

ECO EMERGING

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Editorial

Malaise

In the October 2018 World Economic Outlook, the IMF lowered its economic growth forecasts for the majority of the emerging and developing countries. Over the past six months, the downside risks to their short-term prospects have worsened, and some have even materialised. The IMF sees higher tariff barriers and trade tensions as one of the main threats to economic growth. International financing conditions are also expected to deteriorate further. Investors proved to be selective during the recent bout of emerging market turmoil. However, the sources of vulnerability are likely to continue to rise and the risks of contagion in case of a shock could spread gradually.

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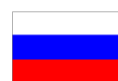
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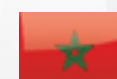
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Malaise

In the October 2018 World Economic Outlook, the IMF lowered its economic growth forecasts for the majority of the emerging and developing countries. Over the past six months, the downside risks to their short-term prospects have worsened, and some have even materialised. The IMF sees higher tariff barriers and trade tensions as one of the main threats to economic growth. International financing conditions are also expected to deteriorate further. Investors proved to be selective during the recent bout of emerging market turmoil. However, the sources of vulnerability are likely to continue to rise and the risks of contagion in case of a shock could spread gradually.

Between the April and October 2018 editions of its World Economic Outlook, the International Monetary Fund has revised downwards its economic growth forecasts for the vast majority of countries. For the emerging and developing economies as a whole, average real GDP growth is expected to level off at 4.7% in 2018 and 2019. This is relatively solid growth, which is very close to both the 2017 rate and the average of the five previous years. But new forecasts are significantly lower than in the April outlook, which called for average real GDP growth of 4.9% in 2018 and 5.1% in 2019. According to the IMF's new scenario, the period of economic growth acceleration registered in 2016-2017 is already over.

Economic growth estimates were lowered for numerous emerging and developing countries, illustrating the diversity of risks threatening their short-term prospects. There were a few upward revisions, mainly for the oil exporting countries, such as Saudi Arabia and Russia, which benefit from the stronger-than-expected increase in oil prices in 2018 (+31% in the IMF scenario) and their relative stability in 2019.

The downside risks to growth have worsened over the past six months and some have begun to materialise, foremost of which is the rise of protectionism. New tariff barriers will drive up the cost of trade, dampening China's export prospects as well as those of some of its Asian trading partners (notably Taiwan, South Korea and the ASEAN countries) due to the risk of cascading effects through the region's supply chains. World demand growth, and thus Asian exports, have already slowed in 2018 following a vigorous rebound in 2017: according to CPB, global trade volumes increased 3.7% year-on-year in January-July 2018 compared to 4.4% in 2017. Yet only the most recent figures show a possible impact of US protectionist measures (given the acceleration of Chinese merchandise shipments to the US last summer and the recent slowdown in Taiwanese and South Korean exports). Moreover, uncertainty over growing trade tensions between the United States and its trading partners could curb private investment and thus aggravate the recessionary impact of protectionist measures. Eroding confidence is also likely to contribute to the rise in global financing costs.

Global borrowing conditions for corporates and governments in emerging countries have deteriorated since Q2 2018. Until now, foreign investors have taken a selective approach to portfolio investment outflows. Emerging countries with severe external imbalances and weak macroeconomic fundamentals (and possibly also with high political risks) have been hit hardest by capital

outflows and currency depreciation. Turkey and Argentina are the two extremes (they post major external and internal imbalances and high foreign-currency debt burdens). Their currencies collapsed between March and September. Currencies also fell sharply in South Africa and Brazil (hit by deteriorating public finances and sluggish economic growth) and in India and Indonesia (where current account deficits are widening due to the upturn in oil prices, and external financing partly relies on short-term capital). Russia is the big exception: the rouble has dropped sharply over the past six months due to tighter international sanctions, despite improvements in both the current account and fiscal surpluses. Central banks in these countries have raised policy rates in recent months, in turn constraining domestic demand. In the short term, international financing conditions are expected to continue to tighten, and this trend could even accelerate abruptly in case of a new shock (such as a stronger-than-expected increase in US inflation or a political shock).

Seen in this light, the international environment is likely to continue to become less favourable (reduction in capital flows and higher financing costs, slowdown in external demand and trade volumes, high oil prices), resulting in the gradual spread of risks within the emerging countries and an increase in their macroeconomic vulnerability (higher inflation, wider external deficits, less dynamic economic growth and pressures on public finances). Against this backdrop, financial volatility and risk aversion are bound to rise, and international investors could opt for less discriminating strategies, therefore aggravating contagion effects between emerging countries in case of a shock.

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China

Which growth engines could pick up the slack of exports?

The Chinese authorities have responded to the economic slowdown and US trade barriers by loosening monetary policy and letting the yuan depreciate in recent months, while considering fiscal stimulus measures. With policies to boost demand, the economic growth slowdown is likely to continue at a moderate pace in the short term. Any rebound in investment, however, is likely to be limited, restricted by the deterioration of export prospects, corporates' excessive debt, industrial restructuring measures and Beijing's determination to promote healthier development in the real estate market. As to private consumption, it may not be strong enough to pick up the slack.

US trade barriers are striking Chinese industry at a wrong time. Firstly, the world market share of China's export sector has been declining for the past two years (reaching 13% in 2017), principally due to the erosion of its cost competitiveness. Moreover, export growth has lost steam since early 2018. So far, this slowdown has been in line with the electronics cycle and less dynamic world demand, and not due to US trade barriers. To the contrary, growth in exports to the US even picked up between June and September, probably due to the acceleration of shipments in anticipation of higher tariffs (chart 2). Secondly, for several months now, Chinese corporates have been experiencing some difficulties due to tighter domestic credit conditions and the economic growth slowdown. This has been illustrated by the upturn in non-performing loans in commercial banks' balance sheets and by the rising number of defaults in the bond market.

The protectionist shock further darkens China's export and economic growth prospects. We have revised downwards our real GDP growth forecast for 2019 to 6.1%, compared to our previous estimate of 6.3% made last quarter. We have not changed our 2018 forecast of 6.4%. As a matter of fact, even if there is a high risk that US tariff hikes will be extended – at least temporarily – to all Chinese exports (about half are currently targeted by tariff increases of between 10% and 25%), the economic slowdown should remain moderate in the short term¹.

Merchandise exports to the US account for 19% of China's total exports, and only 4% of its GDP. The contribution of foreign trade to GDP growth has diminished over the past decade, which should reduce the direct impact of the current shock. Yet the export sector is still a key engine of economic activity because private consumption is not solid enough to pick up the slack and because the export industry's performance has gearing effects on the rest of the economy, via investment, the job market and thus consumption. As a result, the expected export growth slowdown could strain the needed process of expansion in private consumption.

■ Which policy measures to help absorb the shock?

Consequently, the authorities are expected to implement an economic policy mix that will help reduce difficulties of export corporates and boost domestic demand. Yet they have relatively little manoeuvring room. Monetary policy has been loosened slightly

¹ For more on the recent economic growth slowdown and the impact of US protectionist measures, see EcoPerspectives, BNP Paribas: *China – Concerns*, Q3 2018 and *China – Not the right time for a trade war*, Q2 2018.

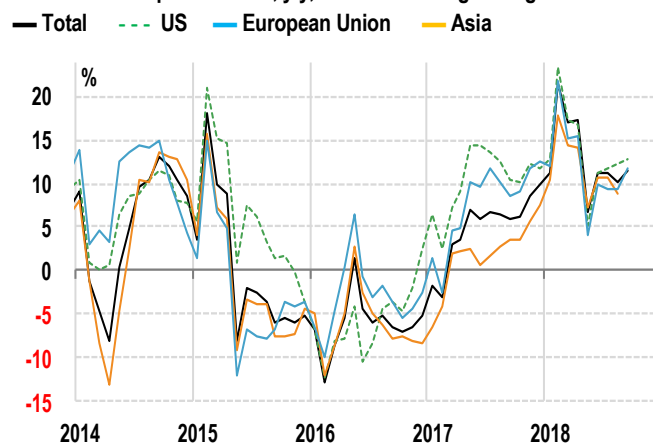
1- Forecasts

	2016	2017	2018e	2019e
Real GDP growth (%)	6.7	6.9	6.4	6.1
Inflation (CPI, year average, %)	2.0	1.6	2.1	1.9
Official budget balance / GDP (%)	-3.8	-3.7	-3.3	-3.6
Central government debt / GDP (%)	16.1	16.3	18.1	20.2
Current account balance / GDP (%)	1.8	1.4	0.6	0.1
Total external debt / GDP (%)	12.7	14.2	14.3	15.2
Forex reserves (USD bn)	3 011	3 140	3 041	2 853
Forex reserves, in months of imports	18.6	17.0	14.8	13.3
Ex change rate USDCNY (year end)	6.9	6.5	6.9	6.9

e: BNP Paribas Group Economic Research estimates and forecasts

2- Export growth is losing steam

Merchandise exports in USD, y/y, 3-month moving average:



Source: China General Administration of Customs, BNP Paribas

since Q2 2018, mainly through liquidity injections in the financial system (on 7 October, the government announced that reserve requirement ratios would be lowered again to 14.5% from 15.5%). Retail banks are being encouraged to step up lending, notably to small and mid-sized companies. This monetary policy loosening represents a major policy shift: since year-end 2016, the authorities' explicit priority was to reduce the risks of financial instability and to deleverage state-owned enterprises. In the short term, this could



slightly aggravate the China's already excessive debt (non-financial sector debt was estimated at 226% of GDP in mid-2018²). Even so, improving financial sector regulations, downsizing shadow banking activities and reducing the sources of vulnerability in the financial system are bound to remain top priorities. Consequently, monetary policy easing measures are likely to remain very cautious.

China's exchange rate policy has also evolved since Q2 2018. The yuan has lost 9% against the USD and 4% in nominal effective terms between the end of March and the end of September, after appreciating over the previous 15 months. Against the backdrop of US monetary tightening, a stronger dollar and currency depreciation pressures in emerging markets, the authorities have let the yuan depreciate to offset partially the negative effects of higher tariffs on the export sector. If new protectionist measures are introduced, the yuan could weaken further. Yet Beijing will have to limit the use of the exchange rate policy to avoid aggravating tensions with Washington and prevent yuan depreciation pressures, which could trigger a vicious circle of capital outflows, new pressures on the currency and financial volatility.

Lastly, on the fiscal policy front, the authorities are expected to implement tax incentives to boost corporate and household demand and measures to stimulate investment in public infrastructure. Central government finances are solid enough to absorb any deterioration: after improving slightly to 3.3% of GDP in 2018, the fiscal deficit could swell to 3.6% in 2019, and its debt should hold close to 20% of GDP. In contrast, local governments, which continue to fund most infrastructure projects, are constrained by an already heavy debt burden (44% of GDP, including financing vehicles). Consequently, even if the authorities intend to develop public-private partnerships and to increase strongly new local government bond issues (to RMB 1000 bn in H2 2018, up from RMB 333 bn in H1), the rebound in infrastructure investment is likely to be limited (the nominal growth rate dropped from 19.8% y/y in January-August 2017 to 4.2% in the same period in 2018, and is likely to remain below 10% in the short term).

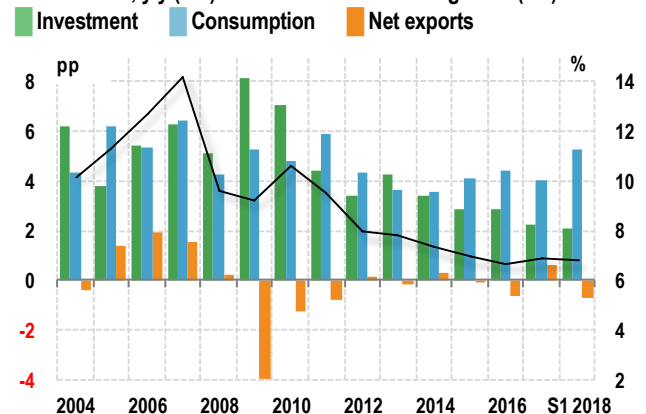
■ Can private consumption pick up the slack from exports?

The rebound in investment on other key sectors is also likely to remain mild. Investment in the manufacturing sector (+7.5% in January-August 2018) will be restricted by deteriorating export growth prospects and the need to rein in corporate debt, as well as by industrial restructuring measures to reduce excess production capacities and to shut down the most polluting factories. Investment in the real estate sector (+7.9% in January-August 2018) will be restrained by the authorities' efforts to promote a healthier property market development and to curb house price inflation.

That leaves private consumption. It accounted for only 39% of GDP in 2017 and might not be solid enough to pick up the slack from investment and external demand. Moreover, it is also likely to be hit by the slowdown in exports. Growth in volumes of retail sales

3- Fragile rebalancing process

— Real GDP, y/y (rhs) and contribution to GDP growth (lhs)



Source: National Bureau of Statistics of China, BNP Paribas

weakened from 10% y/y in mid-2017 to 6.6% in August 2018, notably due to the expiration of tax incentives on automobile purchases and the downturn in durable goods purchases. Yet households benefited from a slight upturn in real wage growth in 2017 (estimated at 7.1%), and the consumption of services has increased, as suggested by the solid revenue growth of services enterprises. This means the sources of growth have continued to be rebalanced slowly, fuelled primarily by the expansion of services. As a matter of fact, the combined contribution of public and private consumption to real GDP growth rebounded to 5.3 percentage points (pp) in H1 2018, after declining to 4.1 pp in 2017 (chart 3).

However, the export growth slowdown is bound to hit the job market in the short term, and the resulting deceleration in wage growth risks weighing on household spending. In addition, the development of China's private consumption continues to be hampered by a very high household savings rate (40% of revenues, and national savings represent 46% of GDP). Even if social welfare and housing reforms are gradually implemented, Chinese households will maintain high savings to cope with the still very high cost of housing, education, healthcare and retirement. Lastly, household debt has increased rapidly in recent years, reaching 49% of GDP in Q1 2018, and the debt servicing burden could soon begin to cut into their budgets.

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² Estimates are based on "social financing" data and local government bonds, and exclude the central government.



India

Rising pressures

Pressures have been on the rise since April 2018. Narendra Modi's power has eroded. His party lost its majority position in the lower house of parliament. Growing difficulties in the financial sector have sparked higher refinancing costs. Despite solid growth in the first quarter of fiscal 2018/2019, the rupee has fallen to the lowest level on record after depreciating by more than 13% against the USD. India is vulnerable to higher oil prices (23% of imports) and capital outflows. Although its external position has weakened, India is nonetheless in a much more comfortable position than it was five years ago. At the end of September, foreign exchange reserves still covered 1.4 times its short-term external financing needs (less than 1 year), compared with 0.9 times in 2013.

