Editorial

#Brexit

Three months after the referendum, it might be tempting to call the Brexit vote a non-event. Yet it is much too early to measure the consequences, other than on GBP. For the UK, the challenge is to continue attracting international investors. This task will be especially difficult given that monetary policy is geared towards holding down interest rates, and public finances are bound to deteriorate. All of this points towards a long depreciation of GBP…
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Three months after the UK referendum, it might be tempting to call the Brexit vote an economic non-event. Yet it is much too early to measure the consequences, other than its downward pressure on GBP. For the UK, the challenge is to continue attracting international investors, at a time when the country risks losing access to the European market. This task will be especially difficult given that monetary policy is geared towards holding down interest rates, and public finances are bound to deteriorate. All of this points towards a long depreciation of GBP, which will provide scant economic support while undermining the country’s attractiveness.

Today’s world lives in the moment. Thanks to modern communications, we learn about, analyse and understand everything in real time. To refuse to acknowledge technology’s effectiveness would be to deny the modern world. Yet this immediacy has its drawbacks: it is often synonymous with fugacity. What we learn in a flash, we forget just as quickly. There can be no other explanation for the fact that some are still mystified by the currently low level of inflation. If we can’t remember that less than 10 years ago the global economy was hit by the worst crisis since the 1930s, then it is impossible to explain why economies with growth rates close to their long-term potential are not generating inflation. Our past is crucial. Our future is, too. We should not mix up “impact” and “consequences”. Today, it would be wrong to conclude that the UK referendum will not have consequences simply because it did not have an impact on economic surveys, which dipped temporarily. After sounding the alarm across the board, the indexes regained their health in the month that followed, and have been trading at record highs for several months. Uncertainty dictated a wait-and-see approach, but once the uncertainty was lifted, life returned to normal.

But the only trouble is that Brexit hasn’t happened yet; it will happen. For several weeks, we were able to muse on the idea that creative Albion would find a solution to free itself from its own undoing: unlike a House of Commons vote, a referendum is not binding; the people would be called back to the voting booths once the Brexit camp’s lies had been exposed; it was not enough to vote to leave the EU, the terms of a Brexit agreement must also be approved, and if a convincing exit plan could not be reached, then maybe it could accept to remain European... In early October, Theresa May cut short these speculations: negotiations between the UK and the Europeans would begin before March 2017, with Brexit effectively taking place in spring 2019.

Yet the UK’s priorities are not all that clear. Theresa May emphasises the importance of maintaining her country’s privileged access to the European market, but places top priority on controlling immigration flows, even though that is not possible without a reduction in the freedom of movement of goods, services, and capital. Text is important, but so is the context: Theresa May delivered her declarations in front of the Conservative Party, and seen in this light, it is easier to understand her tough stance. This leads us to question whether she is firmly committed or simply posturing. Is her speech designed to rally “Brexeters” around an exit plan that they might not find so appealing? She might also be determined to show her firmness just a few months before launching negotiations with the Europeans.

One thing is certain: expectations of a painful, costly Brexit have sharply undermined GBP. Since 23 June, the real effective exchange rate of the British currency has fallen 15%. The negative effects will spread rapidly, via a loss of household purchasing power and higher production costs for companies. Some expect the weak GBP to provide support, but this must be kept in perspective: although exporters1, through their sales prices, recover all or part of the higher cost of inputs, the gains in external competitiveness are limited by as much. The last time GBP depreciated sharply – by more than 25% in effective terms in 2007-2008 – it did not benefit the UK’s trade balance.

The most devastating effects are yet to come. Without going into detail, the press is filled with related announcements: American banks are worried about the durability of the “European passport”, the Japanese authorities accuse the UK of breaking its promise never to leave Europe; and industrial groups are threatening to freeze investment until the new customs tariffs are revealed, and whether or not they will be offset by subsidies. As the business world is quick to point out, the decision to locate in the British Isles is motivated by access to Europe’s 500 million consumers more than to the UK’s 64 million.

What economists fear most is that FDI inflows could dry up. Foreign direct investment offers several advantages: it is often associated with productivity gains linked to technology imports, and provides stable coverage of external financing needs. It is worth keeping in mind that the UK has one of the world’s highest current account deficits, at about 6% of GDP. As a result, the country must attract foreign capital. But this task is made harder by the Bank of England’s policy of keeping interest rates low, which is justified by deteriorating growth prospects. At the same time, public finances are bound to come under pressure as efforts are made to boost household purchasing power, to support corporate competitiveness to attract FDI, and to compensate for European subsidies of the past. Moreover, the pressure on GBP is bound to grow. The UK referendum might not have had an impact, but Brexit surely will have consequences. They will be felt over the long term, in the form of slower growth. Rather than a cataclysm, we are dealing with erosion, which is hard to elaborate in just 140 characters.

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1 The import content of UK exports is 23.1%, compared to 24% in the OECD countries, 15% in the United States and 14.7% in Japan.
United States

The Spirit and the Law

After three quarters of 1% growth, the US economy is poised to rebound in Q3 2016. Thereafter, growth is more likely to return to about 2%. At this pace, it will probably take a few more years to close the output gap. Consequently, the normalisation of monetary policy is likely to be a very gradual process. The Fed’s commitment to this policy has drawn fierce criticism in the pre-election period. On November 8th, Americans will vote not only for their next president, but also for the entire House of Representatives and a third of the Senate. There is little hope that the next Congress will be any more productive than the three previous ones, regardless of who is elected to succeed Barack Obama. And yet there is no end to the challenges that lie ahead...

Once again growth was disappointing in Q2 at an annualised quarterly rate of 1.4%. The economy has slowed sharply. In the last three quarters for which statistics are available, growth was limited to 1%, compared to 2.2% in the post-recession period. Most of this slowdown can be attributed to corporate spending. After slowing sharply throughout 2015, inventories contracted in Q3 2016 for the first time since 2011, and business investment has declined since Q4 2015. Total corporate spending made a negative 1-point contribution to growth over the past three quarters, after making an average positive contribution of 0.9 points since mid-2009. The nearly 2-point reduction in growth from one period to the next was partially offset by stronger contributions from household consumption (+0.4 points), public spending (+0.3 points) and foreign trade (+0.1 points).

