9% in Q4. It has recovered since early 2016, but only mildly, with Q2 growth of only 0.7% y/y (see chart). In a lacklustre regional and international environment, Taiwanese exports contracted in volume and value terms from Q1 2015 through spring 2016. As a result, investment has stalled (+1.2% in real terms in 2015 and -0.2% y/y in H1 2016) and corporates have slashed inventories. Private consumption growth has gradually slowed (from 2.3% in 2015 to 1.9% in H1 2016) in response to the deterioration of labour market conditions (the unemployment rate picked up slightly to 4.1% in August) and the continued erosion of household confidence over the past eighteen months. The period of uncertainty prior to the general elections has indeed given way to growing fears about the island's economic prospects and renewed tensions with China.

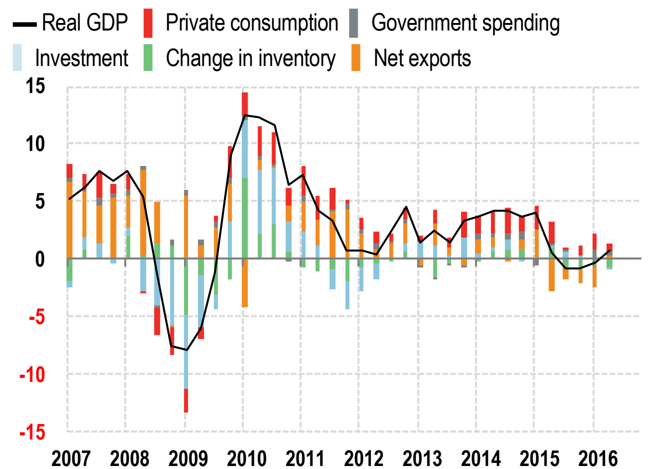
1- Forecasts

	2014	2015	2016e	2017e
Real GDP growth (%)	3.9	0.6	1.0	1.5
Inflation (CPI, year average, %)	1.2	-0.3	1.1	0.5
Budget balance / GDP (%)	-0.9	0.1	-0.4	-0.6
Gen. Gov. debt / GDP (%)	37.9	36.8	36.7	37.3
Current account balance / GDP (%)	11.7	14.5	14.7	13.5
External debt / GDP (%)	33.6	30.4	32.0	34.0
Forex reserves (USD bn)	419	426	435	440
Forex reserves, in months of imports	15.9	19.5	22.6	22.4
Exchange rate USD/TWD (year end)	31.7	32.9	33.5	34.0

e: BNP Paribas Group Economic Research estimates and forecasts

2- Economic growth has stalled

Real GDP growth (y/y, %) and contribution to growth (pp)



Sources: DGBAS, BNP Paribas

Public sector investment has contracted for more than two years. In contrast, government spending rebounded this year, after providing no support for growth in 2015 (-0.3% in 2015 and +3.7% in H1 2016).

The industry has also been showing signs of improvement in recent months. After a 12-month decline, industrial production growth has swung back into positive territory since May, and reached 5.8% y/y in September. Exports have rebounded slightly since July (although this trend came to a halt in September), and manufacturing PMI rose in September to the highest level since Q3 2014. Even bank lending growth seems to be picking up again (+3.2% y/y on average in the period June-August 2016, vs. 2.6% in the three previous months), buoyed by an accommodating monetary policy. To address weaker domestic demand and the absence of inflationary pressures, the central bank lowered its key policy rate on four occasions between September 2015 and June 2016. The key rate has held at 1.375% since the end of June (see chart).

In the very short term, several factors that have contributed to the turnaround in economic growth in recent months are bound to persist. Taiwanese industry will continue to benefit from the rebound in the global electronics cycle and the stabilisation of Chinese growth (see “China: credit risks still rising” on page 9), and the authorities are expected to maintain accommodative monetary and fiscal policies. Yet their manoeuvring room is likely to be fairly crimped. Interest rates are already very low, which restricts the central bank’s scope of action, and the government’s manoeuvring room is hampered by the structural vulnerabilities of public finances. Deficits and debt are moderate, thanks to the government’s policy prudence and consolidation efforts undertaken in 2010-2015, but fiscal policy is in fact not very flexible. First, the tax base is narrow, limiting the government’s capacity to increase spending and contributing to the persistence of deficits in the long run. Second, the ageing population is already putting pressures on the pension system. Lastly, the existing public debt ceiling has already virtually been reached (the debt/GDP ratio was estimated at 37% at year-end 2015).

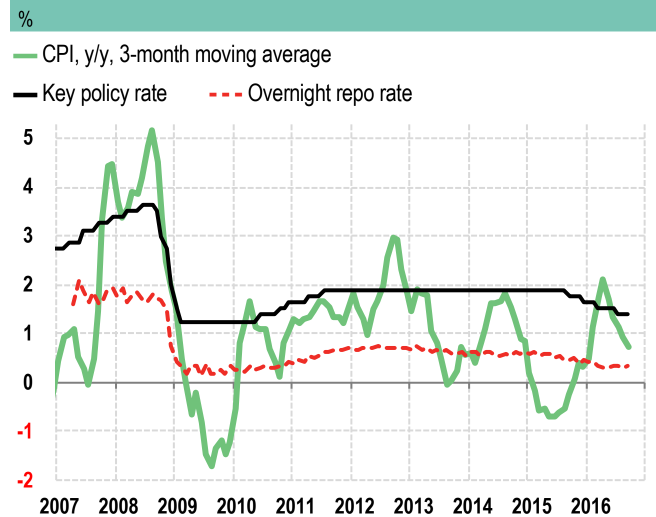
All in all, we are looking for real GDP growth of 1% in 2016 and 1.5% in 2017, up from 0.6% last year.

Need for a new medium-term economic model

Economic growth could continue to weaken in the years ahead. According to the latest IMF forecast (*World Economic Outlook*, October 2016), real GDP is only expected to grow by 2.2% a year in the period 2017-2021, down from 4% in 2007-2011, and 5.4% in 2002-2006. First, if cross-strait tensions were to persist, they could erode the confidence of Taiwanese residents, domestic and non-resident investments, and the island’s exports (China absorbs 26% of Taiwan’s merchandise exports, or 40% including Hong Kong, and accounts for 40% of tourist arrivals).

With its dependence on Chinese final demand and electronics exports (electrical machinery and equipment account for 39% of total exports), Taiwan remains vulnerable to the weakening of world trade, the structural slowdown in China’s industrial growth and the gradual increase in competition in high-tech sectors. In the little-supportive external environment of the past five years, Taiwan’s growth potential has eroded due to weaker capital accumulation and the slower labour productivity growth, as well as a smaller increase in the working-age population (which will soon begin to decline).

3- Low rates



Source : Macrobond

Faced with these observations, the new government intends to give the economy a shot in the arm. First, it wants to encourage the development of new technologies with very high value-added. From this perspective, it has identified five high-priority sectors (green energy, biotechnology, intelligent machines, connected objects and national defence). A project for a vast industrial park has been launched with high ambitions of becoming the future “Asian Silicon Valley”. Second, the government hopes to strengthen its trade ties with countries other than China, such as Japan, South Asia and the United States. Yet current tensions with China, and the island’s increased diplomatic isolation this could lead to, risk making it harder for the authorities to negotiate trade agreements with new partners.

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Thailand

An unstable equilibrium

The vote in favour of the draft constitution proposed by the military junta, in power since May 2014, is not good news. It does not resolve any of the political or social conflicts, while anti-democratic measures in the draft text suggest that the new constitution will not last much longer than the previous ones. Political uncertainty was clearly exacerbated by the king's recent death, and is bound to last several more years. In the meantime, economic growth is picking up feebly, buoyed by tourism revenues and public spending. Yet Thailand's competitiveness and attractiveness continue to erode, while competition with other countries in the region is increasingly straining FDI inflows.

A new constitution is adopted

In early August, Thais voted – against their interests – to approve the new constitution proposed by the military junta. Eliminating the majority of citizens' political rights, the draft constitution was approved by 61% of voters (with a participation rate of 60%). A supplementary question added to the referendum at the last minute was approved by 58% of votes: in the name of "national reform", Thais were asked to agree that an unelected prime minister could be appointed jointly by the House of Representatives and the Senate. The constitution's approval paves the way for new elections to be held, probably at the end of 2017.

Although the election campaign was conducted under severe restrictions – the "no" vote was forbidden to campaign – the results were interpreted as the people's will to bring an end to the political unrest that has dragged on since the absolute monarchy was abolished in 1932.

Skin-deep stability

To the contrary, adoption of the new constitution could represent a new phase in an unending cycle – coup d'état, new constitution, elections, coup d'état – as has been the case every 5 years on average since 1932. Since that fateful year, the king's legitimacy has never been called into question. Roughly speaking, the exercise of power tends to pit the elite, the bureaucrats and the military (urban dwellers, close to the royal family), who seek to hold all power, against rural-based "democrats", for whom power should be exercised by elected political representatives.

The speed with which the successive constitutions were abolished has only weakened their impact. Each constitution seems to have been tailor-made to serve the interests of the coup's organisers, and to keep them in power, by favouring the elite and the military. The new draft constitution also aims to institutionalise the junta's presence, which has been in power since the May 2014 coup. Another purpose is increasingly obvious: to ensure the military's presence at the head of government at the time of the king's succession.

For the next five years, the military junta will appoint the entire Senate[1]. The prime minister (who could be from the military) will be appointed jointly by the Senate and the House of Representatives. Even though elections are to be held, the government could remain entirely composed of men from the military. Negotiations have only just begun over the nomination of General Prayuth Chan-ocha, the junta's head and current prime minister. Despite campaign promises to the contrary, it would then be impossible to revise the constitution. The only solution would be to abolish it through another military coup.