■ Economic growth is still robust for the time being

India's economic activity has rebounded strongly since fall 2017. In the first quarter of fiscal year (FY) 2018/2019, GDP grew 8.2% year-on-year (y-o-y). Household consumption and the dynamic services sector are still the main growth engines. Industry continues to make a smaller contribution to growth than services, but industrial activity was up 13.5% in fiscal Q1 FY2018/2019. Robust investment (+10% y-o-y) fuelled the production of capital goods.

Growth prospects are still favourable but the risks are on the rise. Business confidence indicators are still in positive territory, although they slipped slightly in August. It is also worth noting the slowdown in activity in infrastructure and automobile sales. Economic activity could also be strained by rising inflationary pressures, the increase in customs duty, the rupee's depreciation, monetary tightening (+50bp since summer) and the liquidity squeeze.

■ Greater financial-sector risks

The rebound in lending has fuelled the acceleration in economic growth. Yet the supply of loans could be strained by the deterioration in the financial situation of banks (84% of domestic lending, excluding government loans) and non-bank financial institutions.

At the end of March 2018, state-owned banks, which produce 55% of the loans granted by the banking and non-banking sector, reported major losses (roughly USD 9.6 bn). To consolidate their balance sheets, the government began injecting capital again as early as July 2018. The five most fragile banks¹ received capital injections of INR 113 bn (USD 1.7 bn) of the INR 650 bn (USD 11 bn) programmed by the end of March 2019. Even so, the rating agencies do not believe the amount of capital injections will suffice to fuel renewed lending, even though they should enable the banks to meet the new capital adequacy ratios adopted at the end of March 2019. For the private banks (22.5% of loans outstanding²), the situation is nothing like that of the state-owned banks, even though it has deteriorate slightly over the past two years. The non-performing loan ratio increased by 1.3 points to 4.2% in March 2018.

¹ Allahabad Bank, Andhra Bank, Corporation Bank, Indian Overseas Bank and Punjab National Bank

² Rural and non-resident banks distribute 13% of lending.

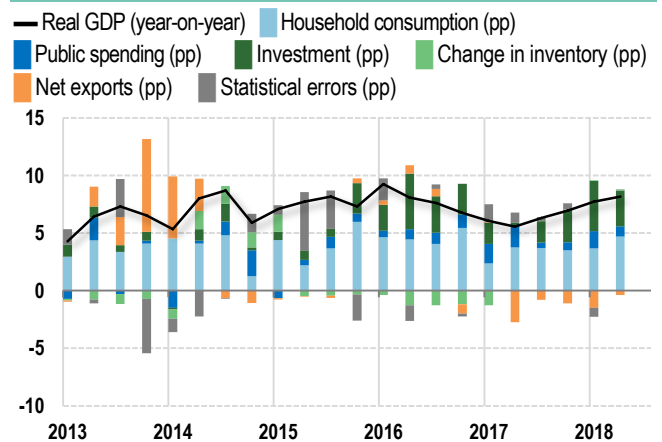
1- Forecasts

	2016	2017	2018e	2019e
Real GDP growth ⁽¹⁾ (%)	7.1	6.7	7.4	7.6
Inflation ⁽¹⁾ (CPI, year average, %)	4.5	3.6	4.8	4.6
Central Gov. Balance ⁽¹⁾ / GDP (%)	-3.5	-3.5	-3.4	-3.2
Central Gov. Debt ⁽¹⁾ / GDP (%)	47.2	47.0	46.5	45.5
Current account balance ⁽¹⁾ / GDP (%)	-0.7	-1.9	-2.4	-2.2
External debt ⁽¹⁾ / GDP (%)	20.7	20.4	20.8	20.6
Forex reserves (USD bn)	360	409	400	420
Forex reserves, in months of imports	11.6	11.5	9.4	10.8
Ex change rate USDINR (year end)	67.9	63.9	72.0	72.5

(1): Fiscal year from April 1st of year n to March 31st of year

e: BNP Paribas Group Economic Research estimates and forecasts

2- Real GDP growth acceleration



Sources: CEIC, BNP Paribas

Non-bank financial companies, whose weight has increased significantly over the past five years, might have to sharply curtail their lending activity as well. At the end of March, they accounted for more than 16% of credit supply (about 13% of GDP). Infrastructure Leasing and Financial Services (IL&FS), a company specialising in the development of infrastructure and lending services, defaulted in mid-September, and the public authorities were forced to intervene to keep it from going bankrupt. This triggered strong upward pressures on the bond market and reduced the refinancing capacity of non-bank financial companies.



At a time of higher liquidity needs (due to taxes payable at this time of the year), the squeeze on liquidity increased, although it was nothing like the levels that prevailed five years ago. The call money rate has increased by 60bp since January to 6.5% at the end of September (vs. 10.4% in September 2013). To limit these pressures, the central bank stepped up its asset purchasing programme. Nonetheless, it expects liquidity to remain under high pressure through March 2019.

■ Greater pressures on public finances

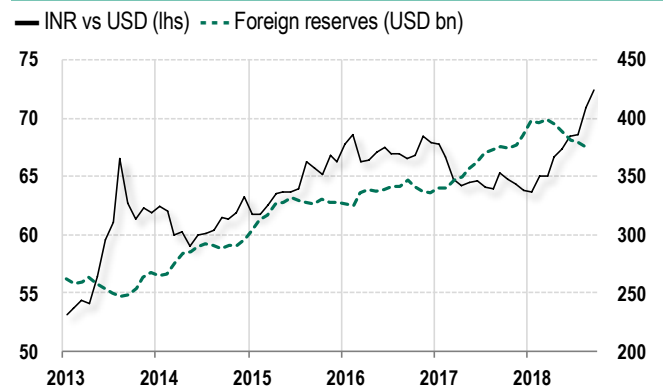
In the first five months of fiscal 2018/2019, the deficit hit 94.7% of its full-year target. Although this is not as bad as the budget overrun reported at the same period last year (96.1% of its full-year target, before revision), it will nonetheless be hard for the government to meet its target of reducing the budget deficit to 3.3% of GDP (vs. 3.5% in FY2017/2018), much like what happened last year. Revenues amounted to less than 28% of the full-year target. Although direct taxes increased sharply, indirect taxes rose only 4.6%, far short of the government's full-year target of an increase of more than 16.9%. VAT revenues were more than 23% below the government's target. Moreover, even though the finance ministry reiterated its determination to reduce the fiscal deficit, it must also deal with a busy electoral calendar. The administration has already announced an increase in the minimum support price for crops.

■ The rupee is at an all-time low

On 8 October, the dollar hit an all-time high against the rupee close to 74. The rupee has depreciated by more than 13% since the beginning of 2018, the sharpest decline reported among the emerging Asian countries. India is vulnerable to higher oil prices and capital outflows. To limit the downside pressure on its currency, the central bank made two 25-bp key rate increases in June and August, but the liquidity squeeze in the financial sector is restricting the manoeuvring room of monetary policy.

As net oil importer (23% of imports), India reported a 22% increase in its trade deficit in H1 2018. Although the current account deficit rose by 0.8 percentage points, it was nonetheless limited to 2.1% of GDP thanks to remittances by overseas workers. In mid-2013, in comparison, the current account deficit hit 5% of GDP. Foreign direct investment increased slightly to 1.2% of GDP, but this failed to cover the increase in the current account deficit. As a result, it has become more difficult to finance during a period of fierce tensions in the emerging markets. Like the other emerging countries, India has reported major capital outflows since April 2018 linked to rising trade tensions between China and the United States, the strong US economic performances, and the Federal Reserve's monetary tightening. In India, the stock of non-resident portfolio investment has declined by USD 18 bn (compared with USD 12 bn in Malaysia and USD 21 bn in Indonesia). Consequently, net capital inflows were down 79% q/q in the second quarter. They were not big enough to cover the current account deficit, which triggered a decline of nearly USD 25 bn in the central bank's foreign reserves. To at least partially offset the pressures on the current account balance, at the end of September the government announced that it was raising import duty on 19 items. Yet the impact on the current

3- Pressures on the rupee and foreign exchange reserves



Sources: RBI, BNP Paribas

account balance should be minimal, because these products account for only about 2.5% of India's imports. If the pressures on the rupee were to accentuate, in contrast, the government could opt to place quotas on gold imports, as it did in 2013.

Despite these balance-of-payment pressures, India is in a more comfortable situation than it was five years ago. At the end of September, foreign exchange reserves covered 1.4 times its short-term financing needs (less than 1 year), compared with only 0.9 times in 2013.

■ Chipping away at Narendra Modi's supremacy

Until last May, Narendra Modi seemed to be unshakeable. His Bharatiya Janata Party (BJP) lost its majority in the lower house of parliament after elections were held for four vacant seats. By joining forces against the BJP, the opposition parties managed to win the elections in two key bastions (Uttar Pradesh and Maharashtra). Although the coalition partner, the National Democratic Alliance (NDA), still holds a majority in the lower house of parliament, its position is not as comfortable as it was a year ago. According to the latest surveys published in July, the NDA should win the general elections in 2019, although it will lose some seats. Upcoming elections in four states between now and the end of January 2019 will help test the risks facing the ruling party, although the BJP currently controls three of the four states that will be holding elections.

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Brazil

Radical political changeover?

The economic, political and moral crisis that has held Brazil in its thrall for several years has crystallised in general elections that have seen a section of the electorate swing to the right. The Roussef and Temer presidencies – marred by corruption scandals and two years of deep recession in 2015 and 2016 – have provided a fertile ground for a further fragmentation of Brazil’s political landscape. The swinging of the political pendulum risks increasing social tensions at a time when the macroeconomic environment deteriorates as growth loses steam, investment contracts, government debt builds up and the external environment looks increasingly uncertain.

■ A possible shift to economic liberalism?

In a national context where corruption, violence and unemployment have been key preoccupations of the electorate, and with the country ranking last (137th) on the criteria “public trust in politicians” (component of the World Economic Forum’s Global Competitiveness Index 2017-18), Brazilians headed to the polls on October 7th to elect their President, 54 of their 81 Senators, all of their federal and regional Parliamentarians and their 27 State Governors. The polls’ predictions of recent weeks were borne out in the first round of the presidential elections as Jair Bolsonaro of the Partido Social Liberal (PSL) and Fernando Haddad of the Partido dos Trabalhadores (PT, or Workers’ Party) found themselves through to the second round.

Over and above the marked polarisation of the electorate, two important developments - largely underestimated by polls - defined the elections: Bolsonaro’s score (46% of the popular vote, or 49 million votes, 18 million more than his challenger); and the major shakeup in both the Senate (87% of new entrants out of the 54 seats in contention) and the lower house where the PSL markedly improved its footprint (52 seats out the 513, from just one in 2014), making it the second most represented party after the PT). Financial markets - which had partly anticipated the showdown between Bolsonaro and Haddad in the run-up to the vote - welcomed the results favourably. Equity markets soared, anticipating a wave of privatisations in the event of a Bolsonaro victory. The real made gains against the dollar, continuing its upward trend initiated at the end of September. The currency which has experienced bouts of volatility during the year is still down 14% year-to-date.

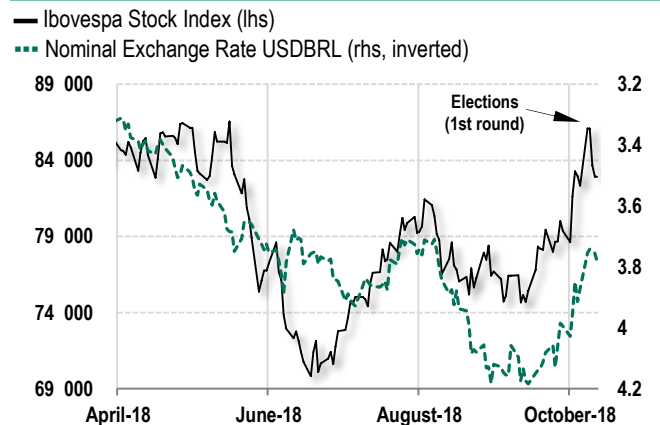
On the economic policy front, Bolsonaro is a liberal. To address the country’s fiscal challenges he proposes a drastic scale back of government through large-scale privatisations, spending cuts and a transition towards a funded pension scheme. If elected, he will most likely “depoliticise” his cabinet appointing prominent figures from the military and the business world. Paulo Guedes, an economist trained at the University of Chicago, would be his Finance Minister. Haddad, on the other hand, would prioritise job creation and the revitalisation of the economy over fiscal consolidation. If elected, Haddad intends to reverse the Temer government’s reforms, which would entail lifting the cap on public spending (in real terms), suspending privatisation initiatives, repealing the labour code reform and reintroducing minimum local content requirements (in terms of both goods and services) in the energy sector. In addition to introducing a unified value-added tax, he would also seek to

1- Forecasts

	2016	2017	2018e	2019e
Real GDP growth (%)	-3.5	1.0	1.5	3.0
Inflation (CPI, year average, %)	8.7	3.4	3.7	3.7
Fiscal balance / GDP (%)	-9.0	-7.8	-7.6	-7.4
Gross public debt / GDP (%)	70	74	77	82
Current account balance / GDP (%)	-1.3	-0.5	-1.2	-2.2
External debt / GDP (%)	31	27	29	29
Forex reserves (USD bn)	365	373	380	375
Forex reserves, in months of imports	32	30	27	23
Exchange rate USDBRL (year end)	3.3	3.3	3.3	3.2

e: BNP Paribas Group Economic Research estimates and forecasts

2- Market rally ahead of the elections



Source: Thomson Reuters, BNP Paribas

reinvigorate the role of publicly-owned banks in the economy and would pursue a policy of concessions based on Public-Private Partnerships (PPP).

■ A lacklustre recovery

The economic recovery, initiated in 2017, has struggled to latch on. Tainted by the truckers’ strike¹, GDP only progressed by +0.2% q/q in Q2 in seasonally adjusted (sa) terms, and by +1% y/y. Consumer spending barely held on (+0.1% q/q sa) while investment, which had experienced an upturn for a year, contracted sharply (-1.8% q/q sa) most likely affected by the wait-and-see attitude ahead of the

¹ Eco Perspectives, 3rd quarter 2018



elections. Ultimately, growth was kept afloat thanks to an uptick in public expenditure (+0.5% q/q sa), and more importantly a strong positive contribution from stock building which offset a negative contribution from net external demand.