In Q3 2016, corporate spending is unlikely to strain growth quite as much. In August, new durable goods orders (excluding defence and aircrafts) increased for the third consecutive month at an annualised rate of 2.3%. Though not particularly impressive, these performances are nonetheless the most solid in a year, at a time when inventories are no longer contracting. As a result, growth is expected to rebound as signalled by the various nowcasting models: +2.2% according to the New York Fed, 2.1% according to the Atlanta Fed and 3.6% according to the St Louis Fed.

- Accommodating but firm

Although growth is set to rebound in Q3, everything suggests that it will return to a rate of about 2% thereafter. On the Fed’s monetary policy committee (FOMC), members anticipate mild but stable growth, barely higher than their estimate of the economy’s long-term growth potential1. At this pace, over-capacities will be absorbed very gradually2, and the Fed is unlikely to meet its inflation target before 2018 (2% annual increase in the price index for personal consumption expenditure). Seen in this light, we can better understand why the FOMC members energetically renewed their commitment to a very gradual normalisation of monetary policy. By the forecast horizon (2019), the Fed funds target rate would be at only 2.6%, still below the long-term equilibrium rate of 2.9%.

The Fed’s strategy of maintaining a slightly accommodating policy over the long term aims to continue providing the economic support necessary to absorb the over-capacities inherited from the crisis, without generating inflationary pressure. The level of interest rates necessary to meet this target is open to debate, especially considering how hard it is to estimate the neutral rate of interest3. But some FOMC members fear an accommodating monetary policy will eventually end up threatening financial stability. This explains why three regional Fed presidents expressed dissent.

Eric Rosengren’s dissent caught our attention. Long an unwavering supporter of the aggressive easing of monetary policy – in late 2013,

1.8%, if we use the median long-term projection for GDP.
2. The output gap, the difference between actual and potential activity, would currently be about 2% of potential GDP according to the CBO, 1.5% according to the IMF and 1% according to the OECD.
3. The neutral or natural rate of interest ensures growth in line with potential growth without generating inflation, and allows an equilibrium between savings and investment. See “The dynamics of real interest rates, monetary policy and its limits,” Philippe d’Arvisenet, Conjuncture BNP Paribas, May 2016.

1- Summary of forecasts

<table>
<thead>
<tr>
<th>Annual growth, %</th>
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2. Households to the rescue

<table>
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<th>Contribution to GDP growth, annualised quarterly rate, %</th>
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<tbody>
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<td>Q3 2009 - Q3 2015 – Q2 2016</td>
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Source: US Bureau of Economic Analysis
he thought it was still too early to taper – he is now worried that the commercial real estate market is overheating. Although Fed Chair Janet Yellen admits that the price-to-rent ratio is high (and the return on investment is low), she points out that asset valuations are not abnormally high with regard to historical data. She also adds that the Fed has specific tools at its disposal to manage this type of risk, suggesting that she continues to think that interest rate policy is not the most suitable tool for preventing the growing risks to financial stability. Lastly, she notes that the Fed’s close monitoring has not shown any leverage building up associated with rising asset prices, nor an excessively maturity transformation, two of the symptoms that preceded the 2008 crisis.

Washington, we have a problem

Looking beyond the Fed, the debate is less theoretical and much less serene. Granted, it is not easy for the Fed to explain why key rates are near the zero lower bound at a time when the rate unemployment is close to its equilibrium. There is nothing new about the political attacks on the Fed. Four years ago, one of the Republican candidates warned Ben Bernanke to stay out of Texas. The current campaign is an amplified echo of previous ones. During the press conference following the last FOMC meeting, Janet Yellen had to respond to no fewer than three questions on the possible political nature of the Fed’s actions. By insisting that the Fed is apolitical, and that politics are never broached during FOMC meetings, she also avoided a more pertinent question: why was the Fed more worried about the results of the UK referendum last June than it is today about the outcome of the US presidential election?

Granted, the economic platforms of two candidates have never been so divergent. US economic prospects vary widely depending on which platform is adopted. For the Republicans, it is a matter of cutting household and corporate income taxes, while slashing discretionary spending. Hillary Clinton’s platform, in contrast, is centred on the middle class and families, education and healthcare, and all of her proposed measures would be financed via a more progressive tax system. The public debt trajectory would hardly change under the Democrat’s platform, but would explode under the Republicans, especially since we doubt their underlying assumption that growth would accelerate to 3.5%. The US economy has not enjoyed such buoyant growth since the second half of the 1990s, when productivity gains were about 2 points higher than they are today.

The lack of interest in the economic platforms of the two main presidential candidates is one of the characteristics of the 2016 election. This is not only due to the personality of the two candidates; there is very little probability that either platform will be implemented. As powerful as he (or she) might be, the President of the United States does not have absolute power: the US constitution sets in place checks and balances. On November 8th, the American people will not only choose Barack Obama’s successor, they will also elect the entire House of Representatives and a third of the Senate, the two congressional chambers of the federal government endowed with legislative powers. We are not trying to deny the importance of the US president, who notably has the power to nominate the members of the Fed’s Board of Governors and the Supreme Court judges. Yet we should not underestimate Congress’ power either. As the past six years have shown, with a congressional majority it is hard for the president to impose his (or her) policies.

Today, the polls suggest that the Republicans will maintain their House majority while the Senate is evenly divided. In theory, as the Senate’s president and its 101st member, the vice president would be in a position to cast the tie-breaking vote in the president’s favour. In practice, however, most bills require a larger majority to pass the Senate (3/5ths, or 60 senators). All in all, it looks like the next Congress will be very similar to the past three. A Republican president would certainly benefit from a House majority, but the Democrats would be in a position to block him in the Senate. Hillary Clinton would probably have to deal with a hostile Congress, as was the case for Barack Obama. In the short term, we risk seeing another series of threats to shut down the government over the debt ceiling. In the longer term, much needed reforms are likely to be postponed again. There is nothing new about the challenges facing America. Four years ago, we wrote these lines: “For the federal government, this means deep-seated reforms: fiscal reform, reform of redistribution, reform of the financing of public goods whether in education or infrastructure.” Considering the gridlock that has gripped Congress over the past four years, we can only conclude that everything still remains to be done.