[1] Under the previous constitution voted in 2007, half of the Senate was directly elected through elections and the other half was appointed by a committee of seven high-level officials.

1- Forecasts

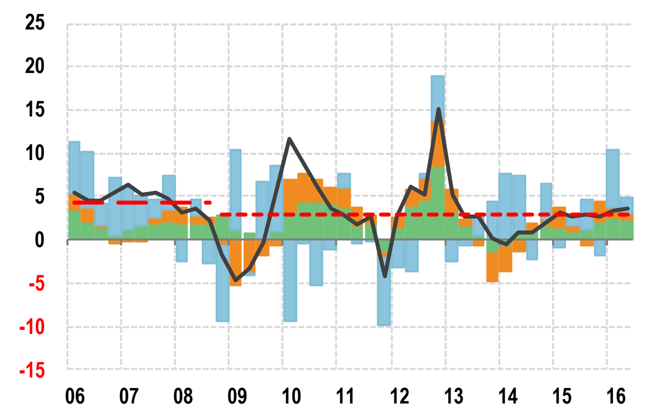
	2014	2015f	2016f	2017f
Real GDP growth (%)	0.8	2.8	3.0	3.0
Inflation (CPI, year average, %)	1.9	-0.9	0.5	1.7
Gen. Gov. balance / GDP (%)	-2.5	-2.2	-3.2	-3.3
Gen. Gov. debt / GDP (%)	30.4	31.0	32.9	34.7
Current account balance / GDP (%)	3.9	8.1	10.0	8.0
External debt / GDP (%)	34.8	33.8	33.8	32.4
Forex reserves (USD bn)	151	151	156	160
Forex reserves, in months of imports	7.8	8.0	8.5	8.5
Exchange rate THB/USD (year end)	33.0	35.8	35.3	36.0

f: BNP Group Economic Research estimates and forecasts

2- Modest growth recovery

Contribution to GDP growth in pp and y/y % change

Consumption | Investment | Net exports | GDP (%, y/y) | Average 2000-2008 | Average 2009-2014



Source: National Accounts

No short-term solutions

Far from the "national reconciliation" promised by the military when it took power, the new situation could help widen the differences between the two camps. As the terrorist attacks committed just a few days after the elections show (in a region where the constitution was approved by more than 80%), the current regime still faces high

risk of a popular uprising. Despite the apparent stability promised by the military, the political and social crises plaguing the country have not been resolved in any lasting manner. The king's death creates a new source of alarm. The local population is not very appreciative of the king's son and designated heir, who is suspected of being close to Thaksin Shinawatra, the former prime minister, overthrown during a previous coup in 2006. The crown prince has requested to "delay" ascension to his father's throne, leaving the military with full latitude to organise the king's succession as they see fit.

Mild recovery

Real GDP growth rebounded to 3.4% y/y in H1 2016, from 2.8% in 2015. Public spending and tourism revenues, which were not hurt much by the recent terrorist attacks, helped offset the decline in merchandise exports and sluggish private demand.

These two growth engines should continue to provide support in the short term. Tourism revenues rose strongly in 2015, up 20% y/y, and increased another 11% y/y in the first 8 months of 2016.

After the government's first stimulation measures announced in September 2015, which accounted for nearly 5% of GDP and mainly benefited the most vulnerable segments of the economy, a vast infrastructure improvement plan was launched in late 2015. The 8-year plan is expected to account for a total of 13% of GDP. The government will directly finance 5%; state-owned companies, 75% (with government guarantees); and private investment, 20%.

Public spending is likely to remain rather limited in scope, since the government has pledged to prevent public accounts from deteriorating too much before new elections can be held. Moreover, actual spending is likely to be smaller than initially announced. In the first 10 months of the fiscal year, government spending increased 7% y/y. Excluding the social security fund's surplus, the deficit should hold below 3% of GDP in 2016 and 2017 (vs. 2.2% in 2015). The success of the infrastructure improvement plan will depend heavily on private-sector participation.

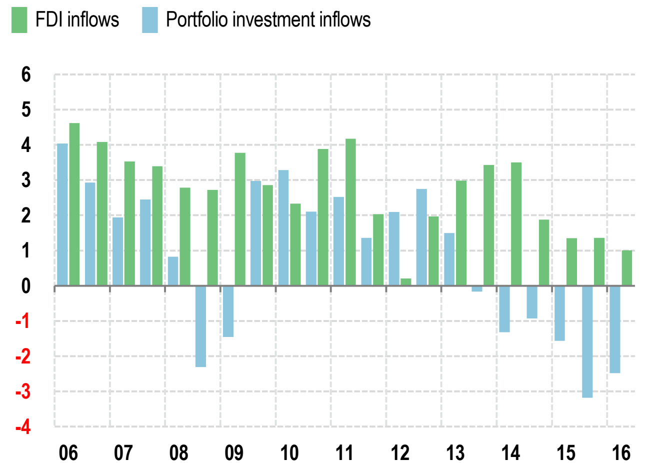
Downturn in FDI since the 2014 coup

Yet for Thailand, improving infrastructure is a key challenge. The country's attractiveness has been hard hit by more than 10 years of political instability, a series of short-term populist policies, and the lack of a structural policy.

The lack of attractiveness for investors can already be seen in the deterioration in the financial account balance. Over the past three years, portfolio investment flows have fallen sharply in all segments. FDI inflows have dropped from an average of 3.5% of GDP in 2005-2011, to 2.5% of GDP between 2011 and H1 2014 (the military coup occurred in May 2014). Since H2 2014, FDI inflows have slipped to 1.5% of GDP, and then to 1% of GDP in H1 2016.

Faced with this environment, Thailand would stand to benefit from joining the Trans-Pacific Partnership (TPP), one of the largest free-trade agreements signed by 12 countries (excluding China) in late 2015[2]. Discussions are underway for Thailand to join.

3- Lower FDI inflows (% of GDP)



Source: Central Bank of Thailand

In addition to reducing tariffs (which other pre-existing trade agreements have already reduced sharply), the TPP seeks to facilitate the development of supply chains between member states. Members must also comply with new requirements in terms of the environment, labour and the protection of intellectual property.

Together, TPP's 12 signing members account for more than 40% of Thai exports and 45% of FDI inflows. Thailand already has trade agreements with most of the TPP members, with the exception of the United States, Canada and Mexico. But if Thailand does not join PTT, it risks facing greater competition in the US market (10% of exports) in key segments like agriculture and automobiles. It would also face much fiercer competition with the signing countries, especially Malaysia and Vietnam, notably for basic and manufactured goods.

Lastly, FDI flows initially earmarked for Thailand could end up being redirected to other TPP members, who would benefit from easier access to the US market. This means FDI from the US, Japan and South Korea could bypass Thailand.

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[2] The 12 signing countries are Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, the United States and Vietnam.

BNP PARIBAS

The bank for a changing world

Malaysia

A delicate transition

Malaysia's economic situation has deteriorated. Growth has slowed, the current account surplus is shrinking, and the 1MDB corruption scandal has sparked a domestic political crisis and the loss of confidence of international investors. The political situation could remain muddled for several more years. Yet Malaysia's medium-term prospects are still favourable. If the country's political situation stabilises and the business climate improves, Malaysia's integration in the regional economy and its upmarket shift in global supply chains could make it one of the main beneficiaries of the new Trans-Pacific Partnership (TPP) free trade agreement.

World-scale financial scandal

Malaysia has long been seen as the region's most politically stable country. The current ruling coalition has governed the country since its independence in 1957. After the 2013 legislative elections, however, national unity seems to be increasingly fragile in the midst of a structural slowdown in growth.

The current Prime Minister, Najib Razak, has been severely weakened since summer 2015 after he was accused of being involved in an international-scale financial scandal. He was accused of embezzling enormous sums from the 1MDB sovereign fund, which he himself created after taking power in 2009 (and managed through April 2016), to support his policies and to modernise the country's infrastructure. Although corruption charges have been officially dropped, the prime minister's exact role in the fund's management and the fraud's organisation continues to be investigated closely, both nationally and internationally.

Several countries, including Switzerland, the United States and Singapore, have launched investigations to uncover any embezzlement linked to the fund's financing. Although the investigations carefully avoid naming the country or the prime minister as being directly responsible, Malaysia's image has been tarnished. Looking beyond the 1MDB scandal, it is the quality of corporate governance that has been called into question, and the country's ability to improve its institutional framework.

In the most recent report on global competitiveness, published by the World Economic Forum in September 2016, Malaysia has fallen 7 places from its ranking in the previous report, after six consecutive years of improvement. The hardest hit indicators were access to financing, the fight against corruption and governance.

Early elections?

From a domestic perspective, even though the prime minister was officially cleared of any wrongdoing, his legitimacy has been strongly called into question. Moreover, the financial scandal only adds to a long list of economic and social grievances.

So far the prime minister has managed to maintain the support of his government and the party he heads, the United Malays National Organisation (UMNO), notably by winning two partial elections in May and June. The prime minister has also postponed the UMNO internal election to maintain control over the party.

At the same time, several high-profile members of UMNO and various opposition parties have created an alliance to force the prime minister to resign. This alliance is headed by Mahathir Mohamad, Malaysia's prime minister from 1981 to 2003, who is determined to drive Mr. Razak from power.