On the supply side, the service sector alone helped bolster growth, with a rise of +0.3% q/q sa. Manufacturing and construction saw a contraction of -0.8% q/q sa, while growth in the agricultural sector was muted. That being said, Brazil Services PMI remains below the 50-point mark (46.4 in September).

At the end of June, the statistical carryover for 2018 stood only at 1%. The latest indicators show mixed signals regarding the evolution of economic activity in Q3. On the one hand, industrial production and the consumer confidence index have deteriorated. On the other hand, the upturn in credits to household combined with a slight improvement in the labour market (marked by a one point reduction in the unemployment rate to 12.1% over the period March to August and the acceleration of wage growth in real terms in August) should help support consumer spending.

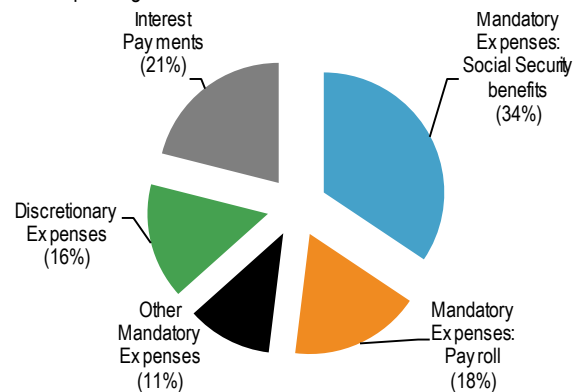
Despite stable inflation at 4.5% in September, and a continued modest capacity utilisation rate, the yield curve appears to anticipate a tightening of monetary policy by year end. At a time where further currency depreciation can be expected - following a general retreat of non-resident portfolio investments from emerging markets - inflation is likely to pick up as a result of the pass-through associated with increases in certain commodity prices. In contrast to neighbouring Argentina, the weakness of Brazil's currency does not reflect balance of payments imbalances (the financial account is largely positive, thanks to direct investments), but rather echoes concerns over fiscal consolidation in an uncertain political environment. Since 2013, the government has not been able to extract a primary budget surplus (-2.3% of GDP expected in 2018) to offset the cost of interest payments (expected to absorb 16% of government receipts by end-2018) and thus contain the march forward in gross debt to GDP ratio (77% expected at end-2018 versus 51.5% at end-2013). Other constraining factors include low economic growth and high mandatory spending which are characterized by poorly targeted social security transfers and very generous pensions. The weakness of the BRL produces an additional constraint for stabilizing the debt ratio, in spite of public external debt only accounting for 3% of total public debt².

■ A complicated heritage, a challenging governability and a risk of social tensions

When he takes office on January 1st 2019, the elected President will inherit a macroeconomic environment characterized by a dual reality. While on the one hand inflation is stable and moderate by historical standards and the country boasts a solid net external asset position thanks in part to the continued resiliency of foreign direct investments (Brazil was the 3rd largest recipient of FDI in 2017 according to UNCTAD), on the other hand fiscal accounts exhibit very little room to manoeuvre, debt service costs are high (16% of

3- Budget: little room to manoeuvre (2017)

% of total spending



Source: Tesouro Nacional, BNP Paribas

government spending and 6.1% of GDP in 2017) and potential growth is significantly lower than 10 years ago (4.5% versus 2.5%).

Against this national backdrop, the external environment is expected to be less supportive due to the reorientation of China's growth model, the slowdown in global growth and trade, tighter global liquidity conditions and higher oil prices. Faced with these headwinds, the future government will find itself in a delicate position as it seeks to reform the pensions and social security systems at a moment where markets remain on close watch.

Translating the candidates' electoral platforms into policies will also be constrained by the increasing political fragmentation in Congress which may hinder governability. Given the new distribution of seats, the lower house will be even more fragmented than it was before, with 9 parties having between 25 and 40 seats each in a house where no fewer than 30 parties are represented (against 26 prior to the elections). In this potentially deleterious policy environment, it remains to be seen if coalition-building will embrace a partisan look and potentially translate into political inertia. High levels of political fragmentation are also not likely to encourage the political class to reform itself, at a time where hundreds of politicians are still implicated in corruption scandals. Brazil's political life will no doubt continue to live at the rhythm of prosecutions and plea bargains.

The election of Mr Haddad would not only result in the potential rolling back of the Temer reforms but would also not meet the aspirations of a large section of the population to witness a radical political changeover as well as see a deep clean-up of Brazil's governance act. A Bolsonaro victory on the other hand could lead to potential abuses at the hands of the security forces; coupled with greater economic austerity and an overhaul of Brazil's social model, this could lead to an intensification of social unrest and a surge in political violence.

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² Eco Perspectives, 2nd quarter 2018.



Russia

The risk of new sanctions puts pressure on the rouble

Despite the improvement in economic fundamentals (strong rise in the current account surplus, accelerating GDP growth and a fiscal surplus), the rouble depreciated by 13% against the dollar between April and September 2018. Tighter US sanctions in April and again in August 2018, combined with the threat of new sanctions this fall, triggered massive capital outflows. Despite a highly volatile rouble, bond and money market pressures have been mild. To counter the downside pressure on the currency, the Russian central bank raised its key rates in September, for the first time since 2014, and halted its foreign currency purchases on behalf of the finance ministry.

■ Growth accelerates in H1 2018

The economy grew 1.6% year-on-year (y/y) in the first half of 2018. Tighter US sanctions did not hamper activity, which was driven by dynamic domestic demand (bolstered by higher real revenues) and a rebound in the manufacturing industry. The upturn in manufacturing can be attributed to higher oil production quotas, but also to the increased output of machinery and capital goods, buoyed by dynamic investment and household consumption.

Although industrial output was still dynamic in July (+3.9% y/y), economic activity is expected to slow in the quarters ahead for several reasons including the rouble's depreciation, the VAT hike on 1 January 2019, higher interest rates and the risk of a further tightening of US sanctions.

In the longer term, raising the retirement age and a 6-year investment spending programme should help boost the potential growth rate.

■ Inflationary pressures are under control

Price increases were mild in the first eight months of the year and averaged 2.4% y/y. Inflationary pressures have picked up slightly since June (+3.1% y/y in August), but are still lower than the central bank's inflation target of 4%, which it revised upwards in September. The economy is feeling the effects of the rouble's depreciation¹ while nearing full production capacity utilisation.

The VAT hike on 1 January 2019 is expected to lift prices by an additional 0.8 to 1.1 percentage points in 2019, assuming the rouble does not depreciate any further. The 2-point increase in the standard VAT rate applies to 66.1% of consumer goods. Moreover, the VAT rate will be raised from 10% to 20% for 25.7% of consumer goods.

To counter the rouble's high volatility and to dampen inflationary expectations, the central bank raised its key rates by 25 basis points (bp) at September's monetary policy committee meeting.

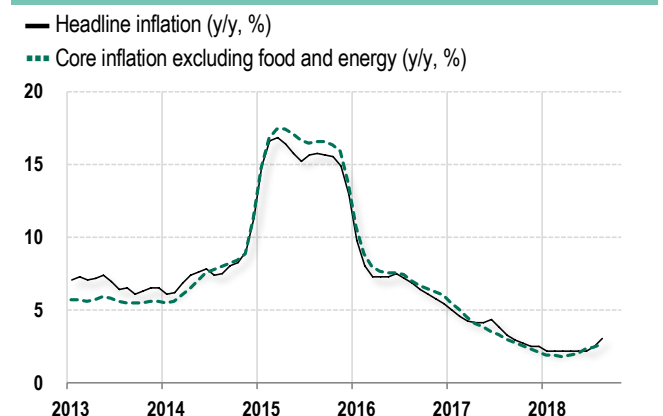
¹ The central bank estimates that a 10% decline in the nominal effective exchange rate generates a 1 percentage point increase in prices over a 3- to 6-month horizon.

1- Forecasts

	2016	2017	2018e	2019e
Real GDP growth (%)	-0.2	1.5	1.7	1.7
Inflation (CPI, year average, %)	7.1	3.7	2.7	4.1
General Gov. balance / GDP (%)	-3.7	-1.5	0.5	1.7
Public debt / GDP (%)	13.3	12.6	12.5	12.3
Current account balance / GDP (%)	2.0	2.6	5.5	4.5
External debt / GDP (%)	39.5	32.9	30.3	27.7
Forex reserves (USD bn)	318	347	375	420
Forex reserves, in months of imports	11.1	10.3	12.8	12.9
Ex change rate USDRUB (year end)	60.3	58.3	67.0	69.0

e: BNP Paribas Group Economic Research estimates and forecasts

2- Inflation is under control



Source: CBR, BNP Paribas

■ A fiscal surplus and the rebuilding of sovereign fund in 2018

In the first 8 months of the year, the federal government reported a fiscal surplus of RUB 1830 bn, the equivalent of 3.1% of GDP, compared to a fiscal deficit of 0.7% of GDP in the year-earlier period.

After reporting a deficit for six consecutive years, the finance ministry is forecasting a full-year surplus of about 1.3% of GDP. The consolidation of public finances is mainly due to a big increase in fiscal revenues arising from oil & gas activities (+46.6%). Yet excluding oil & gas, the fiscal deficit still narrowed by more than



11% in the first 8 months of the year, thanks to the combination of higher non-oil & gas revenues (+15%) and tight control over public spending, which rose only 2.6% over the period. The non-oil-and-gas deficit was the smallest in six years.

At the same time, windfall revenues from oil and gas activities were funnelled into the National Wealth Fund (NWF). In the first 8 months of the year, the NWF increased by USD 10 bn to USD 75.8 bn. At the end of the year, we must also add in the USD 38 bn acquired by the central bank on behalf of the finance ministry.

For the next three fiscal years, the government has decided to pursue a less cautious and less conservative fiscal policy. Although it is forecasting fiscal surpluses of 1.8%, 1.1% and 0.8% of GDP, respectively, in 2019, 2020 and 2021, the government plans to increase the public spending to GDP ratio (+1.1 percentage points of GDP in 2019) for the first time since 2015.

The increase in public spending can be attributed notably to the social and economic development programme announced by president Putin last May. The equivalent of 7% of GDP (RUB 8 trillion) will be invested in the country's development between 2019 and 2024 to develop infrastructure, increase the level of education and boost healthcare spending. The government's goal is to raise the investment rate from 21.7% of GDP in 2017 to 25% of GDP by 2024. Yet even if the government manages to implement this programme, private investment will continue to be hampered by strong structural constraints.

The finance ministry does not intend to use the revenues generated by the VAT increase (estimated at 0.5% of GDP) to finance this social and economic development programme. Instead, it will be financed through domestic market bond issues each year for the equivalent of 0.5% of GDP.

■ The rouble depreciates sharply despite a higher current account surplus

In H1 2018, the current account surplus swelled to the equivalent of 6.7% of GDP, up from 3.3% of GDP in the year-earlier period. This improvement can be attributed to the strong increase in the trade surplus (+3.3 percentage points to 11.4% of GDP), thanks to the increase in oil and gas exports and to a lesser extent other types of exported goods.

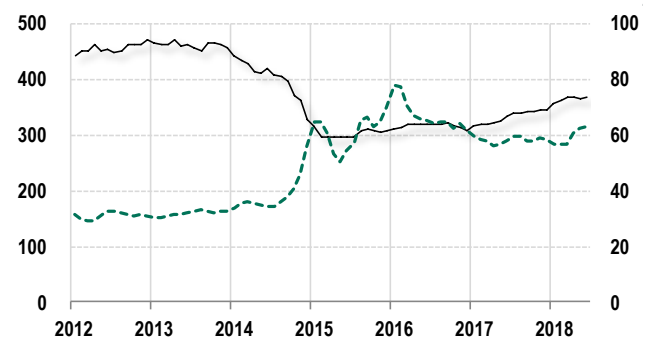
Yet despite the improvement in macroeconomic fundamentals, Russia reported massive capital outflows following the tightening of US sanctions. The rouble depreciated by 13% against the dollar between April and September.

According to the balance of payments statement, sales of Russian assets by non-resident investors swelled to USD 17 bn in the second quarter. In comparison, this figure averaged more than USD 32 bn per quarter between Q3 2014 and Q1 2015. This movement continued in July and August. As a result, the share of sovereign debt held by non-resident investors declined by 7.9 percentage points between April and August to 26.6% on 1 September.

The rouble's depreciation was accentuated by the central bank's foreign currency purchases on behalf of the finance ministry (to

3- Downward pressures on the rouble

— RUB per USD (rhs) - - - Foreign exchange reserves (USD bn, lhs)



Source: CBR, BNP Paribas

shore up the National Wealth Fund) for an amount equivalent to more than USD 24 bn between April and August. To counter the rouble's decline, the Russian authorities decided at the September monetary policy committee meeting to halt currency purchases on behalf of the finance ministry through the end of the year.

Despite the show of mistrust on the part of non-resident investors, pressures in the money and bond markets are still mild. Between April and September 2018, 10-year government bond yields rose only 100bp, deposit rates declined and the increase in 5-year CDS was limited to 25bp. Yet it could become harder to finance its USD-denominated debt if the US Congress were to approve two proposals, the Deter Act and the Daska Act. Both bills call for limiting the access of Russia's state-owned banks to the market for USD and to prohibit US investors from holding newly issued Russian bonds. Neither bill is very likely to be adopted because they are only supported by a minority of senators. This situation could change, however, after the US mid-term elections.

Yet Russia's foreign exchange reserves, which amounted to USD 373 bn at the end of August, largely cover the refinancing needs of the country's external debt, which are estimated at USD 79 bn by year-end 2019.

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Turkey

The tight-rope walker

A currency crisis broke out in August. Beyond (geo)politics, the main reasons behind the collapse of the TRY are the worsening in Turkey's macro fundamentals and erosion of the credibility of its policy mix. The authorities have limited room for manoeuvre and announced a tightening of economic policy, which has led to some respite in the financial markets. Reconciling with the West is also required to regain investors' trust. Turkey's economy is heading toward a text-book "boom and bust" cycle and stagflation. The macro adjustment is going to favour a narrowing of the current account deficit, but the country's external financing needs will remain huge. Banks are the main channel for the transmission of balance of payments troubles to the real economy.