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4 The Fed’s interest rates apply to the economy as a whole, and not only to the areas where risks might arise. Although they can definitely curb some excesses, they also affect healthy sectors. Monetary policy should only be used as a last resort to combat these risks.

Eurozone
Slowly, but not so surely

There are some things that are not doing so badly in the eurozone. Employment, for example, is regaining strength, although it will not fully offset the negative impact of the rebound in energy prices on purchasing power. Lower interest rates are reviving lending and stimulating growth prospects in construction, although it may not be enough to record a sustainable acceleration in investment. The gradual improvement in public finances and the flexibility introduced by the European Commission have paved the way to somewhat more favourable fiscal policies, but not enough so to make a big difference in the countries that need it most. This leaves the ECB with little choice but to do more, whatever it costs.

Though not unfavourable for European growth, the world economic environment is resolutely morose. Granted, the global situation is bound to pick up in 2017, but the improvement will remain mild, at least according to the latest 2017 forecasts by the OECD (3.2%, vs 2.9% in 2016) and the IMF (3.4%, vs. 3.1%).

What is most striking about this slightly buoyant environment is that it is shrouded in uncertainty: all the world’s major economic zones are facing high political risks (US elections, rising Euroscepticism and the refugee crisis in Europe, etc.) and/or economic risks (normalisation of US monetary policy, Brexit, China’s slowdown, Japanese monetary policy, etc.). Faced with so many unknowns, a recovery scenario that does not take into account potential setbacks seems to be extremely fragile.

Growth: slowdown ahead?

Seen in this light, the eurozone can only count on its own strength. Unfortunately, the economy slowed in Q2 2016, with GDP rising only 0.3% q/q, the weakest performance since spring 2014. Admittedly, a backlash was widely expected after a rather dynamic Q1 (+0.5% q/q). Yet the slowdown is clear for all to see, especially after Eurostat released its latest revisions. Growth slowed from a stable pace of 2% year-on-year in the last three quarters of 2015, to 1.7% and then 1.6% in Q2 2016.

Looking beyond the customary fluctuations from one month to the next, survey data presented by the European Commission provides a rather clear picture of the trends at work in recent months: business confidence has been trending slightly upwards in industry and much more strongly in the construction sector, buoyed by low interest rates and apparently by the support of public investment in certain member states. Since the beginning of the year, in contrast, business climate has been slowly eroding in the services sector – the index is on the verge of dropping below the long-term average – and has also fallen sharply in retailing, albeit from high levels. Consumer confidence has also declined. The current slowdown clearly results from a less buoyant environment for household, mainly related to the evolution of prices. The main source of purchasing power gains for the past two years, the drop-off in oil prices, is now a thing of the past. Even if the rebound were to stop at current levels (oil prices were fluctuating around EUR 42 in September, compared to a low of less than EUR 30 in January 2016), the upturn in energy prices would continue to drive up the inflation rate in the months ahead via base effects. After bottoming out at -0.2% in February 2016, headline inflation has already picked up to 0.4% in September, despite core inflation was virtually flat at about 0.8%.

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<td>1.9</td>
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e: BNP Paribas Group Economic Research estimates and forecasts

2- Contributions to GDP growth

We expect headline inflation to exceed 1% as of Q1 2017. This means households will face a massive loss of purchasing power growth, too important to be offset by labour market trends. The labour market is holding up fairly well1, and the potential for an acceleration seems fairly slim: after a 3-year rebound, the pace of job creations strengthened again to 1.4% in H1 (1.6% for the number of hours worked). The pace of job creations is even high with respect to economic growth prospects, but for the moment, surveys are still looking relatively upbeat for the months ahead.

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1In dynamic terms, not in terms of the level of employment or unemployment.
Although a slowdown in household demand seems almost certain next year, the other key factors of growth are more uncertain. Foreign trade has slowed sharply in recent quarters, reflecting both the slowdown in global demand and the euro’s past appreciation. In real terms, the exchange rate has stabilised against its 38 main trading partners since the beginning of 2016, and it is fairly low, which means European companies stand to benefit from the slight acceleration expected in world growth, assuming it materialises. In this environment, should we expect to see more cutbacks in investment, the most disappointing change in the components of demand in Q2? Some factors argue for an ongoing recovery, notably in construction. Nonetheless, we prefer to remain cautious, given the blatant shortfall in demand in most of the member countries, and the very high degree of uncertainty currently surrounding economic and political prospects in several eurozone economies.

**Budgets: half-hearted support**

In terms of fiscal policies, the average trend in 2017 is not expected to differ very much from the slightly expansionist policies observed in 2016. Once summed up, the draft fiscal proposals that the member states are preparing to submit to Brussels will probably fuel expectations of a slightly smaller easing of the EMU’s structural balance in 2017 (between -0.1 and -0.2 percentage points vs. -0.3pp in 2016), but we think the risks lean towards slightly greater expansion than stated in these drafts in the eurozone’s biggest countries (Germany and Italy, France also, although in this case it would be better to speak of “less restrictions”). Uncertainty is highest in Spain: assuming a legitimate government can be set up rapidly, it will undoubtedly have to adopt major savings measures next year, given the strength of economic activity and the lag in the adjustment of public finances.

The European Commission has its work cut out. On the one hand, Jean-Claude Juncker’s team seems to be very serious about the flexible interpretation of fiscal rules, and about calls by several international organisations for policies to stimulate demand in the eurozone. The Commission is also fully aware of the rising political risks within the eurozone, fuelled notably by the sluggish recovery. At the same time, it also knows that it is putting part of its credibility at risk as well as that of the European fiscal framework, concerning their capacity to get certain member states to pursue fiscal consolidation efforts.