Yet this alliance of parties with divergent views is highly fragmented, and internal dissension could prevent it from taking action. Faced with this situation, which is still favourable, the prime minister might decide to move forward the next legislative elections, initially slated for mid-2018.

If early elections are held, the UMNO might be tempted to keep the prime minister from participating in the election (by forcing him to resign) in order to hold on to power, while the opposition continues

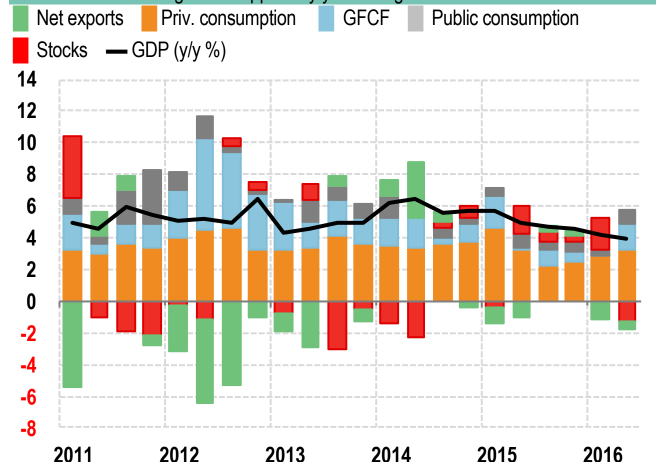
1- Forecasts

	2014	2015	2016f	2017f
Real GDP growth (%)	6.0	5.0	4.0	4.5
Inflation (CPI, year average, %)	3.1	2.1	2.0	3.0
Gen. Gov. balance / GDP (%)	-3.4	-3.2	-3.1	-3.0
Gen. Gov. debt / GDP (%)	52.7	54.3	53.0	52.8
Current account balance / GDP (%)	4.4	3.0	2.0	1.0
External debt / GDP (%)	63.3	64.9	65.4	59.6
Forex reserves (USD bn)	114	94	99	103
Forex reserves, in months of imports	5.6	5.4	5.8	5.9
Exchange rate USD/MYR (year end)	3.5	4.3	4.2	4.3

f: BNP Group Economic Research estimates and forecasts

2- Real GDP growth is slowing down

Contribution to GDP growth in pp and y/y % change



Source: National Accounts

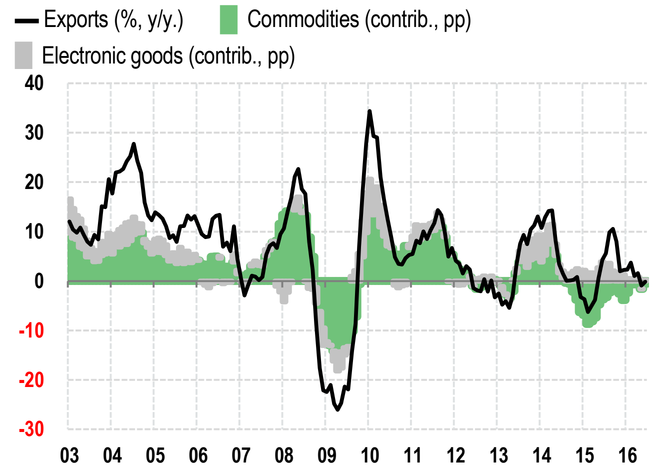
to fragment. Early elections would significantly increase political instability in the months ahead.

Growth slows in the short term

Since mid-2014, real GDP growth has gradually slowed, from 6.5% y/y in Q2 2014, to 4% in Q2 2016, undermined by the decline in oil and commodity prices, the slowdown in Chinese growth and the political crisis. Growth is expected to slow further in the upcoming quarters.

Private demand will continue to be the main growth engine: the contribution of public demand is bound to be small, since the government has pledged to pursue its fiscal consolidation policy, even in the case of early elections. Exports rose only 1.5% y/y in the first 8 months of the year: although commodity prices and exports to China both picked up, they remain weak. All in all, real GDP growth slowed to 5% in 2015, down from 6% in 2014, and is expected to slow even further in 2016, to 4%.

3- Weak exports



Source: Department of Statistics

What are the advantages of signing TPP?

In the medium to long term, Malaysia must meet several challenges. It must reduce its external vulnerability by restoring the confidence lost during the political and financial scandal. Non-residents' share of the public debt exceeded 30% of the total in Q2 2016, which means the country is highly exposed to a change in investor sentiment.

Malaysia is also one of the ASEAN members with the highest level of integration in global supply chains and in the regional economy. Exports to China (14% of total exports) are comprised of manufactured goods included in regional supply chains (mainly electronic components), non-petroleum commodities (palm oil), and end products. This means that its manufactured goods exports are doubly hit by the slowdown in Chinese growth and sluggish world trade.

Despite several reforms designed to diversify the sources of growth, oil still accounts for 10% of total exports. Generally speaking, commodities (including food, fossil fuels and chemical products) account for nearly 25% of exports. The current account surplus has already narrowed significantly over the past decade, dropping from an average of 12% of GDP in 2000-2010, to 5% of GDP in 2011-2015 (and 2% in 2016).

Malaysia's participation in two new trade agreements, the Trans-Pacific Partnership (TPP) and the Malaysia-European Union Free Trade Agreement, seem to be good opportunities to revive the country's competitiveness and attractiveness.

The TPP, signed by 12 countries[1] excluding China in late 2015, is part of a new generation of trade agreements that cover numerous areas, reaching beyond the usual reduction in tariffs to include investment policies, intellectual property, and labour market regulations. In the medium to long term, assuming the business climate does not deteriorate any further, participation in TPP could help further the goals of Malaysia's 11th 5-year plan, which calls for the acceleration of productivity gains and an upmarket shift in global supply chains.

By 2020, the 5-year plan is targeting GDP growth of between 5% and 6% a year, annual inflation of less than 3%, an increase in private investment by more than 9% a year, and the creation of 1.5 million jobs, notably through a public and private investment programme focused primarily on infrastructure. The plan also incorporates a bigger social dimension than before, and is targeting gross national income (GNI) per capita of more than USD 15,000.

A January 2016 study by the Peterson Institute for International Economics claims that Malaysia, along with Vietnam, stands to benefit most from TPP. First, it would be Malaysia's first trade agreement with the United States, as well as with Canada, Mexico and Peru, and would significantly improve access to their markets. Second, as part of the engagements made by signing TPP, Malaysia would have to undertake reforms to improve corporate governance, its biggest weak point, notably by reforming the management of state-owned companies.

Based on their model, real GDP would increase 8% and exports by 20% by 2030. The sectors that would benefit most are textiles and the manufacturing industries, including iron and steel, chemicals and electronic components.

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[1] The 12 signing countries are Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, the United States and Vietnam.

Turkey

Another economic stress test

Culminating a series of (geo) political shocks over the past three years, the aborted military coup of 15 July triggered a spontaneous outpouring of national support for President Erdogan. Yet the massive repression of institutions and the private sector that followed has created a growing sense of unease. Although the financial markets reacted relatively mildly, political tensions have severely strained economic growth in Q3, after a sharp slowdown in Q2 driven by a contraction in private consumption. Several support factors should keep the economy from collapsing, but there are growing concerns about the medium-term deterioration in public finances, which are rather healthy for the time being.

Relatively stable markets despite political shock

The failed military coup of 15 July bolstered the ruling party's executive power. Fearing the return of the dark days of a past that is still all too present in Turkey's collective memory, the people and the political class as a whole formed a united front in support of President Erdogan (AKP), just as Turkey's isolation on the regional and international stage had reached its peak. Allies of the AKP party until 2013, Imam Gulen's Cemaat movement is accused of infiltrating all levels of Turkish institutions (including the government, justice, police and army) and plotting the coup. Over the past three months, the repression has spread to the business world, academia and the media. Arrests, dismissals and suspensions have reached an alarming scale, weakening the "sacred union" around the preservation of democratic values.

Market jitters following the aborted military coup proved to be short-lived. Bolstered by the massive sell-off of hard-currency instruments held by resident investors and deposit holders (USD 10.5 bn in two weeks), the Turkish lira depreciated by just 5% against a euro-dollar basket for a few days before levelling off thereafter. Moody's announcement that it was downgrading Turkey's sovereign rating to speculative grade on 23 September triggered a new wave of market volatility, bringing the Turkish lira under pressure, a movement accentuated by the rebound in oil prices. Interest rates and spreads have increased slightly.

All in all, there has been a net inflow of portfolio investment since early 2016 (+USD 3.4 bn), and it has remained in positive territory since July (+USD 1 bn). The Turkish lira has shed 6% against a euro-dollar basket since January. The Istanbul stock index is still up 6%. The yield on 5-year Treasury notes has declined by 140 basis points (bp) to 9.2% in the midst of monetary easing. Moreover, the spreads between 10-year sovereign Eurobonds and US Treasury bonds (310bp) and 5-year CDS premiums (250bp) have increased by only 20bp since the beginning of the year.