■ Currency crisis

The Turkish lira (TRY) plummeted 20% against the US dollar (USD) in August, the most severe depreciation in a single month since the 2001 crisis and of the same magnitude as the currency's plunge in October 2008. The currency crisis has been latent for several months, with the USDTRY depreciating by 40% over the past six months. According to our calculations based on CBRT data, so far Turkey has not experienced a huge decline in foreign portfolio investments (-USD 2.5bn year-to-date including -USD 0.8 bn since August 10). Meanwhile, FX bank deposits dropped markedly (-12% in USD terms since March or -USD 23 bn, including -USD 7.6 bn in August), driven by residents' FX deposits (which account for 85% of total FX deposits). The latter have rebounded very slightly over the past few weeks. Carry-trade positions have also declined.

Apart from (geo)politics (notably US sanctions), the main reason behind the collapse of the TRY is the worsening of Turkey's macro fundamentals and the erosion of the credibility of its policy mix. Mounting tensions between Turkey and the US have intensified with "the Pastor Brunson crisis". On August 10, the US imposed commercial sanctions on Turkey, which in turn announced retaliatory measures. The US is not a strategic trade partner of Turkey (only 6% of Turkey's exports go to the US). Nonetheless, investors have feared further escalation in the diplomatic dispute and even a breaking of the two countries' bilateral relationship. More fundamentally, in the context of emerging-market tensions, the rising US dollar and US bond yields, trade tensions, rising oil prices and increasing geopolitical risks, Turkey has been considered as a weak link amongst EMs due to overheated economy and increasing macroeconomic imbalances, both internal (inflation) and external (current account deficit). Expansionary fiscal policy and pressure on the central bank to cut interest rates have underpinned investors' concerns.

■ Three key milestones to regain investors' trust

The authorities had no alternative but to announce a tightening of economic policy in September, which has led to some respite in the financial markets in recent weeks. Three milestones are required to reassure investors: 1/ strengthening the credibility of the central bank; 2/ giving pledges of fiscal orthodoxy; 3/ reconciling with the West.

The CBRT, which is "structurally" behind the curve, bowed to pressure from the markets. It hiked its policy rate by 625bp to 24% on September 13 and stated that further tightening will be delivered,

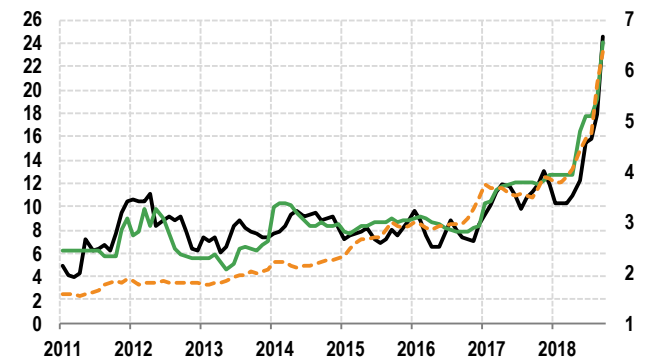
1- Forecasts

	2016	2017	2018e	2019e
Real GDP growth (%)	3.2	7.4	3.0	1.1
Inflation (CPI, year average, %)	7.8	11.1	16.8	18.9
Budget balance / GDP (%)	-1.5	-1.9	-2.4	-2.1
Public debt / GDP (%)	28.3	28.3	30.2	31.6
Current account balance / GDP (%)	-3.8	-5.6	-5.4	-3.0
External debt / GDP (%)	46.9	53.3	63.4	60.6
Forex reserves (USD bn)	90.6	82.6	66.0	58.0
Forex reserves, in months of imports	5.1	4.0	3.0	2.7
Ex change rate USDTRY (year end)	3.5	3.8	6.1	7.0

e: BNP Paribas Group Economic Research estimates and forecasts

2- Foreign exchange rate, inflation and policy rate

— Inflation (y/y % change, lhs) — USDTRY (rhs)
— Weighted average cost of CBRT funding (% per annum, lhs)



Source: CBRT, Turkstat

if needed. With consumer price inflation reaching 24.5% y/y in September and producer price inflation exceeding 46% y/y mainly owing to the FX pass-through, even monetary tightening of such a magnitude might be not enough to re-anchor inflationary expectations.

For the time being, public finances remain rather sound (low budget deficit and debt). But the three main credit rating agencies downgraded Turkey's sovereign rating and most of the local banks' ratings. The government must give pledges of fiscal rectitude, at the risk of exacerbating the slowdown of the economy (cf. infra). In



addition, the revival of the structural reform agenda, which would not bear fruit in the short term, may eventually be viewed positively by international investors. The government's New Economic Programme (NEP 2019-2021) announced on September 20 calls for the end of its "growth-only" policy. It acknowledges the need for a rebalancing of the economy, fiscal discipline and transformation in manufacturing and exports. It also announces the upcoming stress-test on banks, which highlights the recognition of the corporate debt issue. As for fiscal policy, the government announced the suspension of some investment projects. It identified roughly 2% of 2018 GDP of savings (TRY 60 bn, half of which are investments) and additional revenue (TRY 16 bn) for 2019. But the markets have been puzzled by the lack of detailed measures and should judge by deeds and not by words.

The two first milestones may be "a shot in the dark" if the tensions with the US do not abate and President Erdogan does not tone down his rhetoric vis-à-vis foreign investors. The release of Pastor Brunson on October 12 may pave the way for a warming of bilateral relationship.

■ Technical recession is looming

Real GDP, of which growth moderated in Q2 2018 (5.5% y/y vs. 7.4% y/y in Q1), is likely to contract in H2 2018 and even H1 2019 as domestic demand shrinks, while global demand and the weak TRY continue to support exports. Despite a carry-over effect on GDP growth is 4.8% as of mid-2018, real GDP growth is expected to average 3% this year. As for 2019, the likely economic recovery in H2 should allow GDP growth to reach about 1% on average.

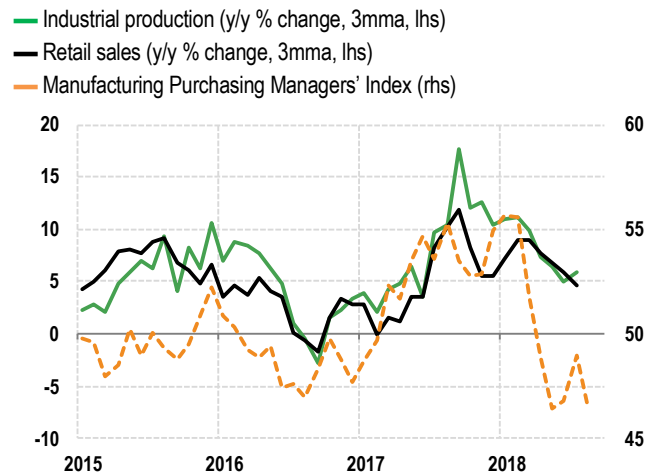
This scenario is consistent with high-frequency and advanced indicators. Confidence indices have tumbled in recent months. Industrial output and retail sales are slowing. The manufacturing PMI has been below 50 (the threshold between expansion and contraction) since April. Imports have slumped in August. Weekly data shows that growth in consumer credit has turned negative in recent weeks. The unemployment rate is increasing again.

■ Facing huge external financing needs

The macroeconomic adjustment that is underway should go hand-in-hand with a rapid narrowing in the current account deficit (CAD) in the coming quarters. In 2009, the CAD was divided by 4 to 1.7% of GDP in line with the 4.7% contraction in real GDP, while nominal GDP in USD terms declined by 15%. Since July, the trade deficit has begun to shrink thanks to dynamic exports, the slowdown in domestic demand and strong tourism receipts. It is worth noting that unidentified capital inflows (i.e. net errors & omissions) have increased very fast in 2018 (USD 8.3 bn in H1 2018), which has helped to support the balance of payments. Anecdotal evidence suggests that part of these inflows is constituted of repatriations of Turkish corporates' off-shore assets.

Nevertheless, Turkey's external financing requirements (current account deficit plus external debt amortisation) are expected to remain significant (about USD 200 bn within twelve months). By comparison, official FX reserves stood at USD 68 bn (excluding gold) and the CBRT's "free" FX reserves amount to only USD 28 bn.

3- Industrial production, retail sales and PMI



Source : Turkstat, Markit, BNP Paribas

In the end, the government has continued to deny recurrent rumours (since end-2016) about the implementation of capital controls (higher taxes on FX deposits do not constitute capital controls). Resorting to the IMF's financial support appears to be highly unlikely unless both the Turkish government and the US government (IMF's main shareholder) make a U-turn in their policy stance.

■ Banks are the main channel for the transmission of balance-of-payment troubles to the real economy

The financial sector (banks plus non-bank financial institutions) has to bear a large share (a little more than USD 100 bn) of the country's external financing needs in the coming year. Banks are exposed to counterparty risk and the rollover in derivatives markets, in which the CBRT has become a major player since late August. They are also exposed to double transformation risks (i.e. maturity risk, indirect FX risk) as 1/ they have used the FX swap market to close their FX position while financing TRY-denominated loans, and 2/ they have lent massively in FX to non-financial companies.

Fortunately, Turkish banks enjoy sound financial metrics, notably strong capital buffers. But further TRY weakness and pressure on FX liquidity are likely to increase credit risks arising from corporate debt distress and restructuring demands. Given the economy's high level of euro-dollarisation, a drying-up of FX liquidity (i.e. a cut in external financing and/or a run on FX deposits) and rising interest rates would inevitably lead to further slowdown in bank lending or even contraction in credit and further deterioration in banks' asset quality. Most of corporates FX liabilities are financial loans (USD 293 bn while import-related loans are USD 42 bn), of which about 60% are domestic loans and 40% external debt. The sectors that are the most vulnerable are 1/ energy 2/ transport & telecommunication, and 3/ construction.

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Ukraine

At the mercy of the IMF

Ukraine's economy has stabilised somewhat after the crisis in 2014-2015. The economic recovery is still on track. Thanks to tight monetary policy, inflation has been moderating and the hryvnia has been broadly stable despite emerging market tensions. The government has met its fiscal targets and reformed the gas and banking sectors. But the economy is not yet out of the woods. Ahead of the presidential elections (March 2019), (geo)political risks are high. Structural reforms need to be completed to strengthen investors' confidence. Given large FX debt repayments in the coming year, Ukraine needs to unlock new financing from the IMF and other official lenders as well as global markets in order to avoid liquidity shortages.

■ A macroeconomic stabilisation of sorts...

The macro adjustment that followed the recession and devaluation of 2015 is over. On the positive side, following a 16.5% cumulative contraction in real GDP in 2014-2015, economic activity regained some steam from 2016, underpinned by domestic private demand and the government's fiscal stimulus. Inflation returned into single digit territory in June 2018 thanks to a hawkish central bank. The economic recovery has gone hand-in-hand with fiscal consolidation in 2017. The budget deficit was 1.5% of GDP last year and public debt declined to 72% of GDP from a peak of 81% of GDP in 2016, notably thanks to the government's increasing difficulties in tapping international debt markets.

On the negative side, the current account deficit (CAD) has been widening again due to higher energy prices and stronger domestic demand. The 35% fall in export volume since 2011 highlights Ukrainian exporters' difficulties to diversify away from Russia. In addition, the US decision to impose tariffs on steel has started to depress global prices for steel, which is one of Ukraine's main commodity exports. Foreign direct investment has declined markedly since 2013 due to Euromaidan events, the Crimea crisis and the Donbas conflict. They do not offset the CAD and make Ukraine dependent on debt-generating capital inflows, notably official financing (see infra).

Since the beginning of the year, activity has accelerated further. Real GDP grew by 3.8% y/y in Q2 after 3.1% in Q1. Household consumption (+4.2% in Q2) has been supported by 1/ the steady pace of wage growth after several years of austerity (the minimum nominal wage was increased by 16% in 2018), 2/ social transfers (pensions were increased in October 2017 and March 2018), 3/ emigrated workers' remittances (thanks to visa-free entrance to the EU, notably in Poland), and 4/ fast consumer credit growth. Investment has been expanding at double-digit annual rates for two years (+14.2% in Q2). Meanwhile, the contribution of net exports to GDP growth has continued to be negative. On the supply side, agriculture performed very well in Q2, thanks to an early harvest season, and construction has continued to boom.

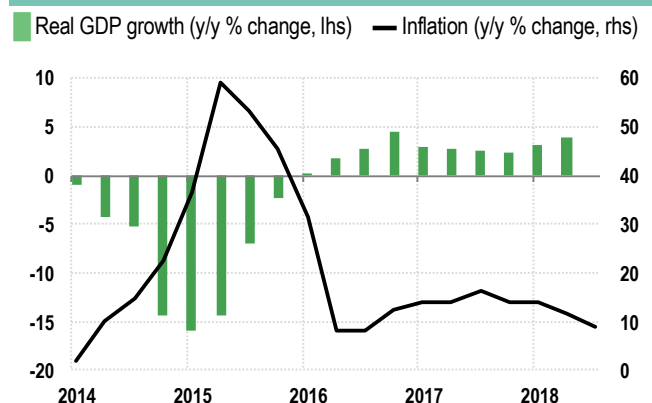
Headline inflation has been trending downward since March and stood at 8.9% y/y in September, despite robust domestic demand and wage growth. First, a good agricultural harvest and lower global meat prices have eased pressure on food prices. Second, the increase in utility prices has slowed thanks to a high base effect. Third, Ukraine moved to a flexible FX rate regime in 2014, and the

1- Forecasts

	2016	2017	2018e	2019e
Real GDP growth (%)	2.4	2.5	3.5	2.5
Inflation (CPI, year average, %)	13.9	14.4	11.3	7.5
Gen. Gov. balance / GDP (%)	-2.9	-1.5	-2.6	-2.3
Gen. Gov. debt / GDP (%)	81.2	71.8	71.0	70.1
Current account balance / GDP (%)	-4.1	-3.7	-4.4	-4.1
External debt / GDP (%)	121.8	106.6	98.2	94.7
Forex reserves (USD bn)	15.5	18.8	17.0	16.7
Forex reserves, in months of imports	3.6	3.7	3.2	3.0
Exchange rate USDUAH (year end)	27.1	28.1	28.3	30.3

e: BNP Paribas Group Economic Research estimates and forecasts

2- GDP growth and inflation



Source: State Statistics Service of Ukraine

relative stability of the hryvnia (USDUAH flat year-to-date and down only 3% since July) has had a positive impact on the prices of imported goods. Fourth, the monetary policy has remained tight.