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2 +6.7% in real terms between April 2015 and January 2016.
3 Since 2013 and the implementation of the “two-pack”, the Commission has the right to review and comment on national budget proposals at the time they are presented to national parliaments. These draft bills must be submitted to Brussels by 15 October.

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**QE: Vital adjustments**

Faced with this environment, the European Central Bank hardly has any choice but to pursue its actions. By maintaining the status quo last September for all aspects of its policy, while announcing the creation of internal committees to “evaluate the options that ensure a smooth implementation of our purchase programme”, the ECB is probably giving itself room to extend its actions, and to amplify them if necessary. Note that QE is officially scheduled to last at least through March 2017, and could be extended thereafter, as long as inflation has not returned to a trajectory that is solidly anchored to its medium-term target (a little below 2%). The deadline is approaching and the ECB will soon have to decide and make announcements. Several options are possible to adapt QE (modify or abandon the capital key rule for the distribution of asset purchases; abandon the deposit rate floor, or increase the issuer limit, currently at 33% per bond line) and ease the constraints created by the shortage of eligible securities in certain countries (notably Germany). Given the current inflation outlook, it is very probable that the programme will be extended, at least until September 2017. This would be accompanied by technical modifications that should improve the effectiveness of monetary policy.

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4 For more information, see “ECB: the status quo, for the time being” and “ECB: the PSPP parameters”, Thibault Mercier, Ecoweek of 9 and 23 September 2016.
Germany
Fiscally solid

Though decelerating during the year, GDP is expected to grow on average at 1.8% in 2016. For next year, fiscal policy will be less accommodative, and energy prices may rise again. As a consequence of the less supportive environment, GDP growth is projected to slow significantly to 1.3%. In particular, private consumption and private investment may be growing at a much slower pace. Due to strong import growth and losses in the terms of trade, the current account surplus could edge down to 7.5% of GDP.

Though decelerating during the first half of the year, the German economy grew at a rather robust pace on average. In the first half of 2016 it reached 2.3% y/y (calendar day adjusted: 1.8%), supported by a very accommodative monetary stance and an expansionary fiscal policy. In addition, the economy benefited from some favourable tailwinds such as low energy prices and capital costs, and a weak euro. These tailwinds were in particular supportive for household spending. In addition, the improvement in the functioning of the labour market, a consequence of the earlier Hartz reforms, has set in a virtuous circle of rapid employment creation and growing consumer confidence. By contrast, the current business climate has done little to stimulate corporate spending, as the uncertain outlook weighed on investment. Moreover, exports strengthened significantly in the second quarter, after having stagnated since the middle of 2015.

In the second half of the year, growth is expected to slow to close to potential, estimated at an annual rate of 1.3%. Early data for the third quarter even point to stagnation in industrial activity. In July-August, manufacturing output was on average around the same level as in the second quarter. However, business confidence indicators for the manufacturing sector and the rest of the economy have remained at a relatively high level. The IFO climate index even reached in September its highest level since May 2014. Against this backdrop, GDP is expected to grow by 1.8% in 2016 (calendar day adjusted), a highest since 2011.

Less policy accommodation and tailwinds

For 2017, the policy mix is expected to be less supportive. Monetary policy should remain ultra-loose, against the backdrop of the low inflation environment in the eurozone and the uncertainties concerning the strength of the recovery and the outcome of the Brexit negotiations. By contrast, fiscal policy will be only mildly accommodative in spite of the upcoming general election in autumn 2017. The government pencils in an increase in federal spending by 3.7% to EUR 328.7 bn (10.5% of GDP) to allow more spending on refugees, pensions and domestic security. Moreover, the Chancellor has announced modest tax reductions of EUR 2.6 billion in 2017 and EUR 3.7 billion in 2018. This should not create extra debt thanks to growing tax revenues related to strong employment growth and very low debt refinancing costs. The government has only limited leeway for stepping up spending because of EU fiscal requirements and the so-called “Schuldenbremse” (debt brake) incorporated in the constitution. The latter requires a cut in the structural deficit to 0.35% of GDP in 2017 in order to reduce public debt to 60% of GDP by 2020.

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e: BNP Paribas Group Economic Research estimates and forecasts

2- Weak corporate investment

![Total investment, Machinery and equipment, Dwellings](source: Destatis)

Moreover, some of the tailwinds that stimulated growth in 2016 will become less supportive or even turn into headwinds. Energy prices will rise again and the euro may stabilise around current levels. Finally, the increase in the national minimum wage by 4% will support purchasing power of low-income earners, but might also hamper their access to the labour market.

Finally, the Brexit negotiations should get underway in early 2017, adding to the uncertainty. In first instance, this will primarily weigh on European investment spending. This will in particular impact Germany’s manufacturing sector, given its specialisation in the production of capital goods.
Slower growth in 2017

As a consequence of the less supportive environment, GDP growth is projected to slow significantly to 1.3% (calendar day adjusted). The main reason is a deceleration in domestic spending. Private consumption growth is projected to slow to 1.2% from 1.5% in 2016, as real disposable income will probably rise less markedly than in 2016. This is mainly because of a rebound in consumer price inflation. Due to the rise in energy prices, the HICP rate could rise to 1.4% compared with 0.3% in 2016. Core inflation should remain virtually unchanged at close to 1%. Another factor for the slowdown is the reduced dynamism of the labour market, as employment is likely to rise at a slower pace. Bottlenecks in the labour market might be eased by the inflow of workers from other EU countries and refugees. The latter could add 250,000 persons to the labour force (+0.6%) in the period between 2015 and 2017. The unemployment rate (ILO definition) may stabilise at close to 4%, one of the lowest in the EU.

On the other hand, consumer spending is supported by the increase in state pensions (4.25% in the old Länder and 5.95% in eastern Germany) in July 2016 and the increase in the minimum wage by 4% in 2017. Moreover, household savings may recede in 2016 and 2017. In the preceding years, the savings rate had increased as households had saved part of the increase in purchasing power related to the fall in energy prices.