The economy slumps, but still has support factors

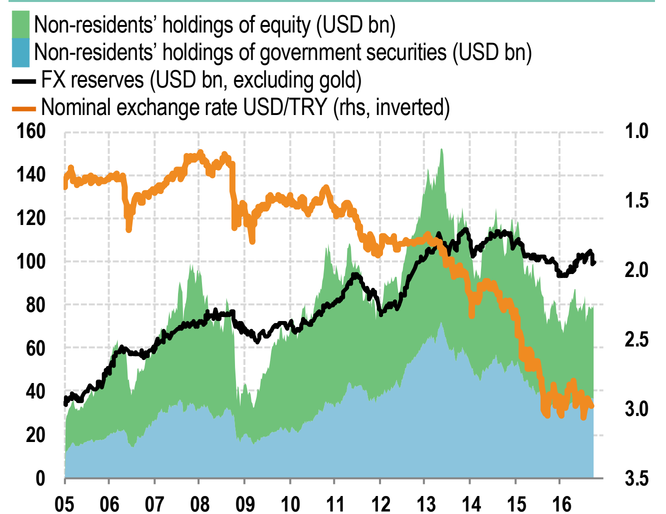
Despite the slowing trend, the Turkish economy has shown proof of amazing resilience in the face of the successive shocks since 2013, with real quarterly GDP growth averaging 0.9% (non-annualised). Yet growth has slowed since the beginning of the year, to only 0.3% q/q in Q2, from 0.7% in Q1 (adjusted for seasonal fluctuations and the number of business days). Household consumption, which has been the biggest contributor to growth for the past three years (67% of GDP, with an average quarterly growth rate of 1.5% q/q since 2013), contracted 0.5% q/q in Q2 after +2.5% in Q1. At the same time, public spending has accelerated rapidly (+3.5% q/q). Private investment, notably for machinery and equipment, also rebounded, up 6% q/q in Q2 after contracting 1.3% in Q1. The volatility of private investment can be attributed to the uncertainty plaguing the business climate and rather moribund export markets (Middle East and Russia), despite a slight improvement with Europe. The duration of the investment trough that followed the 2010-2011 boom suggests that the slowdown is structural. Even though imports have slowed sharply, foreign trade continued to make a negative contribution to GDP growth over the past three quarters. Exports plunged by 2.8% q/q in Q2.

1- Forecasts

	2014	2015	2016f	2017f
Real GDP growth (%)	3.0	4.0	2.7	3.0
Inflation (CPI, year average, %)	8.9	7.7	7.9	8.5
Budget balance / GDP (%)	-1.3	-1.2	-1.8	-2.4
Public debt / GDP (%)	35.0	34.7	34.1	34.1
Current account balance / GDP (%)	-5.5	-4.5	-4.7	-4.9
External debt / GDP (%)	52.7	57.1	61.6	62.3
Forex reserves (USD bn)	106.3	95.7	98.0	101.0
Forex reserves, in months of imports	5.0	5.2	5.9	5.5
Exchange rate USD/TRY (year end)	2.3	2.9	3.1	3.5

f: BNP Paribas Group Economic Research estimates and forecasts

2- External position and FX rate



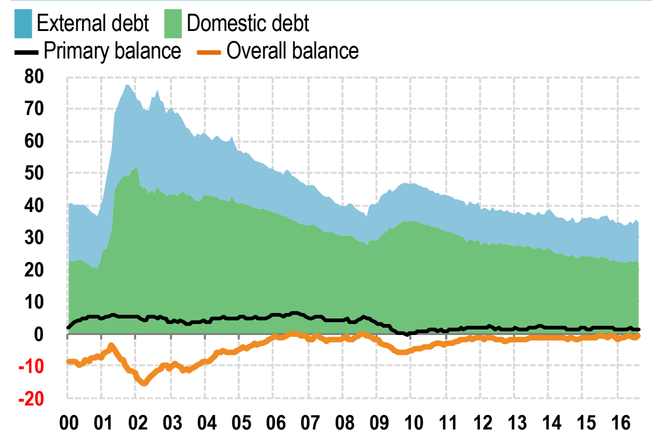
Sources : CBRT, BNP Paribas

Several indicators point to a contraction in Q3 GDP. Labour market conditions have deteriorated since April. Net job creations slowed to 1.4% y/y in June. The Turkish economy even destroyed 222,000 jobs in June (seasonally adjusted figure), in all economic sectors with the exception of services, bringing the unemployment rate to a seasonally adjusted 11%, the highest level in six years. The increase in bank lending also slowed to 9% y/y in August, the lowest level since 2009. Tourism revenues (4.5% of 2015 GDP) plunged above 35% y/y in July-August, in the midst of security fears (terrorist attacks by the PKK and Daech) and Russian economic sanctions against Turkey from November 2015 to July 2016. Since mid-July, the smooth functioning of public services and the business activities of numerous companies have been disrupted. Industrial output dropped 8.4% y/y in July before rebounding 2.7% y/y in August, bringing the decline in the 3-month moving average to 1.4% y/y. Yet the rebound in household confidence in August – which was corroborated by an upturn in retail sales after a 5-month decline – seems precarious: above all it reflects the local population's relief and a kind of euphoria following the aborted military coup. August PMI surveys project a deterioration in economic conditions in the short term.

Even so, certain support factors should boost economic growth in the months ahead, foremost of which is the persistently expansionist policy mix. Given the Turkish lira's relative stability since the beginning of the year and the economic slowdown, the central bank (CBRT) lowered its overnight lending rate by 250bp to 8.25%, gradually bringing it in line with the 1-week repo rate (7.50% since February 2015). Considering the high level of structural inflation (7.3% for the general price index and 7.6% for core inflation in September), the average CBRT refinancing rate of 7.8% means that real interest rates are very low. Alongside the easing of macro-prudential measures (lower mandatory reserve ratios and access conditions for liquidity in the local currency) the CBRT wants to stimulate bank lending, notably household lending, which can already be observed in weekly credit statistics. Several external factors are also expected to support economic growth, namely the very accommodating monetary policies being maintained by the advanced economies, persistently low energy prices and the recent lifting of Russia's embargo against Turkey (exports, tourism and large-scale projects). Even so, the current account deficit is unlikely to improve, and is currently mired near its structural threshold of 4%-4.5% of GDP.

All in all, we expect growth to slow from 4% in 2015 to an average of 2.7% in 2016, before rebounding slightly to 3% in 2017. The IMF and the Turkish government recently revised downwards their growth forecasts. The IMF is now looking for 3.3% growth this year and 3% next year. The government's new medium-term programme (MTP 2017-2019) is based on the assumption of 2016 and 2017 growth of 3.2% and 4.4%, respectively. Even though demographics are favourable, the government's 2018-2019 forecast of 5% GDP growth seems optimistic given the lack of productivity gains since 2008, sluggish investment since 2012, and the constant postponement of structural reforms. We estimate Turkey's medium-term growth potential at about 3.5%, in line with the IMF figure.

3- Public finances (% of GDP)



Sources: Ministry of Finances, BNP Paribas

Doubts about public finances

Although S&P's never considered that Turkey deserved an investment grade rating, Fitch and Moody's both crossed the Rubicon in November 2012 and May 2013, respectively. Moody's just downgraded Turkey's long-term foreign-currency sovereign debt rating to speculative grade with a stable outlook, based on the increase in risks pertaining to the size of the country's external financing needs, weaker economic growth prospects and the deterioration of the institutional environment. Fitch might well decide to follow suit.

The budget deficit was stable at a little more than 1% of GDP between 2013 and 2015, the primary balance remained in surplus and the public debt declined by nearly 2 points, to only 35% of GDP. Although for the past three years, each of the government's fiscal outlooks in the frame of the MTPs has been more pessimistic than the previous one, the public debt and deficit trajectories are not yet a major source of concern. Despite the acceleration in current spending (+16% y/y in the first nine months of 2016), the government could count on a very good H1 for corporate tax collection and one-off revenues (transfer of CBRT profits, privatisations and concessions). In the end, the budget deficit should be limited to less than 2% of GDP in 2016 (1.6% according to the government). The deficit could continue to widen to nearly 2.5% of GDP in 2017 (the government is forecasting 1.9%), since public spending (financing of the minimum wage, pensions, social welfare benefits, security and refugees-related costs) continues to grow more rapidly than revenues. We cannot rule out the possibility of tighter financing conditions, and a nominal depreciation in the Turkish lira (enough to stabilise the real effective exchange rate) would automatically drive up Turkey's foreign currency debt, which accounts for a third of total public debt.

Yet with the primary balance holding near equilibrium, respectable economic growth, and inflation significantly above the 5% target – fuelled in 2017 by wage increases and higher prices for food (end of the embargo on exports to Russia) and utilities – public debt ratios should remain relatively stable in the short to medium term.

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Poland

In the mood to spend more

Squeezed by the reduction in European transfers, investment growth is slowing. Consumption, in contrast, is holding up well, bolstered by public spending, which is paving the way for a soft landing. Solid exports have brought the current account into positive territory for the first time in 20 years. The increase in public spending has not fuelled inflation. The government has launched a family allowance programme as part of efforts to boost the birth rate, expecting to lift the country's long-term growth potential. The cost of these policies will be covered by higher taxes on banks, large retailers and state-owned energy companies. There is also a big temptation to increase debt in the current environment of very low interest rates.

Switching growth engines

Economic growth is showing signs of slowing down after peaking at 4% year-on-year in Q4 2015 (bringing the full-year 2015 average to 3.6%). In the first six months of 2016, real GDP growth slowed to 2.8% year on year (y/y).

Consumption growth continued to rise, up 2.7% y/y in H1 2016. Retail sales growth hit a record high, up 5.6% at an annualised rate in the first 8 months of the year. This trend follows closely the acceleration in real wages, up 5.4% y/y in the first 6 months of the year, thanks to the double impact of labour market improvement and lower prices. The unemployment rate dropped to 5.6% of the active population in August 2016, the lowest level ever reported in post-Soviet Poland.