In light of sustained core inflation pressure and external risks, the central bank (NBU) has continued to increase its policy rate (+350 basis points year-to-date to 18% in September) to help headline inflation converge to its end-of-year target range of 4%-8%. The NBU identified risks arising from a pick-up in consumer demand, a sell-off in emerging markets, tighter US monetary policy, global trade disputes and tensions between the IMF and Ukraine's authorities (see infra).



During January-August 2018, the CAD widened again (USD 2.1 bn against USD 0.8 bn a year earlier), as the increase in the services balance surplus and net transfers (i.e. workers' remittances) did not compensate for the larger trade balance deficit. While export earnings increased 11.6%, the import bill climbed by 15.3%. Ukrainian exports to the EU and Russia now account for 38% and 7% of total exports, respectively.

■ **... but the heavy FX debt service makes an IMF deal critical**

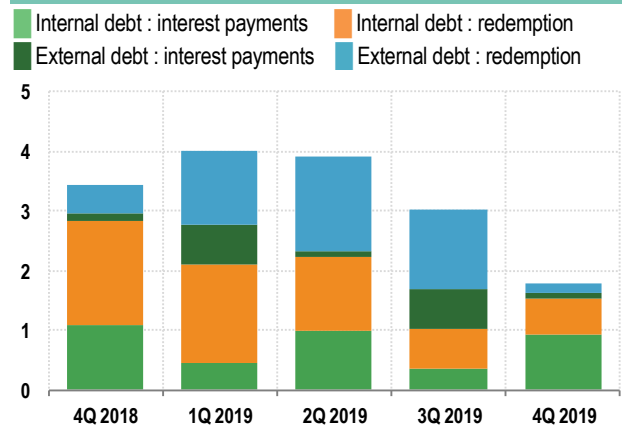
An IMF mission visited Kiev in mid-September in order to assess the status of its extended fund facility (EFF). Completing the review of the four-year IMF programme, which is due to expire in March 2019, will be instrumental to help the government cover its high FX debt refinancing needs and avoid FX liquidity shortages in the coming year. This peak of debt repayments comes at the time of tightening global financing conditions and heavy political agenda with the presidential elections scheduled for March 2019. Ukraine's sovereign Eurobond spreads have climbed 150 basis points year-to-date to 570 basis points as of mid-October.

Ahead of the elections and given an unsuccessful privatisation process, markets have been concerned about the government's ability to keep its budget deficit below the targeted 2.5% of GDP in 2018, a key precondition of the IMF programme. But despite fiscal easing, insufficient external financing may prevent a spending spree and "help" the government to comply with its 2018 budget deficit target.

Despite deleveraging by the private sector, the country's external debt is still high at around 100% of GDP (vs. 130% in 2015), of which 47% is public debt. It is very sensitive to currency depreciation given the low level of FX reserves (USD 17.2 bn or just below three months of import cover) and huge external financing needs. As for the government's FX debt service, Ukraine has to repay USD 10.7bn in H2 2018 and 2019, of which USD 4.3 bn are domestic FX bonds and USD 4.7 bn are interest payments. Ukraine returned to global markets in September 2017 by issuing a USD 3 bn Eurobond. But the government has failed to secure new external financing in 2018 and has had to resort to the local debt market to cover its financing needs. The increase in local interest rates made domestic debt in Hryvnia attractive for both local and foreign investors in Q1 2018. But the appetite for local-currency denominated debt has waned since Q2, forcing the government to issue additional foreign-currency denominated bonds.

The disbursement of the fifth tranche (USD 1.9 bn) of the USD 17.5 bn IMF loan (of which only USD 9 bn have been disbursed so far) has been suspended since April 2017 as the Ukrainian government has not met the IMF's preconditions. Securing the loan tranche would pave the way to further financing emanating from other multilateral lenders (notably USD 1.1 bn from the European Union and USD 800 mn from the World Bank) and international capital markets. Currently, the disbursement of these funds is conditional on greater fiscal rigour, the completion of structural reforms (most notably those designed to fight against

3- Estimated government debt repayment profile (USD bn)



Source : Ministry of Finance, BNP Paribas

corruption) and the increase in the price of gas for households, on which the financial sustainability of Naftogaz depends.

■ **...and the banking system remains fragile**

The Ukrainian banking sector is still recovering. Following the nationalisation in 2016 of the insolvent PrivatBank, the largest retail bank, the government now controls more than half of the banking sector assets. Many smaller banks have been shut down since 2014 and the capitalisation of the remaining viable banks has improved. The central bank has set the end of 2018 as the deadline for banks to recapitalise. Minimum capital adequacy ratios have been increased from 5% in 2016-2017 to 7% in 2018 and should be restored to 10% in 2019.

The banking system returned to profitability in 2018, after experiencing losses in 2014-2017. Net interest rate margins have increased as growth in banks' deposit rates has lagged the surge in lending rates. Nevertheless, the overall liquidity ratio remains constrained as loans exceed deposits by 20%. Banks' profitability and ability to issue new loans to households and corporates are also undermined by the pile of non-performing loans (56% of total loans as of mid-2018), which have required additional provisioning (94% of loans are fully provisioned).

Credit to corporates increased by 6% y/y in June 2018. Local companies have tended to borrow more in local currency while restructuring FX loans. Meanwhile, after more than two years of stagnation, credit to households climbed by 44% y/y in mid-2018, driven by consumer loans and auto loans, while mortgage loans remained stagnant.

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Mexico

Relief

The USA, Mexico and Canada have completed negotiations on a new trade deal to replace NAFTA, which has been in force since 1994. The signature of an agreement in principle is good news for Mexico, as it will calm uncertainties about future trade links with the USA. On the domestic front, the new government is preparing to take power on 1 December. The reforms proposed are already some distance from the statements made during the campaign. Most notably, the incoming President has committed to maintaining the independence of the central bank, fiscal discipline and the country's trade agreements.

■ NAFTA 2.0

On 30 September 2018, the USA, Mexico and Canada announced the completion of negotiations on a new trade deal: the United States-Mexico-Canada Agreement (USMCA). The signature of an agreement in principle brought to an end a year of strained discussions between the three countries and removed the USA's threat of a unilateral withdrawal from any deal. The new agreement will replace the North American Free Trade Agreement (NAFTA), which was signed in 1992 and came into force in 1994.

Details of the final deal are not yet known, but the main changes are likely to affect the automotive sector. 'Rules of origin' have been changed: to be imported without tariffs, the components manufactured in North America included in a vehicle must amount to 75% of its content, from 62.5% previously. The aim is to ensure that the benefits of NAFTA do not extend to products coming from non-member countries which are subject only to minor modifications after being imported into North America. Again in the automotive sector, 40% of production must henceforth come from factories with a minimum wage of USD16/hour. This measure, which was imposed by the USA, was directly targeted at Mexico, in a bid to bring vehicle assembly back to the USA. It could, however, prove insufficient: vehicles that do not meet these criteria can still be imported into the USA subject to a tariff of 2.5% (under the WTO 'most-favoured nation' clause). It will therefore still be advantageous to assemble vehicles in Mexico before exporting them to the US. In addition, a special clause could give Mexico and Canada a partial exemption from the punitive sanctions set out in Article 232, which the US President can trigger for reasons of 'national security'. In practice this means that Mexico can continue to export a quota of 2.6 million vehicles to the USA without running the risk of incurring punitive tariffs. This development limits the scope for growth in the Mexican automotive industry, as total vehicle exports to the USA stood at 2.3 million vehicles in 2017.

Other outcomes from the negotiations will see the inclusion of a chapter on trade in digital products, the revision of the chapter on trade disputes, the opening of the Canadian dairy market and, most importantly, a significant change to the 'sunset clause' promoted by the USA, which would provide for the 'automatic' cancellation of the trade agreement every five years if the three partners are not able to agree on a renewal of its terms. Once it comes into force, the treaty will last for sixteen years, and will be reviewed every six years.

1- Forecasts

	2016	2017	2018e	2019e
Real GDP growth (%)	2.3	2.0	1.5	3.0
Inflation (CPI, year average, %)	2.8	6.0	4.7	3.5
Budget balance / GDP (%)	-3.6	-2.2	-2.0	-1.6
Public debt / GDP (%)	47.9	47.6	46.8	46.5
Current account balance / GDP (%)	-2.5	-1.0	-1.2	-0.8
External debt / GDP (%)	38.9	38.3	36.9	36.7
Forex reserves (USD bn)	167.7	165.0	163.0	161.0
Forex reserves, in months of imports	4.8	4.6	4.1	3.9
Ex change rate USDMXN (year-end)	20.7	19.7	18.2	17.8

e: BNP Paribas Group Economic Research estimates and forecasts

2- Relative stability of the peso over the last 6 months...

— MXN per USD



Source: Banxico

The signature of an agreement in principle will allow a significant reduction in concerns over future trade relations between the USA and Mexico (Mexican exports to the USA account for nearly 80% of the country's total exports). However, it will not be certain that the new treaty will come into force until it has been ratified by all three countries. Ratification by the USA appears to be the most problematic of the three: it is unlikely to take place until early 2019. In the final analysis, therefore, the treaty is unlikely to come into force until mid-2019 at the earliest.



■ 2019: a year of change

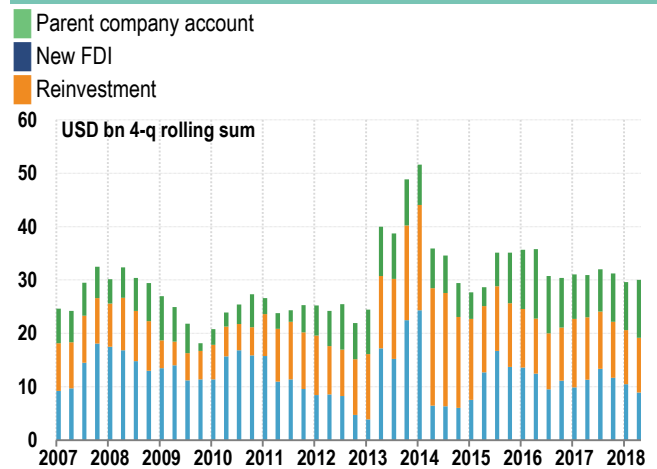
Whatever happens, the promise of a new trade deal is good news for Mexico, and improves short-term economic prospects whilst limiting concern about the change of government that will take place on 1 December.

This said, the President Elect, Andrés Manuel López Obrador, commonly known by his initials AMLO (who led the coalition based around the MORENA national regeneration movement he founded in 2011) has already changed his stance since his election on 1 July 2018. Most notably, he has committed to maintaining the independence of the central bank, fiscal discipline and the country's existing trade agreements. In addition, the proposed reforms announced thus far have been more market-friendly than the more left-leaning proposals put forward during the campaign. The roadmap laid out by AMLO and his team sets a number of targets, concerning reductions in crime; increases in the minimum wage; increasing investment and major infrastructure projects; and the stabilisation of government debt (which represented 47.6% of GDP in 2017). The aim is to boost GDP growth to 4% per year by the end of his term in 2024. For the time being, this change of tone has been welcomed: indices of consumer and investor confidence have rallied.

The new team is backed by majorities in both Congress and the Senate, following the victory of AMLO's coalition in July's elections. Since the beginning of the parliamentary session in September, the coalition's position has been strengthened, with 252 registered Deputies (of a total of 500), from 190 following the elections (to the detriment of the smaller parties). Moreover, the opposition is fragmented, which would seem to give the ruling coalition considerable leeway in introducing its proposed reforms.

In pursuing his ambitious programme, the President will be helped by Mexico's good economic fundamentals: the major reforms introduced in 2014 have dampened the country's vulnerability to external shocks and boosted the investment rate. The opening of the oil sector, and even more importantly the telecoms sector, to private investment has contributed to growth acceleration since 2015 (to an average of 2.7% per year between 2015 and 2017). The IMF now estimates potential growth at between 3% and 4% per year, compared to average growth between 2003 and 2013 of 2.3% per year. Monetary policy is credible, the government's deficit and debt have been reduced in recent years, the dependence of fiscal receipts on the oil sector has declined and the good performance of exports (as well as remittance flows from expatriate workers) has reduced the current account deficit to a modest level. Lastly, despite the size of portfolio investment flows, Mexico's external position (in terms of both solvency and liquidity) remains solid. It is also worth noting that neither the strained relationship with the USA since the election of Donald Trump nor the concerns raised by the election of AMLO have weakened the peso or hit FDI flows.

3- ...and of FDI inflows



Source : Banxico

■ Announced reforms are ambitious

The first two reforms announced relate to fiscal and energy policies, which are closely linked. Concerning fiscal reform, the target set is to "maintain a primary surplus that will allow the level of debt to be maintained unchanged". The financing of social security and infrastructure spending will therefore need to be covered by a reallocation of existing expenditure and a mobilisation of the private sector. AMLO is also planning a programme of 'republican austerity', which will generate savings by: centralising government procurement (thus reducing corruption and generating economies of scale); reviewing a large number of social security programmes (for example in order to eliminate overlap between them); and reducing the government's operational budget. At the same time, energy reform will be based on four main points: increasing oil output; renovating six existing refineries; building two new refineries; and modernising hydroelectric power stations.

For the time being, the exact details of the implementation of these measures are not known, but it would appear that expenditure has been underestimated (as in the case of the renovation of refineries), whilst the savings have been overestimated. Several goals appear particularly ambitious and difficult to put in place in the 2019 budget.

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South Korea

Solid macroeconomic fundamentals

The “détente strategy” adopted by President Moon since taking office in May 2017 would seem to be bearing fruit: in September, the leaders of the two Koreas held their third meeting, and a new trade deal was signed with the USA. On the economic front, the outlook remains good, despite the trade war between China and the USA. On the one side, South Korea’s positioning on value chains is shifting, which should allow it gradually to reduce its exposure to the Chinese economy. On the other, macroeconomic fundamentals are solid and the country’s external vulnerability is very low, allowing it to stimulate the economy if needed.