Total capital spending growth is projected to ease to 1.4% compared with 2.5% in 2016. Judging from the increase in building permits, housing construction should remain buoyant. The market is driven partly by the high level of immigration. Moreover, the favourable labour market situation and the low interest rates have boosted demand for owner-occupied dwellings. As the supply is inflexible in the short-term, house prices have strongly increased, in particular in the big cities. Whereas, between 2010 and 2015, house prices in Germany rose by around 18% on average, apartment prices in Hamburg rose by 70 percent.

Outside the construction sector, firms are reluctant to step up capital spending, despite the capital utilisation ratio has remained close to 85%, just above its long-term average (84.1). Enterprises increasingly mention the lack of skilled labour as an obstacle for new investment projects. In addition, the exceptional low interest rates also are a signal that the business climate is very uncertain. Fearing substantial down-side risks, companies might prefer to postpone their projects until they have better visibility into the return on them.

This reluctance to invest is translated into a substantial savings surplus of the non-financial corporate sector. This has been on a rising trend since 2012, and reached almost 4% of GDP in 2015. In addition, the household savings surplus has remained close to 5% of GDP. As the public sector is unable to take up the slack because of the self-imposed constitutional restrictions, this is translated in substantial current account surpluses. In 2016, the current surplus could even reach EUR 252 billion (8.2% of GDP), the second largest in the world after that of China. In 2017, the trade balance may weaken because of strong import growth and losses in the terms of trade related to rising commodity prices. As a result, the current account surplus could edge down to 7.5% of GDP.

Risks from monetary policy and protectionism

The risk for the forecast will stem primarily from the monetary environment and foreign trade. Although, for the moment, low interest rates have hardly had any effect on consumer prices, they have boosted other prices, such as house prices and stock prices. The IMF recommends the German authorities to develop real-estate related macro prudential tools to contain excesses. Moreover, the low interest environment is a risk for the fragmented German banking sector and life insurance companies.

A second risk is the current wave of protectionism, which is potentially damaging for the Germany’s export-oriented industry. Also the outcome of the Brexit negotiations could negatively affect Germany’s industry by restricting access to the UK market.

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Sources: BIS and Eurostat
France

Growth will wait

Since 2013, French economic policy has concentrated on the supply side. This responds in part to the slowdown in potential growth observed in recent decades, which was aggravated by the crisis. Recent estimates suggest these supply-side policies will have a beneficial effect on GDP in the medium to long-term. In the short term, however, in a deteriorated cyclical environment, they risk placing a further strain on domestic demand. The impact on competitiveness is also diminished by the fact that neighbouring countries are conducting similar policies.

Since 2013, French economic policy has aimed to strengthen the supply side of the economy, i.e. it has tried to improve corporate profitability and competitiveness, boost productivity gains (which partially encompasses the first two goals), and enhance the business environment and functioning of the labour market. Some of the most important measures are outlined below:

- The competitiveness and employment tax credit (CICE) and the Responsibility Pact which are respectively a tax relief measure (around EUR 20 bn in 2015) and employers’ social contribution cuts (around EUR 10 bn).

- The Macron law to promote growth, activity and equal economic opportunity which aimed to introduce greater competition in the goods and services market and simplified regulatory red tape, notably by overhauling the operating conditions for regulated professions, increasing the possibility for businesses to open on Sundays, and facilitating the development of public transport in non-urban areas through coach services;

- The El Khomri law on employment, social dialogue and job security was designed to introduce greater labour market flexibility, notably by giving priority to company-level agreements over sector-wide collective agreements for setting working hours and wages (without calling into question the legal maximum weekly working hours and the minimum wage). The law also spelt out and expanded the conditions under which employers can resort to economic layoffs.

Supply-side policies are supposed to address the structural slowdown in growth observed in recent decades, which was aggravated by the crisis. According to the OECD, potential growth dropped from an average of 1.8% in 2000-2009 to 1.1% since 2010. The slowdown in potential growth is not only a French problem: almost all the advanced countries are facing with aging demographics and a slowdown in technical progress. Yet these trends were accentuated by French economy’s weak points, such as low corporate profitability and rigid labour markets. Improving these factors is one way to raise France’s growth potential, i.e. both the level and pace of activity corresponding to the full utilisation of production factors without generating (too much) inflationary pressure.

- **Mixed short-term effects**

  Economic literature tends to agree on the long-term benefits of supply-side policies ¹. Labour market flexibility helps lower the structural unemployment rate by making wages more reactive to cyclical conditions and/or by favouring a more flexible management of working hours. By reducing prices, greater competition in products market leads to higher consumption, employment and investment. Innovation and the diffusion of technology also benefit from a more open business environment, one that facilitates the arrival of new, more innovative firms, for example by reducing administrative red tape. In its latest review of the French economy (March 2015), the OECD estimates that the measures introduced

¹ For a review, see for instance De Bandt O., Vigna O. (2007), The macroeconomic impact of structural reforms, Bulletin de la Banque de France, n° 164, August

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1- Summary of forecasts

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</table>

e: BNP Paribas Group Economic Research estimates and forecasts

2- Potential growth

In %

OECD average ; — France ; - United States

Source: OECD
since 2012 will boost GDP by 1.6% within a 5-year horizon and by 1.8% within the next 10 years².

In contrast, there is less of a consensus on the short-term impact of supply-side policies. Often the negative effects on employment and consumption can be felt before the positive effects come into play. Yet, there can be an immediate positive effect when the implementation of reforms designed to boost potential GDP fuel expectations of higher future revenues, thereby creating a wealth effect: this stimulates consumption and investment in the short term. Getting a positive response in terms of demand depends on at least two conditions (in addition to the assumption that economic agents have rational expectations ³): first, agents must not be liquidity-constrained; and second, reforms must be seen as credible, either in terms of their concept or implementation⁴. In the end, the ECB notes that in most “micro-based” models, the short-term impact of supply-side policies is either neutral or negligible.