Consumer spending is expected to continue expanding in the short term thanks to the increase in social welfare transfers to families. The 500+ programme, the current government's star social welfare measure which provides family allowances to families with two or more children, is expected to transfer about 1% of GDP to families. Eventually, the government's social policy is also expected to boost residential construction.

Investment, which was the main source of the growth upturn in 2014 and 2015, contracted by 2.5% y/y in H1 2016 according to Eurostat data. This decline follows two years of very dynamic growth, largely financed by inflows of European funds and a significant improvement in the country's capacity to absorb these funds. This source has now been exhausted: the flows from the EU budget are expected to level off and will no longer act as an accelerator of growth.

Foreign trade is still dynamic. Export growth hit an all-time high, up 10% in volume y/y in H1 2016. Thanks to dynamic export momentum, Poland reported a current account surplus in H1 2016, for the first time since 1995.

Poland is in the midst of switching growth engines: investment is easing up, squeezed mainly by the slowdown in European transfers, while consumption is stepping in as the new growth engine, stimulated by the government's social policies. Beata Szydlo's conservative government is determined to respect its electoral promises and increase support for families and retirees.

Public finances: in the mood to spend more

Introduced in April 2016, the 500+ programme provides a family allowance to families with two or more children: PLN500 (EUR117) per child per month, as of the second child. It is the government's main gesture on behalf of families. This family support policy is necessary because Poland has one of the lowest birth rates in Europe, at 1.29 children per woman in 2015. But it represents a major cost for the state budget: according to the Polish ministry of family, labour and social affairs, the estimated cost of the programme is about EUR 5 bn, or 1.2% of GDP a year.

Support for families does not stop there. The government also intends to unroll a housing policy targeting low-income families. The target of the national housing programme is to match the European average in terms of the number of residential units per inhabitant (Poland is currently 28% below the average) through support for both low-priced residential construction and savings. Low-income

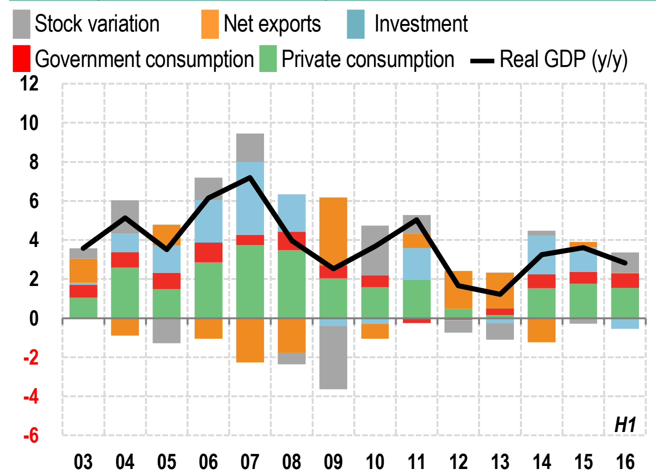
1- Forecasts

	2014	2015f	2016f	2017f
Real GDP growth (%)	3.3	3.6	2.8	2.5
Inflation (CPI, year average, %)	-0.0	-0.9	-0.4	1.9
Gen. Gov. balance / GDP (%)	-3.3	-2.6	-2.8	-3.4
Gen. Gov. debt / GDP (%)	50.5	51.3	52.5	53.6
Current account balance / GDP (%)	-2.1	-0.2	-1.3	-1.7
External debt / GDP (%)	71.5	70.8	72.0	72.5
Forex reserves (USD bn)	94	89	108	111
Forex reserves, in months of imports	5.7	6.1	6.7	6.6
Exchange rate EUR:PLN (year end)	4.30	4.26	4.25	4.30

f: BNP Paribas Group Economic Research estimates and forecasts

2- Poland's main growth engines

Real GDP growth, % and Contribution to growth, pp



Source: Eurostat

families will be able to rent houses with the option of becoming the homeowner at the end of a thirty-year lease. To encourage long-term savings that could be used to finance home purchases, the government intends to set up tax-free residential savings accounts. It also plans to invest in the modernisation of existing housing. This programme should buoy the construction sector, hit by the slowdown in European transfers. Activity in the construction sector has contracted by more than a quarter since the beginning of 2016.

Although these policies favouring families and housing are not very controversial, there has been fierce debate over the government's announcement that it intends to return the legal retirement age to age 65 for men and age 60 for women as from 2018. The government wants to annul the 2013 reform passed by the previous majority, which raised the retirement age to 67. Given the country's unfavourable demographics (ageing population, low birth rate), the cost of this measure, estimated at PLN 8 bn to 10 bn a year (0.5% of GDP), could threaten the sustainability of Poland's public finances. Even so, the proposal won the approval of Poland's lower chamber of parliament in July 2016.

Higher public spending has no impact on inflation

In September 2016, Poland celebrated its 20th consecutive month of falling prices, despite the big upturn in public spending (chart 2) and real wages in 2016. Inflation dynamics can be attributed primarily to external factors, such as deflation in the Eurozone and the decline in commodity prices.

Deflation helps interest rates to decline: the refinancing rate has been at an all-time low of 1.5% since March 2015, which allows banks to offer corporates and households advantageous lending conditions. The total volume of lending by Polish banks to local residents increased 6% year-on-year in August 2016, while consumer credit rose 8%. Credit is thus another factor fuelling the increase in consumption.

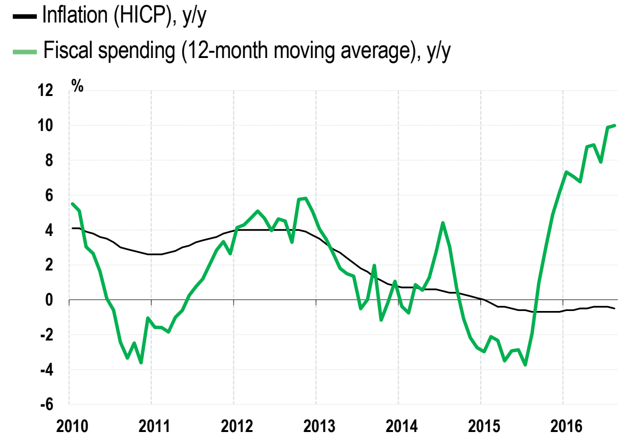
Inevitable tax increases

The increase in government spending will be covered in part by new sectorial taxes, a policy largely inspired by Hungary's example, as well as be one-off revenues. The bank tax act, a 0.44% tax on the assets of financial institutions, is expected to bring in 0.2% of GDP in 2016.

The government is also seeking to raise taxes on large retailers. A proposal for a new progressive tax based on the turnover of supermarkets was adopted in summer 2016, but later suspended after the European Commission opened an investigation into the infringement of competition rules. The Hungarian precedent suggests that the progressive nature of the tax is likely to be abolished. In that case, the tax would bring in only about 0.1% of GDP as of 2017.

The government announced that it is revaluing the capital of state-owned energy companies by PLN 50 bn. As a result, these companies will be liable for additional taxes of PLN 10 bn (EUR 2.3 bn, 0.5% of GDP).

3- Broken link between public spending and inflation



Sources: Eurostat, Ministry of Finance of Poland, BNP Paribas

Compliance with fiscal rules is vital

Despite the slowdown in growth, fiscal revenues increased 7% y/y in the first 8 months of 2016. Moreover, one-off revenues from the disposal of LTE mobile network bands brought in PLN 9.2 bn (0.5% of GDP), which allowed Poland to report a very small fiscal deficit of only 1.6% of GDP in the first 8 months of 2016.

The 2017 draft budget proposal calls for a fiscal deficit of 2.9% of GDP based on growth and inflation forecasts of 3.6% and 1.3%, respectively. These projections could prove to be somewhat optimistic: with the government in a big spending mood, Poland could end up surpassing slightly the European limit of 3% of GDP.

Although changing growth engines does not seem to present a problem in the short term, thanks notably to strong export momentum, the government must still prove that it can have a lasting impact on consumption without undermining the sustainability of public finances. There is a big temptation to increase debt in the current environment of very low interest rates. Seen in this light, it is crucial for the government to comply with the fiscal rules. Public debt is currently lower than the ceiling of 60% of GDP, as stipulated in the Polish constitution and in the Maastricht criteria. More restrictive local regulations, however, require a more moderate level of public spending as soon as the public debt reaches 50% of GDP. By mid-2016, Poland's public debt was already very close to this threshold.

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Egypt

A necessary but insufficient devaluation

The Egyptian pound needs to be devalued due to the deterioration in the country's export competitiveness and the squeeze on foreign-currency liquidity. As previous devaluations show, not only in Egypt but also in Argentina, it is necessary to have a sufficient liquidity shield to maintain control over the forex market. Past devaluations also show that improvements in external accounts depend on numerous factors that are not directly linked to exchange rates. Thanks to external financial support, the Central Bank of Egypt (CBE) should have enough liquidity to successfully carry out the devaluation. Yet external accounts are unlikely to improve before the energy deficit has been significantly reduced from 2018.

The devaluation of the Egyptian pound, expected in the weeks ahead, raises numerous questions. In an increasingly unsustainable economic situation, this devaluation is one of the preconditions – along with energy subsidy reforms and the securing of bilateral and multilateral financing – for the signing of a financial assistance agreement with the IMF.