Affected by the trade war

Whilst tensions mount between China and the USA¹, the “détente strategy” adopted by President Moon since taking office in May 2017 would seem to be bearing fruit. Relations with North Korea are gradually improving. The leaders of the two countries met in September, opening the way, amongst other gains, to a resumption of dialogue between North Korea and the USA. Following this meeting, South Korea and the USA finalised a new bilateral trade deal at the end of September, building on an agreement in principle reached in March of this year. The signature of this new deal highlighted the good relationship between the two countries, although in effect the details of the previous treaty (signed in 2012) remain broadly the same.

This said, South Korea is not immune to the effects of the trade war between China and the United States. Although the tariff increases are aimed only at products from the two countries, the list of products encloses hi-tech items, including electronic components. By their nature, these products are dependent on value chains; Asian countries export components to China, where they are transformed and then exported onwards. As a result, restrictions on China’s trade affect the whole of the region. The worst affected countries will be those with the greatest direct exposure to China and the USA, on the one hand, and those with the greatest integration into regional and global value chains on the other.

This is true of South Korea: exports to the USA and China represent 26% and 12% of total exports respectively, and given the specialisation of its economy, particular in logistics and high technology sectors², the South Korean economy plays a central role in regional production networks. Exports within Asia make up more than 50% of total Korean exports.

In other words, South Korea looks highly exposed to the fallout from a trade war between China and the USA. However, although short-term growth prospects have been downgraded, they remain relatively positive: real GDP growth is likely to fall back only slightly, from 3.1% in 2017 to just below 3% in both 2018 and 2019. Export growth has slowed since the beginning of the second quarter, but

¹ On 17 September, the USA announced an increase of 10% in customs tariffs on approximately USD200 billion of imports from China. In return, Chinese authorities increased tariffs on some USD60 billion of imports from the USA.

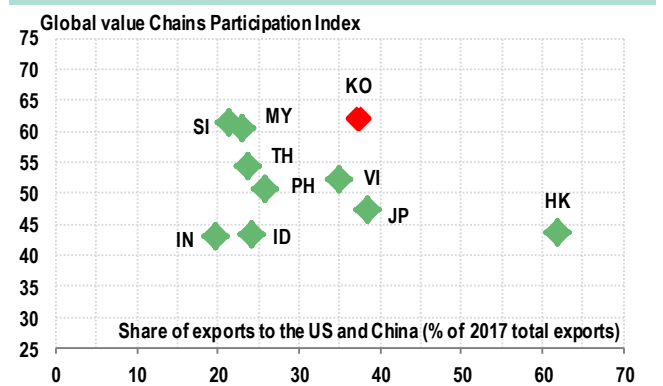
² The semiconductor sector alone represents 20% of total exports whilst exports of machines and electrical equipment to China account for 10% of total exports.

1- Forecasts

	2016	2017	2018e	2019e
Real GDP growth (%)	2.8	3.1	2.9	2.8
Inflation, CPI, year average (%)	1.0	1.9	1.7	1.9
Gen. gov. balance / GDP (%)	1.8	1.4	1.4	1.0
Gen. gov. debt / GDP (%)	38.6	39.6	39.5	39.5
Current account balance / GDP (%)	7.0	5.1	4.5	4.3
External debt / GDP (%)	27.0	27.7	28.3	28.6
Forex reserves (USD bn)	366	384	402	409
Forex reserves, in months of imports	8.4	7.9	7.3	7.5
Exchange rate USDKWR (year end)	1 160	1 130	1 070	1 100

e: BNP Paribas Group Economic Research estimates and forecasts

2- “Direct” exposure to China and the USA



Source: IMF, TIVA

semiconductor companies, and electronics companies more generally, are in good financial health, which should allow them to absorb at least part of the shock. Advance indicators (order books, PMI index) suggest that the semiconductor sector will post good performances over the coming months.

Meanwhile, domestic demand growth is also likely to slow, but will remain strong. Investment growth is likely to be held back by new regulations on the real estate market (and on mortgage lending to consumers), whilst consumer spending will be boosted by increases to the minimum wage and the package of social reforms introduced by the government. Lastly, the easing of political tensions between China and South Korea has enabled a return of Chinese tourists



(the proportion of Chinese visitors as a share of total tourists to South Korea fell from 50% in 2016 to 30% in 2017). Since March 2018, visits from Chinese tourists have been rising again.

■ A move up the value chain

Over the longer term, the diversity of the South Korean economy is a significant strength, which increases its capacity to absorb shocks. According to the "Atlas of Economic Complexity" produced by the University of Harvard, South Korea is the world's third most 'complex' economy – in terms of the diversity of exports and the intensity of knowledge required to produce the goods exported – after Japan and Switzerland. The five biggest export sectors are electronics and printed circuits, automotive, refined oil products, shipbuilding (passenger and cargo) and automotive components.

In addition, for a number of years now we have witnessed a move up the value chain by South Korean industry, which should gradually help to limit exposure to the Chinese economy. From a regional view point, China remains the centre of Asian value chains, but since the early 2010s³ this central role has diminished somewhat in favour of intra-regional relationships between its neighbours.

The 'traditional' structure of regional specialisation based on China, Korea and Japan seems to be shifting slowly towards South Korea and the ASEAN nations. An example of South Korean industry's move up the value chains can be seen in the case of Samsung's smartphones. Some 80% of the assembly of the finished product is carried out outside the country, but with components which incorporate increasingly sophisticated Korean added value. Thus, at a regional level, South Korean companies (mainly from the electronics sector) have become major suppliers of high added value intermediate products.

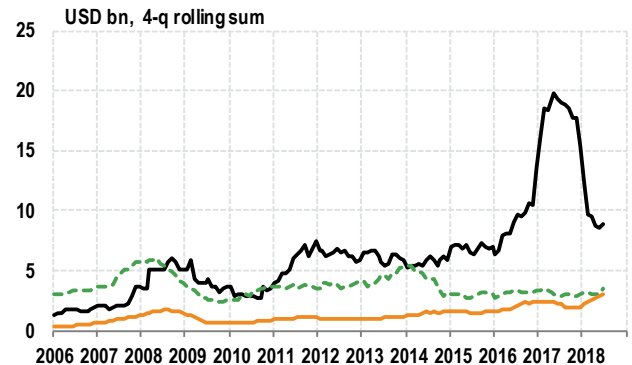
With South Korean direct investment into China having stayed fairly stable over recent years, investment in ASEAN countries, particularly Vietnam (where labour costs are lowest), has risen. At the same time, investment in the United States has grown rapidly since 2016, reflecting the desire of South Korean companies to get closer to their end market.

■ Very low external vulnerability

Lastly, South Korea has solid macroeconomic fundamentals, which will allow the authorities to support the economy if necessary. Inflation is low, the government has had a budget surplus (taking the social security surplus into account) every year since the early 2000s, and government borrowing is at around 40% of GDP with a good profile. In particular, external vulnerability is currently very low. The current account has been in surplus every year for the past decade, at an average of 4.1% of GDP between 2007 and 2017 (5.1% in 2017). The surplus is likely to remain at around 4% of GDP in 2018 and 2019. These surpluses have strengthened the government's position and those of the banking and manufacturing sectors in the event of increased volatility of capital flows. Similarly,

3- Outbound FDI

■ to China
■ to the United States
■ to Vietnam



Source: Korean Central Bank

macroprudential regulations and the package of measures introduced over the last ten years have significantly reduced the vulnerability of the banking and business sectors. Banks' short-term debt now represents 5.5% of GDP, down from 13% at the end of 2009. Lastly, the country's net external position was continuously strengthened between 2010 and 2016. It worsened slightly in 2017 (to 16.2% of GDP) but remains very solid, reflecting the country's reduced vulnerability to capital outflows.

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³ KIEP, "China's Manufacturing development and its implications for Korea", World Economy Brief, Vol.8 No 18, July 2018



Egypt

External vulnerability is limited in the short term

Despite the turmoil that has swept the emerging markets in recent months, we are still confident in the solidity of Egypt's external accounts in the short term. Last year, the current account deficit narrowed significantly, thanks to remittances, tourism and an improved energy account. In the short term, higher oil prices should have only a small impact on the current account. For the moment the central bank's cautious policy is containing the risk of a sudden outflow of portfolio investment. In the medium term, however, several sources of vulnerability persist, including commodity prices, the political environment and the rising cost of debt in foreign currency.

■ Spectacular reduction in the current account deficit

In fiscal year 2018, the improvement in the current account was much higher than analysts expected across the board. The current account deficit narrowed to 2% of GDP from more than 6% in the previous year. Although the trade deficit did not change (USD 37 bn, 12% of GDP), the improvement in the current account can be attributed to a significant increase in private remittances (+21%) and the doubling of tourism revenues. The energy deficit also declined: despite the ongoing need for liquefied natural gas imports and the upturn in oil prices (Brent crude oil rose 65% in fiscal year 2018), the oil & gas deficit narrowed by USD 1.7 bn to 1.2% of GDP, compared to 2.3% of GDP in the previous year. The country's foreign-currency liquidity also improved dramatically thanks to significant capital inflows, including foreign direct investment (FDI) in the energy sector, portfolio investment attracted by high yields, and international financial support. The Central Bank of Egypt (CBE) reported foreign reserves of USD 44 bn at the end of June 2018, the equivalent of 7.2 months of goods and services imports.

The bout of turmoil in the emerging markets last summer spooked non-resident investors, who withdrew their funds from the Egyptian market. Their holdings of Treasury bills have dropped off by a third since May 2018, to USD 14 bn at the end of August. At the same time, non-resident investors have become net sellers on the equity market since late August 2018 (USD 0.35 bn). Even so, net Egyptian equity flows have remained positive since the beginning of 2018, at roughly USD 0.37 bn. The CBE's foreign reserves did not decline over the summer months.

In this environment, the Egyptian pound remained stable against the dollar thanks to the CBE's specific policy, which continues to channel most foreign currency flows towards its balance sheet. The repatriation mechanism, which the CBE uses to have an influence on foreign exchange policy, was eased in order to funnel foreign currency into the interbank market. The interbank market is currently absorbing about a third of foreign currency flows. For the moment, the CBE seems to be giving priority to the stabilisation of the exchange rate, in order to contain inflationary pressures and to provide some stability for non-resident investors. One of the central bank's priorities is to reduce inflation, which has fallen back rapidly after peaking in late 2017. However, ongoing cutbacks in energy subsidies, higher oil prices and the volatility of foods prices have prevented inflation from declining significantly.

1-Forecasts

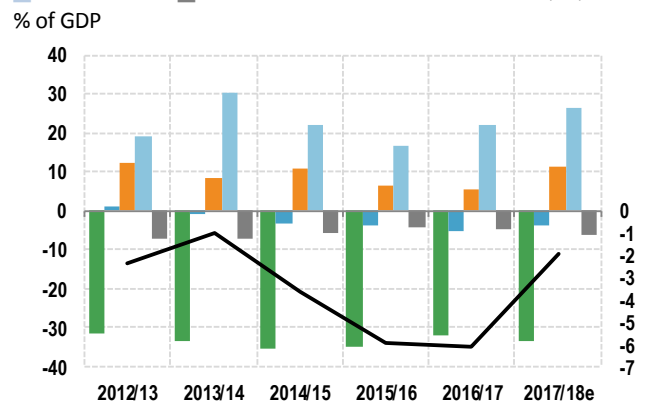
	2016	2017e	2018e	2019e
Real GDP growth (%)	4.3	4.2	5.2	5.5
Inflation (CPI, year average, %)	10.2	23.3	21.5	16.0
Gen. Gov. balance / GDP (%)	-11.2	-11.6	-9.6	-7.8
Gen. Gov. debt / GDP (%)	96	103	89	88
Current account balance / GDP (%)	-6.0	-6.1	-2.0	-2.4
External debt / GDP (%)	17	34	38	38
Forex reserves (USD bn)	18	31	44	44
Forex reserves, in months of imports	3.1	5.5	7.2	6.7
Ex change rate USDEGP (year end)	7.4	8.8	17.9	18.5

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

e: BNP Paribas Group Economic Research estimates and forecasts

2- Breakdown of the current account

Hydrocarbons Non-hydrocarbons Services
Remittances Revenue Current account balance (rhs)



Source: BNP Paribas

■ Limited short-term risks

Despite capital flight by non-resident investors and the high level of oil prices, Egypt's external accounts are not expected to deteriorate much in the short term. For fiscal year 2019, the current account deficit could be limited to about 2% of GDP. Under our central scenario, higher oil prices should have only a mild impact on the external energy deficit for the year 2018-2019. First, we expect the increase in oil prices to be limited between H2 2018 and H1 2019. Second, even though production has declined slightly, the country



remains a net exporter of crude oil (about USD 2 bn in 2017-2018). There is a big deficit for refined oil products, which contributes most of the hydrocarbon account deficit. Yet certain factors are expected to help stabilise the energy deficit. First, the increase in natural gas production should halt the very costly imports of liquefied natural gas. We are nonetheless cautious about the country's capacity to become a natural gas exporter. Second, looking beyond H2 2019, the start-up of production at new refining units should reduce the energy bill. All in all, as a percentage of GDP, the energy deficit is expected to remain flat at 1.2% in 2019.

As to non-hydrocarbon goods, exports are likely to increase moderately given the less favourable outlook for world trade and the priority Egyptian companies are placing on the domestic market. Moreover, the constraints squeezing household purchasing power at a time of high inflation, combined with sluggish corporate investment, should limit the increase in non-hydrocarbon imports.

With the slowdown in the growth of private remittances and the ongoing increase in tourism revenues, the current account deficit is expected to widen slightly in 2018-2019 (2.4% of GDP vs 2% in 2017-2018). Even so, the size of the current account deficit should help maintain foreign currency liquidity. External debt servicing – due mainly by the public sector – amounts to about USD 4 bn a year. Bolstered by the hydrocarbon sector, foreign direct investment should level off at about USD 7-8 bn, the equivalent of 2.5% of GDP. Portfolio investment trends are still the big unknown in the short term, but the risks posed by this volatile capital component on the country's foreign currency liquidity seem to be manageable. In addition to its official reserves, the CBE holds so-called Tier 2 reserves of foreign currency assets, which play a prudential role and are designed to face up to any capital flight by non-resident investors holding short-term Treasury bills. At the end of August 2018, the CBE's Tier 2 reserves covered about 56% of these Treasury bills, and the uncovered share amounted to about USD 4 bn. Under a worse-case scenario of the withdrawal of the totality of portfolio investment stock, and considering that FDI covers the current account deficit, medium and long-term debt flows should largely cover this capital flight. The impact on the CBE's official foreign reserves would be a reduction of about USD 4.2 bn at the end of FY 2018-2019, which would leave a balance equivalent to more than six months of imports of goods and services.