**The macroeconomic environment**

The short-term impact of supply-side policies can be seen to differ depending on the macroeconomic environment that prevails when the reforms are introduced. In an unfavourable environment, when the output gap is negative and interest rates are at their lower bound, supply-side policies tend to have a rather negative effect, notably for policies targeting the labour market. Facilitating layoffs when aggregate demand is weak risks triggering higher unemployment and encouraging precautionary savings. Although a policy of wage moderation can help some companies to maintain their staff, at a macroeconomic level, weaker demand in an already depressed economic environment risks straining total employment, notably via corporate bankruptcies. Moreover, when inflation is near zero, wage moderation does not imply a real decline in the cost of labour: if adjustments cannot be made via prices, then they will have to be made in terms of volume, i.e. via employment.

Some authors underscore the importance of taking into account the deflationary effects induced by a supply-side shock and the central bank’s potential reaction ⁵. In a “normal” situation in which the central bank has sufficient manoeuvring room, a supply-side shock would go hand in hand with a key rate cut to stimulate consumption and investment. When monetary policy is restricted, in contrast, and lower inflation cannot be offset by a key rate cut, then real interest rates rise putting additional pressure on demand.

The IMF recently complemented these theoretical considerations with an empirical assessment of the impact of supply-side policies distinguishing between favourable and unfavourable cyclical conditions⁶. The results tend to support the theoretical models: policies to deregulate labour markets introduced during unfavourable cyclical conditions tend to have a negative impact on activity in the short term. Policies affecting goods and services markets, in contrast, tend to have favourable repercussions, but their effect is diminished when unfavourable economic conditions prevail. Moreover, the IMF study did not identify any significant deflationary effects.

**Effect on competitiveness**

So far, we have only looked at the effects of supply-side policies on domestic demand. Yet these policies are also designed to improve competitiveness in order to capture a greater share of world demand. Yet price-competitiveness can only be improved when there is a decline in the relative price of goods and services between a country and its competitors. This means that it also depends on the policies being pursued abroad. In the eurozone, where there are no exchange rate effects, price competitiveness evolves in line with the inflation spread between member states; while cost competitiveness depends on relative unit labour costs⁷.

Since 2013, the increase in unit labour costs (ULC) has slowed significantly in France: from an average of 2% a year between 2001 and 2012, to 1% in 2013, 0.7% in 2014 and 0.2% in 2015. This trend is linked the moderation of labour costs growth (which in industry and market services dropped from an average of 3% between 2001 and 2012 to 1% in 2014 and 2015), which in turn is largely linked to cuts in the tax wedge. From a European perspective, however, the slowdown in ULC did not lead to gains in cost-competitiveness: since 2013, ULC in France have moved in line with the eurozone average. At an annual average of 0.6%, unit labour costs in France rose at a significantly slower pace than in Germany (1.7%), but were faster than in Italy (+0.4%), while unit wage costs declined in Spain (-0.3%).

Yet we should not jump to the conclusion that it was useless to implement supply-side policies. Although in an integrated trade region, the simultaneous introduction of supply-side policies tends to reduce their effectiveness (they partially cancel each other out and strain overall demand), maintaining the status quo would also seem to be a risky strategy. Using an alternative scenario in which these measures were not introduced, there probably would have been an adverse impact on employment. This is what can be gleaned from the latest assessment of the CICE (tax credit): although it is hard to identify any significant effects on competitiveness and exports in 2013 and 2014, once we include safeguarded jobs (i.e. those that would have been threatened otherwise), the impact on employment ranges between 50,000 and 100,000 jobs.

**Thibault Mercier**

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² This estimate does not include the El Khomri law, but it does take into account the Macron law, which had been announced but not adopted yet.

³ This implies that economic agents make full use of all available information when forming expectations: on average, they are not mistaken.


⁷ Intra-euro trade accounts for about 45% of French foreign trade. One might think that French competitiveness also depends on the nominal currency effect. Yet we should keep in mind that competitiveness depends on the relative change in costs and prices with regard to competing countries, and not with regard to trading partners. France, Germany, Spain and Italy will benefit from the same depreciation of the euro in non-euro markets.
Italy

No confidence, no growth

In the second quarter of 2016, the Italian economy came to a standstill. Confidence, both households’ and firms’, deteriorated. Private consumption decelerated, even though households’ purchasing power recovered, as the personal saving ratio rose to 9.6%. Business investment decelerated, and the slowdown of exports, which has been underway since early 2016, gained momentum. While trade with the rest of the EU remains quite dynamic, especially with most euro member countries, trade outside the EU weights of the overall performance of exports.

- The economy at a standstill

In the second quarter of 2016, the Italian economy came to a standstill, after modest growth in Q1 (+0.3% in Q1). On a year-on-year basis, growth decelerated, at +0.7%. As a result, activity remains around 8 percentage points below its 2008 level. In the coming quarters, growth is expected to remain moderate: the global environment remains challenging, while persisting uncertainty surrounds domestic demand. Assuming no growth in the second half of the year, GDP growth would be limited to 0.6% in 2016.

The recent deceleration of growth reflects the slowdown in domestic demand, after having supported the previous improvement. In Q2 2016, net exports added 0.3 pts to GDP growth, with exports increasing by 2.4% (and imports by 1.4%). As for the supply side, the manufacturing sector particularly suffered – value added fell 0.8% in real terms – with widespread pain. Services fared better, with value added gaining 0.2% over the quarter, but activity still is roughly 30 pp below its pre-crisis peak.

- Slowing consumption and investment

The disappointing growth performance reflects the widespread weakening of confidence. Both households and firms remain extremely cautious, increasing their liquidity buffer instead of significantly expanding spending. Bank deposits of firms recently reached EUR 237 bn, i.e. EUR 65 bn more than in 2008, while those of households increased to EUR 1.3 tr, with almost EUR 150 bn of funds having been deposited in the last four years.