The spread between official and parallel market exchange rates is currently at a record high of more than 60%. This spread is due to foreign currency rationing on the official market as well as to increasing volatility fed by rumours about an imminent devaluation. The competitiveness of Egyptian exports has eroded significantly. The real effective exchange rate has risen practically 50% since 2009. At the same time, Egyptian exports as a share of world trade have fallen by half, from 0.9% in 2009 to 0.45% in 2015. The central bank's foreign currency liquidity has deteriorated constantly since 2011, and has reached an alarming level of less than three months of imports of goods and services. Devaluation raises two questions about the level of foreign currency liquidity, which is necessary to fuel the official market and to eliminate the parallel market, and its consequences on the external accounts, which a priori should be positive. The devaluation must be big enough to fuel the recovery of the external accounts, and there must be enough foreign currency liquidity to ensure the credibility of the new official exchange rate for foreign investors. We have drawn several conclusions from the examination of three past devaluations, in Egypt (March 2016 and 2003) and internationally (Argentina, December 2015).

March 2016: a liquidity shortage

Although last March's devaluation helped partially correct the overvaluation of the Egyptian pound, it resolved nothing in terms of foreign currency liquidity. The devaluation was too small to have a real impact on Egyptian foreign trade: the pound was devalued by only 13%, even though the spread with the parallel market was more than 20%, and barely offset average annual price inflation. Most importantly, foreign reserves were too small to meet foreign currency demand and to unify the forex market. Although the central bank needed an estimated USD 25 bn, it only had a little more than USD 16 bn on hand, and consequently had to continue rationing foreign currencies. The absence of a liquidity shield and an overly timid devaluation of the pound failed to send international investors a strong signal, and they stayed out of the market.

2003 devaluation: hydrocarbons buoy exports

In 2003, the Egyptian pound was devalued by 15% against the dollar at a time when foreign currency liquidity was relatively comfortable: CBE foreign reserves were equivalent to more than 8 months of imports of goods and services. The devaluation triggered a significant increase in Egyptian exports. In volume terms, exports rose 15% on average between 2004 and 2008, and by 27% in value terms over the same period. Foreign reserves also doubled over this period to USD 31 bn at year-end 2008. Despite these positive trends, the devaluation apparently did not enable the Egyptian economy to make sustainable competitiveness gains.

A large part of this export growth was due to a big increase in hydrocarbon exports. Gas exports rose 45-fold in volume terms between 2003 and 2006, largely offsetting the decline in oil exports. All in all, hydrocarbon export volumes increased 27% on average between 2004 and 2006. The increase was even bigger in value

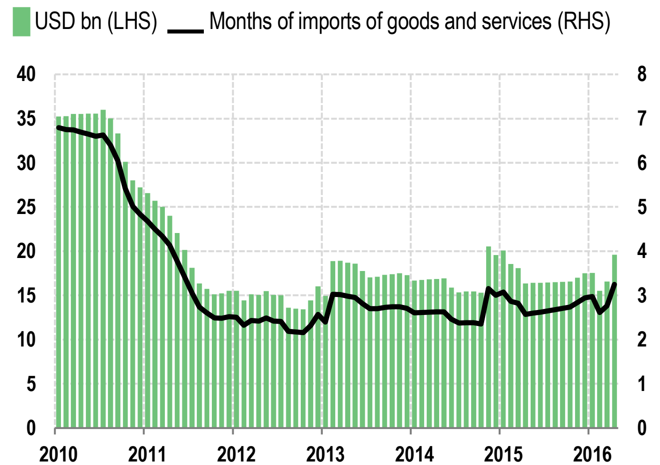
1- Forecasts*

	2014	2015	2016e	2017e
Real GDP growth (%)	2.2	4.2	3.0	4.0
Inflation (CPI, year average, %)	10.1	11.0	10.2	14.0
Gen. Gov. balance / GDP (%)	-12.2	-11.5	-11.5	-10.5
Gen. Gov. debt / GDP (%)	86.0	85.0	82.0	81.0
Current account balance / GDP (%)	-1.0	-3.9	-5.7	-5.5
External debt / GDP (%)	16.0	17.0	19.0	21.0
Forex reserves (USD bn)	15	20	18	19
Forex reserves, in months of imports	2.6	3.1	2.6	3.0
Exchange rate EGP/USD (year end)	7.2	7.6	8.90	12.0

(*) Fiscal years T-1/T (July-June)

e : BNP Paribas Economic Research Group estimates and forecasts

2- Central bank foreign reserves



Sources: ECB, BNP Paribas

terms (+28% on average) due to the ongoing rise in oil prices. The stagnation and then decline in hydrocarbon exports as from 2008 marks the beginning of the decline in Egyptian exports as a share of world trade.

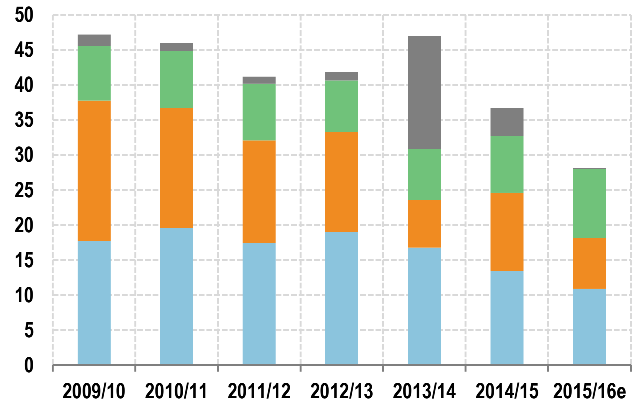
Argentina 2015: a specific situation

The devaluation of the Argentine peso in December 2015 offers a few elements of comparison with the Egyptian situation. Prior to the devaluation, the spread between the official and parallel market exchange rates for the peso was higher than 50%, mainly due to extensive rationing. Alongside a major key rate increase to attract deposits into the official banking system, the peso's exchange rate was devalued until it was brought in line with the parallel market. Since then, the spread between the two exchange rates has averaged less than 3.5%. Foreign reserves have also increased significantly. The improvement in the external accounts observed over the course of 2016 is largely due to specific factors and cannot be attributed to an improvement in external competitiveness. Trade barriers were removed, soya prices surged 24% in H1 2016, and tax amnesty encouraged the return of capital flows. Moreover, the moderate current account deficit (estimated at 2.4% of GDP in 2016) in the midst of an economic recession facilitated the sustainability of the external accounts. All of these factors limit the pertinence of the Argentine example as a model for Egypt.

Egypt in late 2016: strengths and weaknesses

In the light of these three examples, the Egyptian authorities have certain strengths, but the post-devaluation period remains uncertain. If all of the expected external financial support comes together, the central bank's reserves would reach about USD 30 bn, which seems largely sufficient to meet greater foreign currency demand in the official market. In addition to the first tranche of the IMF loan of USD 4 bn, another USD 4 bn will come from Saudi Arabia (a USD 2 bn deposit has already been made) and China, while an international bond issue is expected to raise USD 3 bn. There is much greater uncertainty over the impact of devaluation on the external accounts. Despite strong foreign currency rationing (or an access at a much higher price), imports increased 14% in volume in 2015, and the IMF is expecting even stronger import growth in 2016 (+16%). Although the devaluation should hold down imports as of 2017, the ongoing increase in hydrocarbon imports and the expected increase in oil prices on international markets (+14% for Brent crude oil) should favour import growth in both value and volume. Non-hydrocarbon exports (about a quarter of current account receipts) should benefit from the change in parity, assuming that exporters adjust their sales prices. Yet the current account deficit is likely to remain high at least until 2018. Presently, the key components of the current account deficit are not very sensitive to the price factor. The troubles in tourism (20% of current account receipts in 2010) are largely due to security issues, while the very mixed outlook for world trade growth will strain Suez Canal revenues (9% of receipts). Lastly, the growing energy-related deficit (USD 3.6 bn in 2016, 20% of the current account deficit, compared to a surplus of more than USD 5 bn in 2010) will not begin to be absorbed before 2018, thanks to the start-up of production at the Zohr and Nile Delta gas fields.

3- Main external revenues
% of current account receipts



Sources: ECB, BNP Paribas

Consequently, the chances that the foreseeable devaluation will succeed are uncertain. The pledged financial support corresponds to about a year of the country's external financing needs (about USD 11 bn). This means foreign-currency liquidity will continue to be vulnerable to any unexpected shocks (higher commodity prices, deterioration in the political situation, delays in the start-up of the natural gas fields), which would require central bank intervention to bolster the pound. It seems most likely to us that the Egyptian central bank will not allow the pound to float completely freely, in order to limit imported inflation.

Another major risk is the social consequences of the announced reforms. With inflation currently peaking at the highest level in more than 5 years (+14.1% y/y at end-September 2016), another cut in energy subsidies and the impact of the pound's devaluation on the prices of imported goods will significantly squeeze household purchasing power.

Although the devaluation of the Egyptian pound is necessary, it is nonetheless a risky process for two reasons: the external accounts will continue to show a big deficit at least through 2018, and its potentially negative social consequences. The external financial support promised for this fall will have to be extended for at least the next two years.

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Algeria

Economic growth on life support

Although the economy is hitting hard, it has not contracted, at least not yet. By the end of the year, the oil stabilisation fund will be likely depleted, while the upturn in oil prices – assuming it is confirmed – will be not sufficient to restore the sustainability of public finances. Public debt is low, which leaves some manoeuvring room. Yet there are still concerns about the government's future investment capacity. Reforms are advancing, but very gradually. In the midst of a sustained shock, more will have to be done to remove the constraints on private sector development. Although the financial system's stability is not threatened, liquidity is coming under greater pressure.