■ What about the medium-term risks?

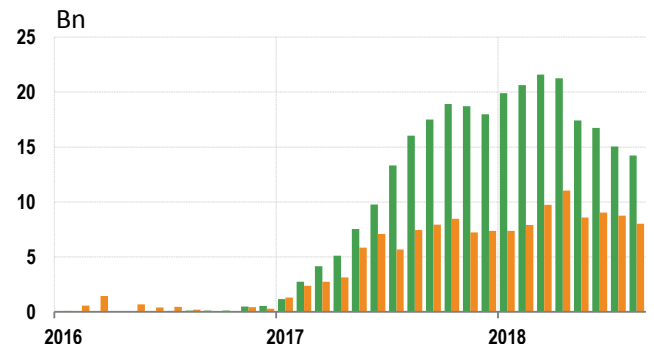
The evolution of foreign currency liquidity is less certain in the medium term. We have identified three categories of risk that could endanger the balance of payments equilibrium.

Energy and food commodity prices are a major component of changes in the trade balance. It is worth keeping in mind that Egypt is still the world's largest wheat importer. Given its reliance on natural gas imports to cover the increase in domestic demand, the current account's vulnerability to commodity prices is likely to increase in the medium term.

The upturn in international interest rates will also affect external debt servicing charges. Payment of interest and principal rose from 7% of current revenues in 2013 to 18% in 2017. For the moment, however,

3- The CBE's cautious policy towards portfolio investment

Treasury bills held by non-residents
CBE Tier 2 foreign reserves



Sources: Central Bank of Egypt, BNP Paribas

the risk is mild given the moderate – but regularly increasing – external public debt (about 18% of GDP in 2017). The government's goal is to limit foreign currency bond issues to USD 5 bn a year.

Political factors in the broad sense of the term must also be taken into account. We have retained two key factors with potentially major negative consequences: a deterioration in the security situation that could endanger the recovery of the tourism sector (13% of current revenues), and the tightening of government policy towards foreign workers in the Gulf countries. This would affect remittances to Egypt (33% of current revenues). For the moment, measures to expulse foreign workers have had relatively little impact on Egyptians given their rather high skills level. Yet about 60% of Egyptian expats in the Gulf countries work in Saudi Arabia, which is tending to tighten its already restrictive policy.

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Saudi Arabia

Non-oil GDP growth prospects remain sluggish

Thanks to increased oil production and higher public spending, Saudi Arabia's economic growth should be able to be positive again in 2018. Yet the private sector is showing only timid signs of recovery, despite fiscal stimulus measures, and we are not expecting a significant turnaround in activity in the short term. Job market reforms and their negative impact on domestic demand have sharply curtailed economic activity. The total number of employed workers has declined while the unemployment rate remains high, especially among youth. Saudi Arabia's low attractiveness for foreign investors does not facilitate the essential reform process.

Oil is fuelling economic growth again

In 2018, the Saudi economy is expected to swing back into growth after contracting 0.8% in 2017. Second-quarter sector data confirm a mild acceleration in activity. Real GDP growth rose to 1.6% yoy in Q2 2018 from 1.2% in Q1. Unsurprisingly, the main growth engines were oil production and public spending.

Activity in the oil sector (which accounts for about 40% of GDP) increased 1.7% in Q2 2018. This illustrates the (small) change in the Kingdom's oil policy. The strategy of OPEC countries and Russia aimed at winning market share and boosting prices seems to be paying off. The gradual introduction of production caps has enabled Brent crude oil prices to rise by almost 50% a barrel since early 2017. For the moment, this has not triggered a significant increase in output by non-OPEC producers, which would have squeezed prices. Yet the oil market situation has changed since the beginning of the year. The drop-off in Venezuelan oil production and the gradual reduction in Iranian exports have required an extra boost in crude oil production from other sources. Given its spare production capacity, Saudi Arabia was able to increase crude oil production by 5% between January and September 2018. It will probably build on this momentum in the short term with the tightening of sanctions against Iran. After declining 3.1% in 2017, we expect oil GDP to rise 2.3% in 2018.

As to non-oil GDP, the situation is positive but strikingly sluggish, notably in the private sector. Public-sector services (13% of GDP) were the main growth engine in the first half of the year. This was largely expected since the government returned to a pro-cyclical fiscal policy fuelled by higher oil revenues (70% of total fiscal revenues in 2017). In 2017, the restrictive fiscal policy stance was the main reason for the very weak growth in the non-oil sector, which rose only 1% in real terms compared to an average of 5.7% between 2011 and 2015. Given our forecast of higher oil prices, this fiscal boost is likely to be maintained and serve as a decisive growth engine in 2018. According to our estimates, non-oil public sector GDP is expected to rise 3.5% this year.

Non-oil private sector activity has been trending upwards since the beginning of the year, buoyed by the industrial sector (excluding refining) and the financial sector (10% of GDP), which is holding to a long-term growth trend. In contrast, the construction sector contracted 3.2%, confirming a trend in place since March 2016. An analysis of high frequency economic indicators confirms a real but mild economic recovery. In September 2018, PMI was still upbeat at

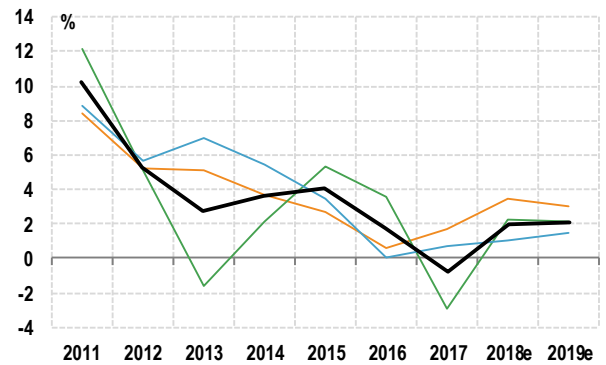
1- Forecasts

	2016	2017	2018e	2019e
Real GDP growth (%)	1.7	-0.8	2.0	2.0
Inflation (CPI, year average, %)	2.2	3.5	2.8	2.0
Central. Gov. balance / GDP (%)	-1.7	-6.4	-1.0	-0.4
Central. Gov. debt / GDP (%)	13.0	17.0	18.0	19.0
Current account balance / GDP (%)	-3.7	-2.1	2.9	3.0
External debt / GDP (%)	21.0	23.0	25.0	26.0
Forex reserves (USD bn)	529	497	522	553
Forex reserves, in months of imports	31.0	30.0	31.0	32.0
Exchange rate USDSAR (year end)	3.8	3.8	3.8	3.8

e: BNP Paribas Group Economic Research estimates and forecasts

2- Real GDP growth

— Total — Non-oil public sector
— Non-oil private sector — Oil sector



Source: BNP Paribas

53.4 points, even though this was lower than in the previous month. Yet in Saudi Arabia's case, the significance of this indicator is debatable. The very low level of non-oil private sector activity in 2016 and 2017 is not reflected in the PMI index, which has held systematically above 53 points.

Lending to the private sector remains very sluggish (+1% y/y in August 2018). Similarly, lending to households increased by only 1% y/y in Q2 2018. Apparently, the traditionally positive impact of higher public spending on private-sector activity is not as strong as



in the past. One of the main explanations for this shift is probably labour market reform.

■ Painful labour market reforms

Among the reforms implemented as part of Vision 2030, the transformation of the labour market is one of the most advanced. The problem has been known for years: the labour market is split between well paid public-sector jobs held primarily by Saudi nationals (90% of public sector employment) and private-sector jobs, the unskilled segment of which is dominated by foreigners. This system, which has engendered high unemployment among Saudi youth (43% in the 20-24 age group), needs to be reformed due to Saudi demographic growth and the increase in female employment.

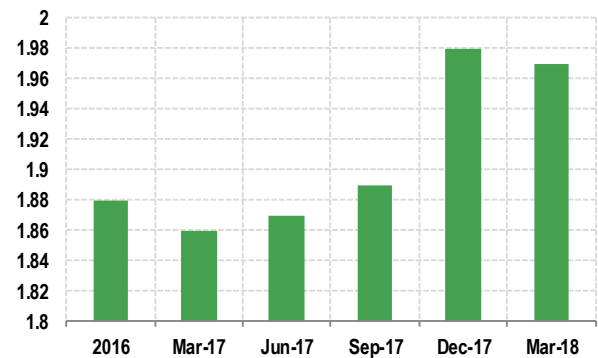
Government measures can be divided into three categories: measures to increase the cost of foreign labour by taxing their employers and raising fees on the family members of foreigners; the introduction of job quotas for Saudi nationals by sector, and efforts to train the Saudi population. One of the most significant measures recently was in the retail trade sector, where foreign workers have to be replaced by Saudi nationals. For the moment, these measures are creating a lot of friction in the labour market, which is a major factor behind the economic slowdown. Between early 2017 and March 2018 (the latest figures available), about 700,000 foreign workers abandoned the labour market, including 234,000 in Q1 2018 alone. Over the same period, 94,000 Saudi nationals joined the private-sector workforce. Obviously this had an impact on private demand (private consumption represents about a third of GDP), even though most of the jobs that were vacated were for unskilled labour. This labour market trend is likely to persist for several quarters, and the negative impact on domestic demand is likely to swell. The departure of foreign workers concerns increasingly skilled job categories. In the face of this situation, we continue to take a cautious approach to our real GDP growth forecasts for the non-oil private sector, which are expected to hold below 2% through 2020.

■ Persistent structural constraints

A major obstacle for Saudi nationals who want to access the private-sector labour market is the wage gap with public-sector jobs and the low attractiveness of many of these jobs. According to the General Authority for Statistics, the average monthly wage was USD 2,960 in the public sector, compared to a private-sector average of USD 1,920 for Saudi nationals and USD 1,040 for foreign workers. From a sector perspective, extraction is the only sector in which the majority of workers are Saudi nationals (58%), but this sector comprises only 1.8% of the country's total employment. The majority of jobs are concentrated in the construction and retail sectors, which account for 39% and 25% of total employment, respectively. These are also the sectors in which the percentage of Saudis workers is the smallest. Saudi nationals account for only 19% of retail sector jobs and 12% of construction jobs.

Foreign investment is one of the driving forces behind job creations in the emerging countries. Yet Saudi Arabia's attractiveness is especially low. In 2017, foreign direct investment (FDI) amounted to

3- Saudis employed in the private-sector (in millions)



Source: BNP Paribas

USD 1.4 bn, the equivalent of 0.2% of GDP. Although this was an exceptionally bad year, it reflects the structural weakness of FDI in Saudi Arabia. In the period 2013-2016, FDI averaged 1.16% of GDP. To counter this problem, the government has introduced measures under which certain major contracts are required to meet local production criteria. This pertains notably to certain sectors of the defence industry.

Labour market reforms aiming to promote jobs for Saudi nationals are bound to continue straining economic activity in the medium term. This is a particularly big challenge given that the Saudi labour market participation rate is fairly low (42% on average).

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Angola

Some encouraging signs

A review of Joao Lourenço's first year in office reveals a rather positive shift in government policies, given the determination to clean up politics and the scope of the economic reforms engaged. After a two-year freeze, Angola is cooperating with the IMF again and a new financing agreement is being prepared in the short term. Yet despite the new government's positive drive and the upturn in oil prices, the country faces several challenges: a deteriorated oil sector, a foreign currency liquidity squeeze, the erosion of household purchasing power and a severely troubled banking system. Mired in a severe economic crisis, the recovery is bound to be very gradual at best.

■ Still in recession

Despite the progress that has been made since the arrival of Joao Lourenço's new government and the upturn in crude oil prices, the Angolan economy is expected to report its third consecutive year of recession in 2018. According to the National Statistics Institute, the economy contracted 2.2% year-on-year in Q1 2018. This contraction was attributed to the 7.3% decline in extracting and refining activities, which account for 33% of GDP, and an 8.8% decline in trade, which accounts for 15% of GDP.

The oil sector continues to face the consequences of the freeze on most oil exploration projects and massive layoffs to reduce operating costs. Oil production has declined continuously, from 1.8 m barrels per day (b/d) in 2015 to 1.45 m b/d in July 2018, due to maintenance work on some oil fields while others have reached maturity. Yet production should improve as of 2019 with the start-up of the new Kaombo oil field (Total)¹ this year. The expected increase in oil GDP should fuel growth of 3.1% in 2019.

Excluding the oil sector, economic growth prospects are also limited by import restrictions, notably on non-priority products, persistently high inflation and the expiration of certain subsidies that had lifted household purchasing power. The banking system's deteriorated financial situation will continue to strain private sector development. Corporates continue to battle with commodity shortages, insufficient equipment and financial problems arising from heavy fiscal pressures.

■ Efforts to attract investors

Joao Lourenço's arrival at the helm a little over a year ago has given the economy a rather positive boost. Since September, the president has headed the MPLA, the last vestige of Dos Santos hegemony, thereby gaining uncontested authority with Angola's political elite and businessmen.

After changing several key positions, the government is trying to improve international investors' perception of the business climate. After simplifying administrative red tape to attract FDI (issuing visas and residency permits), progress has also been made on supplying electricity and issuing building permits. A new law was approved on

¹ Located 260 km from the Luanda coast, this is the biggest deep-water oil project in Angola, with two production and storage units. Overall production is estimated at about 230,000 b/d.

1- Forecasts

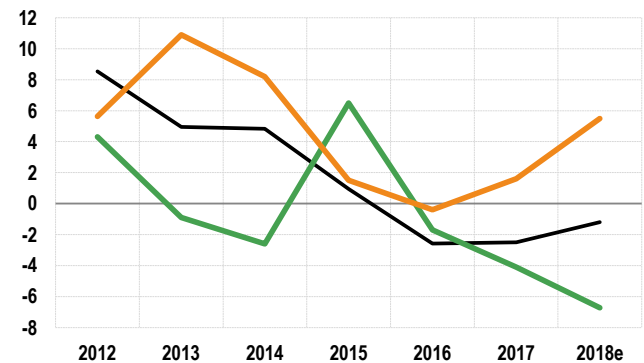
	2016	2017	2018e	2019e
Real GDP growth (%)	-2.6	-2.5	-1.2	3.1
Inflation (CPI, year average, %)	30.7	31.7	20.5	15.8
Gen. Gov. balance / GDP (%)	-4.5	-6.1	-0.3	2.6
Gen. Gov. debt / GDP (%)	75.3	67.3	70.8	68.1
Current account balance / GDP (%)	-4.9	-4.4	-1.6	0.5
External debt / GDP (%)	35.0	33.2	42.6	53.0
Forex reserves (USD bn)	20.8	14.0	15.0	18.0
Forex reserves, in months of imports	8.1	5.1	5.2	6.1
Ex change rate USDAOA (year end)	166	166	310	400

e: BNP Paribas Group Economic Research estimates and forecasts

2- Battered oil sector weakens economic growth

Real growth, year-on-year in %:

— Non-oil GDP — Oil GDP — Total GDP



Source: IMF, Jodi, BNPParibas

non-resident investment, competition and combatting monopolies². Moreover, a project to privatise about 74 state-owned companies³ should attract fresh capital in the medium term.