In Q2, private consumption slowed (+0.1% after 0.5% on average over the previous year). Households’ purchasing power is slowly recovering (up 4 pp from the 2012 trough, but still 8 pts below pre-crisis levels), but households prefer saving over consumption. The personal saving ratio rose to 9.6% from 8.1% at the end of 2015. As a result, consumption is only modestly recovering, remaining 4.4 pp below its 2008 reading. If households’ purchasing power is improving, it is not thanks to activity income. Despite strengthening labour market conditions – the total number of employed is up 600k since the trough of end-2013 – labour income is stable, at around EUR 650 bn in 2015. Given the low level of interest rates, capital income is down. Interest income (from bonds and deposits) is down to EUR 37 bn (from EUR 86 bn in 2008). In twenty years, the share of interest income within total households’ income fell from 10% to 2%.

In Q2, investment was actually up. Admittedly, the rate of growth was limited (+0.2%) and down from Q1 (+0.7%) and 2015 Q4 (+0.9%) performances. Over the last few years, spending on fixed investment have been depressed. Public spending on capital formation was cut from EUR 54 bn in 2008 to EUR 37 bn in 2015. Now Italy exhibits the lowest rate of investment-to-expenditure in the government sector within the eurozone. Given the recent development of gross capital formation, the net value of total fixed assets fell, with a cumulative loss of almost 1%. Over the last three years, new investment did not offset the depreciation of capital, with negative effects on productive capacity.

- Italian exports: a moderate decline

Italian exports have been on a deceleration trend for some months. In July, they were down 0.6% m/m and 7.1% y/y. Over the first seven months of 2016, exports are down 1.2% as compared with the same period of 2015. However, the breakdown by country offers

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1- Summary of forecasts

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Source: BNP Paribas Group Economic Research estimates and forecasts

2- Gross Fixed Capital Formation

Q1 2008 = 100

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Source: Istat
conflicting messages. While exports to other EU-member countries remain solid (+1.6%, Jan-July 16/Jan-Jul 15), trade with non-EU countries is shrinking fast (-4.7%).

Europe’s appetite for Italian goods primarily is from the Eurozone (which account for 40.2% of Italian exports), with one striking exception: Belgium, to which exports are down by 6%. Trade is particularly dynamic with Spain (exports up 5.1%), France (3.4%) and, to a lesser extent, Germany (1.9%). France (10.9%) and Germany (12.8%) remain the two main markets for Italian exports. Still, over the last 25 years, they get less and less crucial. At the beginning of 1990s, roughly 36% of Italian exports were absorbed by France and Germany. As for France, that diminishing importance is explained by trade of transport equipment, electrical appliances and machinery, but also, even if to a lesser extent, of chemical and pharmaceutical, and of food products.

The much larger drop in the weight of Germany within Italian exports is mainly due to the decline in textile sales, accounting for about 11% of Italian exports versus 27% at the beginning of 1990s. But other products also recorded sharp declines: transport equipment, plastic and rubber products. On the other hand, other exports do resist, such as chemical products or Metals.

As for extra-EU countries, from January to July Italian exports declined (-4.7% year-on-year) in all markets except for Japan. In particular, after the extraordinary growth experienced in 2015 (about +21%), sales to the US fell by 2.5%. In the past 25 years the North American country has gained an increasing importance on Italian exports (up to reaching a market share of 8.7% in the first seven months of 2016, compared to 6.8% at the beginning of the 1990s). The US mainly imports from Italy means of transport (17.4% of Italian exports of the sector), food products (12%) and machinery (8.9%).

Many sectors contributed to the overall decline in Italian exports in the first part of the year (-1.2% from January to July compared to the same period of 2015), including coke and refined products (whose exports declined by 30% and account for 3% of all Italian exports), metals (representing 10.6% of the Italian sales abroad and whose sales recorded a -3.6%), pharmaceuticals (-1.9%) and machinery that still play the lion’s share of Italian exports and has recorded a -0.9% decline. On the contrary, a positive contribution came from sales of transport equipment (+2.6%) and food products (+2.3%).

The composition of Italian exports

The changes that have characterised the domestic and global economic environment in the last 25 years have only slightly affected the composition of Italian exports. Compared to the beginning of the 1990s, textile, electronics and electrical appliances have lost weight. In particular the textile sector, which used to represent 17.5% of total exports, now stands at 11.6%, while electronics’ share has been effectively halved (from 6.1 to 3.2%). Among the sectors that have gained weights are those producing machinery and equipment, that today account for more than 18% of the Italian exports (from 16.9% at the beginning of ’90s), metals (market share of 10.6% from 8.7%) and food products (to 7.3% from 5.1%).

In the first half of 2016 the Italian share of world exports (in dollar terms) stood at 3.2% (from 2.8% in 2015). Among the main world exporters, Italy ranks ninth, behind Germany and France but ahead of the United Kingdom and Spain.

In the last years the small size of the Italian exporting operators has remained largely unchanged. The majority of companies that sell products abroad are small-sized: 62.4% of the total (133,615 units) has a foreign turnover lower than EUR 75,000. Only 4.225 companies export products for more than EUR 15 mn, but they account for 70.3% of the overall Italian exports value. The operator’s size is a key factor in determining the number of markets served: around 43% of companies export to a single market/country. Only larger companies sell their products in more than 25 foreign markets (about 63% of those exporting over EUR 15 mn and 77% of those exporting more than EU 50 mn).

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Spain

Slight loss of growth momentum

Spain will continue to outstrip most of its euro zone partners over the next few months but growth is expected to be somewhat more moderate. Consumption and exports will both slow, although exports will still remain buoyant. In turn, companies will be less inclined to invest and create jobs. In addition, once in place, the next Spanish government will have to clean up the public finances. Spain now has until 2018 to reduce its excessive deficit after the European Commission granted it a reprieve last July.

- Exports will make a lower contribution to growth

Spain will continue to outstrip most of its euro zone partners over the next few months. However, after two very strong years, growth is now expected to lose some momentum in the second half of this year and in 2017. GDP, which is expected to grow by 3.1% this year and 1.9% for 2017 and will therefore not move back to pre-crisis levels until Spring 2017.