Growth resilient, but imbalances soar

With the hydrocarbon sector generating more than 95% of exports and about 60% of government revenue, the Algerian economy has been hard hit. Even so, it continues to report satisfying performances in terms of growth. In 2015, GDP growth stabilised at 3.8%. With the exception of the United Arab Emirates (UAE), this was the best performance among oil producing countries in the region. Most importantly, the economy has not shown any tangible signs of slowing down. In the first 6 months of 2016, growth is likely to reach 3.6%, supported among other factors by the renewed momentum of the hydrocarbon sector (+3.2%) after virtually stagnating in 2015 (+0.6%) following an uninterrupted decline from 2006 to 2014. Excluding the hydrocarbon sector, growth slowed to 3.8% in H1 2016 from 5.7% in Q4 2015, but this was mainly due to poor weather conditions which affect the agricultural sector (12% of GDP). In the construction and services sectors, two pillars of the economy, the slowdown should be much less severe, which partly explains the unexpected decline in the official unemployment rate, from 11.2% in September 2015 to 9.9% in April. In any case, we are a far cry from the troubles predicted in mid-2015, even though H2 risks being less buoyant due to the rise in inflation, which has culminated around 8% recently, vs. 5% earlier in the year.

Yet this resilience comes at a cost. The budget deficit has more than doubled in 2015, to 16.2% of GDP, under the combined impact of a record volume of public spending (46% of GDP, up 6 points compared to 2014) and the contraction of fiscal revenues by a little over 10%. At the end of June 2016, the Treasury reported an overall deficit equivalent to 50% of the 2015 deficit and to 70% of the 2016 financing bill. In other words, the dynamics of public finances has not changed, at least for the moment, despite government commitments to cutback spending by 9%. At the same time, three quarters of the H1 deficit was funded by the oil stabilisation fund: DZD 1,333 bn was withdrawn from a stock of DZD 2,151 bn at year-end 2015. Legally, the oil stabilization fund cannot drop below a floor of DZD 740 bn, which suggests that available fiscal reserves will be totally depleted by the end of the year.

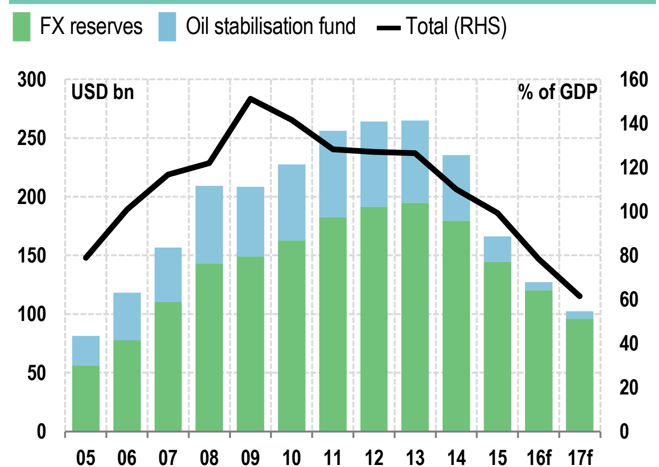
The magnitude of the shock can also be seen in the deterioration in external accounts. The trade balance showed a significant deficit in 2015, and figures for the first 7 months of 2016 continue to paint a bleak picture. At the end of July, exports covered only 56% of imports, down from 70% during the same period in 2015. Despite the recent rebound in oil prices, the current account deficit will remain historically high, at 16% of GDP in 2016, before narrowing slightly to 14.1% of GDP in 2017. Without significant capital inflows, external liquidity will continue to deteriorate. All in all, FX reserves are likely to drop back below USD 100 bn by year-end 2017, from a peak of USD 195 bn in 2013. Nonetheless, the country's external solvency does not seem to be at risk, at least in the short term. Although FX reserves have fallen sharply, they still cover about 20 months of imports of goods and services. Most importantly, external debt is almost inexistent.

1- Forecasts

	2014	2015	2016f	2017f
Real GDP growth (%)	3.8	3.8	3.1	2.6
Inflation (CPI, year average, %)	2.9	4.8	6.6	6.3
Gen. Gov. balance / GDP (%)	-7.2	-16.2	-13.6	-9.9
Gen. Gov. debt / GDP (%)	8.7	12.4	17.3	26.1
Current account balance / GDP (%)	-4.2	-16.4	-15.8	-14.1
External debt / GDP (%)	1.2	1.6	2.1	2.4
Forex reserves (USD bn)	180	145	120	96
Forex reserves, in months of imports	30.3	27.3	25.1	19.7
Exchange rate DZD/USD (year end)	87.9	107.2	113.0	119.0

f: BNP Group Economic Research estimates and forecasts

2- Erosion of buffers



Sources: Central bank, Ministry of Finance, BNP Paribas

Public spending inertia

Armed with abundant financial reserves, the authorities decided to absorb the oil shock at the price of significant macroeconomic imbalances. Although this gradual adjustment strategy was coherent at first, it now leaves numerous questions unanswered. In particular, the public finance trajectory is a major source of concern at a time

when the State continues to play a significant role in the economy (42% of the active population works in the public sector).

The government currently needs oil prices of about USD 90 a barrel to balance its budget. Even if the recent upturn in oil prices is confirmed, it will not suffice. With the probable depletion of the oil stabilisation fund in 2016, the accumulation of fiscal deficits as of 2017 will rapidly drive up public debt. According to our estimates, the public debt will exceed 30% of GDP in 2020, compared to 12% in 2015. Yet this is based on the assumption that public spending growth will remain moderate, which is far from certain. Demographic growth is still very strong (+2% a year). Moreover, the size of public sector wage bill has doubled as a share of GDP in the span of 10 years, and the cost of social transfers is still huge despite the adjustments introduced in early 2016. Under this environment, the government's investment policy is likely to become an adjustment variable, to the detriment of economic activity, even though the high level of public investment (14.5% of GDP over the past five years) clearly offers some streamlining potential.

Very gradual reforms

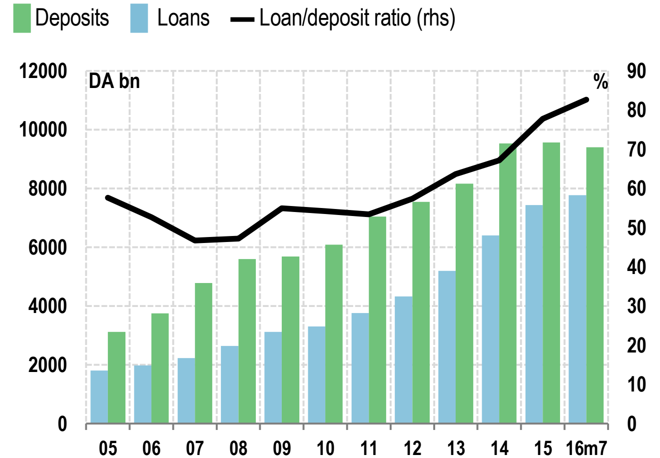
Moreover, for the gradual adjustment strategy to function properly, it must be accompanied by a reform programme to remove the obstacles hindering private sector development. The overall strategy still lacks visibility. On the one hand, a new investment code offering numerous fiscal advantages has just been promulgated, regulations for using foreign currency have been eased for export companies, and the government plans to authorise the listing of the main state-owned banks and to give non-resident investors the opportunity to participate in these operations. Similarly, the 51/49 rule, which limits the stake of non-residents in any new investment projects to a maximum of 49%, was removed from the scope of the investment code and transferred to that of finance law, which gives the authorities greater flexibility to revise it. A first step has been taken: in the 2017 budget, the rule will no longer apply to the banking sector. Even so, it will remain in effect in the other sectors, illustrating the obstacles on the path to greater opening, despite the pressing need to restore the economy's attractiveness. Since 2012, FDI inflows have constantly fallen short of 1% of GDP, compared to more than 3% in Morocco. Measures must also be taken to reduce administrative red tape and to further diminish the weight of the informal economy. This is a long-term strategy, but the more time that slips by, the narrower the room to manoeuvre.

The financial system's stability, a risk to monitor

Like the rest of the economy, the banking sector has been resilient so far. The non-performing loan ratio is certainly high, but remains stable at 9.4%; the capital adequacy ratio is well above regulatory standards at 17% in 2015; and the profitability of the banking system as a whole continues to improve thanks to robust credit dynamics. Banks can also rely on a liquidity buffer built up during the period of high oil prices. The financial system's stability is not threatened in the short term.

However, the consequences of a sustained shock should not be underestimated. In addition to the probable increase in credit risk, due to uncertainty over growth prospects and high exposure to state-owned companies (51% of credit outstanding for the economy), banks are going to have to adapt to a new liquidity environment.

3 - Bank lending and deposits



Source: IMF

The decline in oil revenues and the growing financing need for corporate financing considerably already strain deposit collection. At the end of July, deposits growth even dipped slightly into negative territory. Since credit dynamics have remained relatively strong, there has been a net deterioration in the bank loan-to-deposit ratio. Though still comfortable at 82.7%, this is the highest the ratio has been since the early 2000s. As a result, the central bank decided to reopen its refinancing window in early 2016. The 2017 budget also calls for the government to inject USD 380 million in capital into the state-owned banks, which shows that it takes this subject very seriously. This is especially since banks will also be called on more frequently to cover the government's financing needs, and it must avoid feeding the risk of a crowding-out effect in an economy where credit barely exceeds 40% of GDP.

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South Africa

Political noise and addiction to external financing

The Q2 rebound is likely to be short lived since the economy still lacks a powerful growth engine. Recent political tensions could trigger renewed volatility in the financial markets and reduce the availability of external financing, especially if South Africa's foreign currency sovereign rating is downgraded to speculative grade. This would have a particularly negative impact on growth given the country's substantial financing needs and apparently limited adjustment mechanisms.