² To facilitate non-resident investment, the government eliminated the minimum commitment of USD 230,000 and the obligation to associate with a local partner holding at least a 35% equity stake.

³ Enterprises up for total or partial privatisation include the country's ports, the national airline (TAAG), the Bank of Commerce and Industry (BCI), and the Ensa insurance company.



The new foreign exchange policy also reduces the obstacles to investment. After abandoning the dollar peg in January 2018, the central bank has gradually depreciated the kwanza (AOA) in a controlled manner through a series of auctions. Starting in October, the volume of foreign currency will be increased and the central bank will halt direct sales of foreign currency, which will be handled by authorised retail banks. At the same time, the approval of legislation to facilitate the repatriation of funds held abroad aims to reduce the shortage of hard currency.

As to the key hydrocarbon sector, after new legislation was passed on fiscal rights for natural gas and tax cuts for marginal oil fields, President Lourenço created the new National Oil & Gas Agency. This agency will take over the attribution of oil concessions and the management of production sharing agreements, which were previously managed by Sonangol, which will maintain its exploration, production, refining and exportation activities.

■ Large macroeconomic imbalances

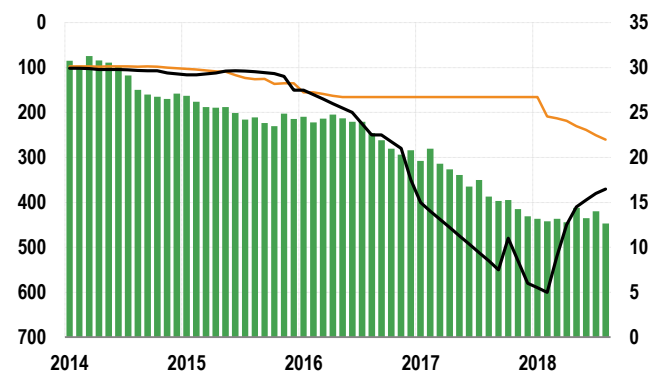
The more flexible foreign exchange regime seems to be gradually reviving the economy, but the recovery will be longer than expected due to major macroeconomic imbalances. With the switch to a more flexible forex regime, the kwanza has lost more than 40% in value against the dollar. The spread between the official and parallel exchange rates is still high but narrowing gradually (chart 2). This indicates that forex pressures will persist in the short term. Despite the upturn in crude oil prices since late 2017, the central bank's foreign reserves have barely increased (to USD 13.2 bn in Q2 2018 from USD 13.3 bn in Q4 2017). Consequently, foreign exchange controls are likely to be maintained in the medium term.

The current account balance is expected to post another deficit in 2018 (-1.6% of GDP). In 2018, the trade surplus was still too small to offset the deficits in the balances of services and revenue. However, it should be possible by 2019, thanks to the ongoing upturn in oil prices. Foreign direct investment and portfolio investment are both weak, which means the external situation will remain extremely fragile, and the country will have to rely on external debt financing. Borrowing on the international capital markets is relatively expensive. Last May, Angola issued a USD 3.5 bn Eurobond with the longest maturity (30 years) at a rate of 9.4%. Despite a better oil cycle, the sovereign spread on foreign-currency debt is still high at about 600bp.

In this context, the government officially asked the IMF to add a financing component to the technical assistance programme to support the Macroeconomic Stabilisation Programme (started in January 2018) and the 2018-2022 National Development Plan. It has requested a 2-year loan of about USD 4.5 billion that can be rolled over for a third year. The signing of such an agreement would signal a change in the government's economic policy. First, it would diversify the sources of international financing. Second, its macroeconomic reform targets are likely to reassure economic agents. Yet the austerity already in place might have to be tightened even further, which risks testing the social acceptance of the efforts currently demanded of the population. Despite the changes made

3- Despite improvements, pressures persist

— Official AOA/USD exchange rate — Black market (inverted scale)
■ Foreign reserves, USD bn (rhs)



Source: BNA, Kinguila, Bloomberg

over the past year, there is still a very fragile balance between the need for reform and the living conditions of the Angolan people.

As to the banking system, it is still ailing. Despite the high profitability of banks, whose revenues rely mainly on foreign currency business and Treasury bonds, the quality of bank assets has deteriorated constantly. The non-performing loan ratio rose to nearly 30% at the end of 2017, compared to 13% a year earlier. This is placing pressure on bank capitalisation. The absence of correspondent banking (with the exception of a few foreign banks) and the slow pace of bank transfers will continue to strain the private sector. Even though transfers have improved since the beginning of the year and the government has no known payment arrears with local suppliers, roughly EUR 1 bn in arrears for the period 2014/2017 are still blocked. This has apparently caused certain corporates to go bankrupt and others to experience major financial difficulties.

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Morocco

Mixed prospects

Morocco's performance was mixed during the first half of 2018. The economic growth recovery is still mild despite good performances in the tourism and manufacturing sectors. Social unrest is rising against a backdrop of endemic unemployment, while the economy is hit again by a swelling energy bill. After several years of consolidation, the twin deficits are expected to widen slightly this year. Although Morocco's macroeconomic fundamentals are still solid, structural reforms are needed to raise the growth potential.

Morocco's economic development largely hinges on its image of stability. Reform efforts are continuing, as illustrated by the flexibilisation of the exchange rate regime introduced in January, and in many respects Morocco is still one of the region's most attractive economies (quality infrastructure, active industrial policy). Yet endemic unemployment is fuelling an upsurge in social demands at a time when the economy is being squeezed by rising oil prices. Despite solid macroeconomic fundamentals, efforts to rebalance the public and external accounts risk coming to a halt while economic growth is still too modest.

■ Structural constraints dampen the recovery

With real GDP growth of only 2.4% in Q2, compared to 3.2% in Q1 and an average of 4.1% in 2017, the Moroccan economy is losing steam. The slowing of growth in the agricultural sector to 3% was expected after a very strong 2017 performance (+13%). Activity outside agriculture, in contrast, was surprisingly weak, with non-agriculture GDP growth dropping to 2.6% in Q2 2018, 1 point lower than in the previous quarter and the lowest level since Q2 2016.

From a sector perspective, the situation is mixed. Momentum remained strong in the tourism sector after a record year in 2017 with 11.3 million visitors. In H1 2018, the number of arrivals and overnight stays was up 10%. The manufacturing sector also held up well, with exports (excluding phosphates) up 8.5% in the first 8 months of the year, thanks to the development of the automotive industry. In contrast, value added in the mining sector contracted 1.1% in Q2 after increasing 13.8% in Q2 and 15% in FY 2017. Another troubled sector is construction, which is still absorbing past excesses (+0.9% in Q2). In terms of domestic demand, household consumption has held up rather well in the face of rising inflationary pressures, but investment remains sluggish. At the end of August, bank lending to the private sector rose only 1.2% (excluding households).

Despite the expected acceleration in H2, economic growth will barely reach 3% this year before slowing slightly to 2.9% in 2019, due to the 0.5% contraction in the value added of agricultural sector (10-12% of nominal GDP, 38% of the working population). Looking beyond the growth vulnerability to the performance of agriculture, what is most disturbing is how hard it is for the non-agricultural sector to regain momentum. At an estimated 3.1% in 2018 and 3.4% in 2019, non-agriculture GDP growth will undoubtedly surpass the 2017 low of 2.8%, but it is still a far cry from the levels necessary to reduce the high unemployment rate (10.2% in 2017),

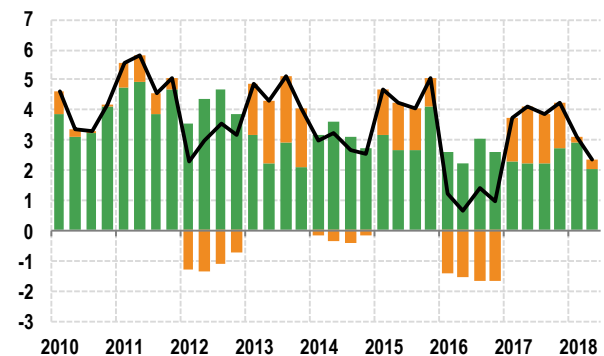
1-Forecasts

	2016	2017	2018e	2019e
Real GDP growth (%)	1.1	4.1	3.0	2.9
Inflation (CPI, year average, %)	1.6	0.7	2.2	1.6
Central. Gov. balance / GDP (%)	-4.3	-3.5	-3.7	-3.4
Central. Gov. debt / GDP (%)	64.9	65.1	65.7	66.5
Current account balance / GDP (%)	-4.4	-3.4	-4.0	-4.3
External debt / GDP (%)	47.8	47.1	45.5	46.6
Forex reserves (USD bn)	24.3	25.3	24.7	25.2
Forex reserves, in months of imports	6.5	6.1	5.4	5.2
Exchange rate USDMAD (year end)	10.1	9.4	9.4	9.6

e. BNP Paribas Group Economic Research estimates and forecasts

2- Sector contribution to GDP growth

- Non-agriculture GDP, in p.p
- Value added of the agricultural sector, in p.p
- GDP, y/y % change



Source: HCP, BNP Paribas

and youth unemployment in particular (26.5%). Numerous structural constraints are hampering the Moroccan economy. Despite the boom in automotive production since 2012, as well as in aeronautics albeit to a lesser extent, the share of manufacturing sector in the GDP is still low at less than 16%. Shortage of highly skilled labour is a problem. According to the OECD, 60% of the active population have no degrees whatsoever while those with degrees are having a hard time finding work (the unemployment rate for university graduates is 28%). Without a better use of human resources, spill-over effects of these new industries to the rest of the economy will



thus remain limited. The business climate also needs to be improved. The investment rate already fell by 4 points between 2012 and 2017.

■ Worsening of macroeconomic imbalances

Despite the emergence of some signs of weakness, the macroeconomic environment is still favourable for economic activity.

Inflation has accelerated under the double impact of higher food and fuel prices, but now seems to have peaked. The inflation rate dropped to 1.7% in August, from an H1 average of 2.4%, thanks to a rather sharp easing of food prices. With core inflation holding steady at 1.2%, the inflationary risk seems to be limited. This means the central bank should be able to maintain a low policy rate, which has held at 2.25% since March 2016.

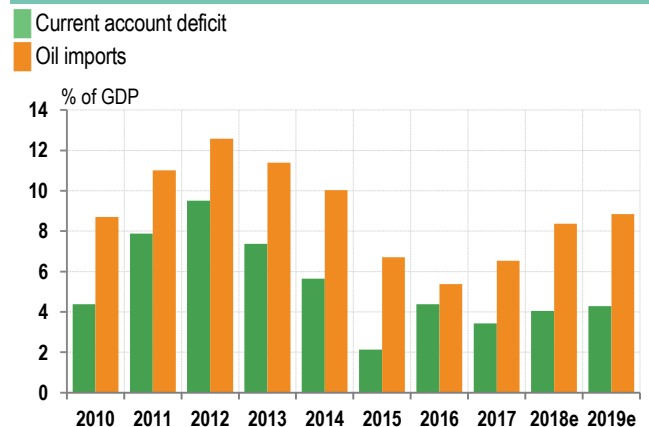
In the first 8 months of the year, the trade deficit widened by 10% due to the swelling of the energy bill (+19%) and imports capital goods (+12%). These two items account for 40% of imports. Pressures will remain strong in the short term since oil prices are expected to stay high in 2019, and the country will continue to develop major industrial projects. Despite hefty tourist revenues (15% of current account receipts) and the launch of a new automobile production unit in 2019 (automobiles are now the main source of exports, accounting for 24% in 2017), the current account deficit is likely to widen above 4% of GDP for at least the next two years, from 3.4% in 2017.

At this level, the coverage of external financing needs is manageable. Net foreign investment flows are robust at about 1.5% to 2% of GDP a year, and the government can access the international financial markets under favourable conditions. A USD 1 billion Eurobond issue is already being planned for 2019. External debt is moderate at 45% of GDP, two-thirds of which is held by the state and state-owned companies, and the country's risk premium is just at 159 basis points (bp), one of the lowest among the emerging countries. Moreover, Morocco is not exposed to portfolio investment flows, which is a rather positive factor in the current environment. All in all, we expect Morocco's foreign reserves to remain at a comfortable level of more than 5 months of imports of goods and services.

Yet the current account is still highly vulnerable to commodity prices. The energy bill accounts for more than 15% of imports, while phosphates make up 18% of exports. Similarly, the tourist sector is vulnerable to fluctuations in the local and regional security situation.

A similar observation can also be made about public finances. The budget deficit was trimmed to 3.5% of GDP in 2017, from 6.8% in 2012, but is expected to widen again this year to 3.7%. Budget execution at the end of August reveals some of the difficulties that lie ahead. Although spending as a whole is tightly controlled, the gains generated by the overhaul of the subsidy system are now over. Once again, fiscal revenues fell short of expectations, confirming a trend that has seen their value in percentage of GDP erode by more than 2 points since 2012. As a result, government debt should continue to rise to 65.7% of GDP in 2018. At this stage, debt sustainability is not called into question. Less than a quarter of the

3- External accounts deteriorate moderately



Source: Office des changes, BNP Paribas

debt is denominated in foreign currency, and attractive financing conditions in the local market help to debt service at a moderate level. Interest payments absorb only 12% of government revenues, and the apparent cost of the debt is 4.2%, one of the lowest rates among the region's oil-importing countries. Even so, this should not mask the rise of the government debt by nearly 20 points of GDP since 2009. The country's debt dynamics will have thus to be reined in. But little fiscal manoeuvring room and rising social demands should make the task difficult to achieve.

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