A deceptive rebound

The rebound in Q2 real GDP growth (+3.3% q/q saar, vs. -1.2% q/q saar in Q1) is likely to be short lived since the South African economy still lacks a powerful growth engine. On the supply side, the strong pick-up in activity observed in the mining and manufacturing sectors accounted for about 70% of the acceleration in real GDP growth. Yet these rebounds should be read in light of Q1 poor readings, and are therefore hard to extrapolate. So is the surge in exports (+18.1% q/q in Q2, vs. -8.1% q/q in Q1), which is their mirror on the demand side, and can hardly continue in a persistently morose external environment. Above all, domestic demand was still anaemic in Q2. Household consumption rose only mildly, up +1% q/q saar in Q2, and investment continued to contract (-4.6% q/q saar) for the third consecutive quarter. The strong Q2 performance should therefore not be allowed to mask the recessionary pressures that continue to strain the economy.

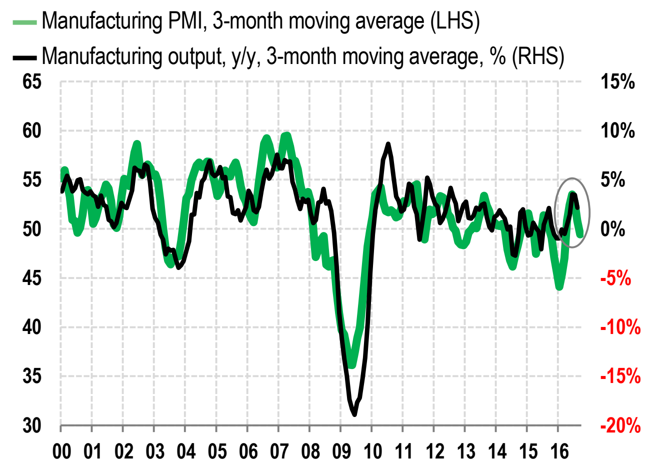
The composite business cycle indicators reported by the South African Reserve Bank (SARB) still do not suggest that the economy is about to bottom out, and Q3 data available so far are not very encouraging. On the supply side, both the PMI and production figures suggest that the manufacturing sector is unlikely to have repeated its Q2 performance in Q3. In July-August, manufacturing production printed 1.5% below Q2 average, meaning that the sector could have contributed negatively to Q3 real GDP growth. On the demand side, retail sales (-0.4% m/m in July-August compared to the previous quarter's average) and household lending (-4.3% yoy in real terms in August) both signalled the persistent weakness of consumption. In this environment, we continue to call for very weak growth this year and next, with South African real GDP rising barely 0.4% in 2016 and 1.3% in 2017. This forecast could even prove to be overly optimistic if political tensions continue to build.

1- Forecasts

	2014	2015	2016f	2017f
Real GDP growth (%)	1.6	1.3	0.4	1.3
Inflation (CPI, year average, %)	6.1	4.6	6.2	5.3
Gen. Gov. balance / GDP (%)	-4.3	-4.2	-4.0	-3.8
Gen. Gov. debt / GDP (%)	46.8	50.5	51.2	51.0
Current account balance / GDP (%)	-5.4	-4.4	-4.3	-4.2
External debt / GDP (%)	41.4	43.3	45.5	47.3
Forex reserves (USD bn)	44.3	41.6	39.8	36.8
Forex reserves, in months of imports	4.9	5.9	6.6	5.9
Exchange rate ZAR/USD (year end)	11.6	15.5	14.2	14.8

f: BNP Paribas Group Economic Research estimates and forecasts

2- Still weak industrial momentum



Source: BER- Stats SA - BNPParibas

Political rumours on the rise

Political tensions have picked up following August's municipal elections in which the ANC staged its worst performance (53.9% of the vote) since the end of apartheid, and lost control of three of the country's biggest metropolitan areas (including Pretoria and Johannesburg). Rumours about an "early recall" of President Zuma have come back to the forefront, with the president also facing the threat of the possible reinstatement of 783 corruption charges that were thrown out just a few weeks prior to his 2009 election. In mid-August, Finance Minister Pravin Gordhan was summoned by the Hawks, an elite police unit, on allegation related to corruption charges and the creation of an illegal rogue spy-unit when he was head of the tax administration, but declined to appear. After weeks of uncertainty, the National Prosecuting Authority (NPA) has decided to pursue the case, but for the moment it is only retaining fraud charges related to the granting of pre-retirement benefits and subsequent reinstatement of a high level official while Pravin Gordhan was finance minister. These relatively minor charges, at least with respect to the positions held by Pravin Gordhan, and his recent disagreements with Jacob Zuma have fuelled rumours of a political complot in which the president himself is pulling the strings.

In any case, these political rumours are increasing the probability that South Africa's foreign currency sovereign rating could be downgraded below investment grade, notably by Standard & Poor's. In our view, the rating agencies could act swiftly if dissensions were to grow within the ANC or if the corporate governance of state-

owned companies deteriorates further. From a more general perspective, the recent political/legal affairs might have a negative impact on the markets. The rand depreciated by 3.5% after the NPA announced its decision to pursue charges against the finance minister, while 5-year CDS gained nearly 20 basis points. Pravin Gordhan's resignation or dismissal would surely trigger even wider movements. The markets reacted very strongly last December after Jacob Zuma dismissed the previous finance minister, Nhlanhla Nene, and replaced him with a fairly unknown member of parliament supposed to be more pliant. The president was forced to backtrack, and reappointed Pravin Gordhan, the finance minister from 2009 to 2014, whose "clean hands" reputation reassured investors. Another game of musical chairs at the head of the finance ministry – coupled with a possible downgrade of the foreign currency sovereign rating – would probably trigger greater financial volatility. This is bound to have a negative impact on the dynamics of non-resident capital flows, with a harmful impact on growth.

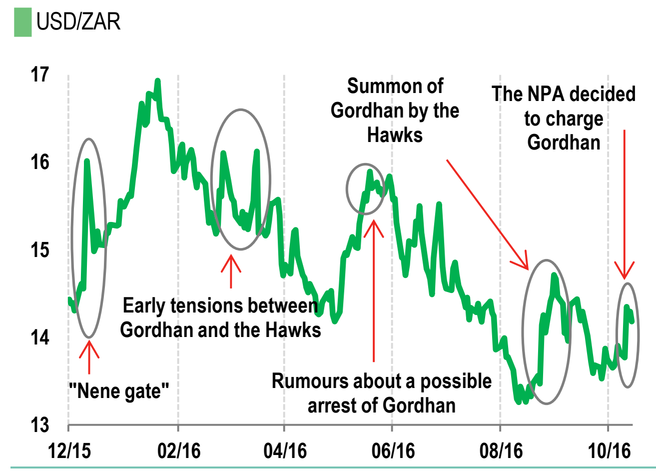
Highly dependent on external financing

South Africa has a hefty current account deficit (5% of GDP on average since early 2012, and 4.4% of GDP over the past four quarters), whose financing is rather dependent on short-term capital flows. Since 2014, FDI inflows have covered less than a third of the current account deficit. In net term, FDI have even turned out to be negative due to rising investments abroad by residents. In contrast, the relative weight of net bank financing reported as "other investments" and poorly identified capital flows classified as "unrecorded transactions" has increased since 2012. However, the sustainability of these two categories of flows is uncertain in our view. For the most part, bank financing lines seem to be made of short-term loans, while the drivers of "unrecorded transactions" are unknown by definition. Net portfolio investments have continued to cover about a third of the current account deficit, although with major fluctuations that bear witness to their volatility.

The size of South Africa's stock of non-resident portfolio investment (USD 196 bn in Q2 2016) also suggests that there could be major capital outflows in case of an abrupt change in expectations, even after taking into account the drop-off in valuations that would occur during a massive sell-off. According to estimates by JPMorgan and the IMF, "forced sales" alone – due to regulatory restrictions or index-linked investment strategies – would amount to about USD 2 bn if the foreign-currency sovereign rating were to be downgraded below investment grade, and USD 6 bn if the local-currency debt were also downgraded. Yet this figure does not take into account the impact a sovereign downgrade would have on the ratings of other local issuers and on the regulatory capital requirements for foreign banks holding South African sovereign debt instruments.

3- Political rumours: an additional source of volatility

USD/ZAR exchange rate



Sources: Reuters, BNPParibas

Of course, some factors may limit the risks of an abrupt adjustment. First, South Africa's foreign-currency financing needs are smaller than suggested by the balance-of-payment data, if only because 44% of the country's external debt (and corresponding payments) are denominated in rand. Second, residents hold an estimated USD 450 bn in foreign assets, and we estimate that about half could be rapidly liquidated to cover foreign-currency financing needs. Currency depreciation would also trigger the automatic repatriation of foreign assets by financial institutions for regulatory reasons. The central bank also has more than USD 40 bn in foreign reserves, an amount high enough to cover next year financing needs in our view.

Despite these support factors, the adjustment might be recessive should capital inflows decrease in the coming months/years, and even more so in case of net capital outflows. Exports do not show much expansion potential, especially since supply-side constraints limit their sensitivity to currency depreciation. Given the non-negligible pass-through that exists between the exchange rate and prices, the SARB would also probably have to tighten monetary conditions again to limit the currency's depreciation and avoid a slippage in inflation. All in all, the adjustment to less favourable capital flows dynamics would necessarily entail a sharp reduction in imports, i.e. in consumption and investment.

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Publisher: Jean Lemierre
Editor : William De Vijlder