First of all, foreign demand (32.7% of GDP in H1 2016), which has been the main growth driver over the past few years, will suffer from the persistently bleak global economy, despite a slight improvement. The lack of impetus in the euro zone, its main trading partner, will affect exports in particular. Secondly, although Spain has managed to gain international market share over the past few years, mainly thanks to an improvement in competitiveness, it is now suffering from a slowdown in productivity growth. Lastly, there is also uncertainty over the consequences of Brexit. The result of last June's referendum has so far had little effect, but uncertainty over the terms of the UK's exit from the European Union, the expected slowdown in UK growth over the next few months and the fall in the pound sterling are all likely to weigh on trade between the euro zone and the UK and, ultimately, on trade with Spain, which exports almost 8% of its goods to the UK.

The worsening business climate in the manufacturing sector this summer and a decline in the new export order index (to an average of 51.7 in Q3 2016 from 53.4 in Q2 2016) also signal a less favourable outlook for exports.

- Slower momentum in domestic demand

This slowdown will spread to the entire economy. Financing terms will remain advantageous thanks to the ECB’s ultra-loose monetary policy, but companies will probably be less inclined to invest due to the poorer growth outlook.

Household consumption will continue to support growth during the next few quarters but at a slightly slower pace than in late 2015 and early 2016. Like growth in activity, the job creation rate will weaken, which in turn will put a brake on salary increases and, therefore, on growth in disposable income, especially as overcapacity in the labour market will persist. Unemployment is only falling gradually (to 19.6% in July) and will remain high.

In addition, according to the Markit survey, most of the jobs are likely to be created in the services sector, as between the second quarters of 2015 and 2016 (+434 000). This sector, and in particular hotels and restaurants (8.8% of total jobs in H1 2016), should continue to benefit from a buoyant tourism market. UK tourists, who contributed more than 20% of total tourism expenditure in the first eight months of the year, could shy away from Spain to a certain extent, but the country still has many benefits, particularly in the current geopolitical climate. However, services create low-productivity, poorer quality and, therefore, less well-paid jobs. In addition, a high proportion of employees, in services and in other sectors, are employed on a temporary basis. Temporary contracts accounted for 25.8% of total employment in Q2 2016 versus a euro zone average of 18.6%.

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1 52.2% of Spain’s exports went to the euro zone in the first half of 2016.
Furthermore, some of the late 2015/early 2016 drivers will also begin to fizzle out. The baseline effects due to the past fall in oil prices will fade. The consumer price index, which moved back into positive territory in September (+0.1% y-o-y), will therefore continue to edge up over the next few months. The likely tightening of fiscal policy could also affect growth in 2017.

- **Deficit reduction on hold**

Spain had a budget deficit of 5.1% of GDP in 2015 as opposed to the agreed 4.2%, but was given a reprieve in July by the European Commission due to the efforts it has already made and the fact that the country has no government.

However, Spain, which has been under the corrective arm of the Stability and Growth Pact since 2009, now finds itself in a tricky position. It still does not have a government likely to adopt the necessary corrective measures. No political party was able to win a clear majority in the Congress of Deputies (set at 176 of a total 350 seats) in either the December 2015 or last June's elections. The centre-right Ciudadanos party and the Canarian nationalist coalition (CC-PNC), with their 32 and 1 seats respectively, supported the right-wing Popular Party (PP), which came first in the June elections. But, between the three of them, they only have 170 seats, which is not enough to form a government. So they would have to win the support of the traditional Socialist Party (PSOE), which has 85 seats, at the investiture session, or failing that its abstention. But the PSOE has so far refused to do that and is still hesitating over its strategy. If it allows the PP to form a government by abstaining at the investiture vote, some unhappy left-wing voters could rally to the radical left party Podemos. If it refuses to abstain and new elections are called, it could lose seats compared with the previous elections. The internal strife within the PSOE has tarnished the party’s image and it no longer has a leader capable of conducting the campaign since its chairman resigned. Recent surveys also show that the PSOE has lost ground since last June. However, the early October resignation of its leader Pedro Sanchez, who is firmly opposed to the PP’s return to power, could change things and a government could be formed by the 31 October deadline. Otherwise fresh elections will be held at the end of December.

However, a minority and, therefore, more unstable government will find it hard to rule. Spain will be unable to present measures to clean up the public finances when it has to present its 2017 budget to the European Commission in mid-October but will nonetheless have to make substantial efforts to correct its excessive deficit by 2018. The budget deficit could reach 4.6% of GDP this year and public debt, which stood at 99.2% of GDP in 2015, will likely continue to rise.

Catherine Stephan

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BRAZIL

A crucial turning point ahead

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

■ Eyes on reforms

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

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

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

■ A few positive economic and financial signals

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

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

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

A sluggish labour market hampers the recovery

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

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

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

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

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Russia

A painful recovery

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

A painful recovery

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

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

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

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

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

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

A widening deficit

Over the first eight months of 2016 the government’s budget deficit hit RUB 1,518 billion, equal to 3% of GDP, putting it 67% higher than in the previous financial year. This increase was due to falling receipts (-9%), particularly those from oil (-25%), and came despite the exceptional income generated from the sale of Airosa shares (estimated at USD 800 million). At the same time, cuts in government spending, have been extremely modest, at just 2%. Higher pension costs and debt servicing costs (up 13% and 21% respectively) offset the sharp cut in military spending (down 27%). In order to control the budget deficit, the government has decided to sell its holdings in two oil companies, Rosneft and Bashneft, between now and the end of the year, or at the latest early next year if market conditions are not favourable beforehand. Even in this case, the budget deficit will exceed the government's initial target of 3% of GDP.

Over the first eight months of the current year, the deficit has mainly been funded from the reserve fund, which had been reduced to just...
USD 32 billion by the end of August, USD 38 billion lower than a year before. In order to stem the bleeding from this fund, the government made two debt issues, one in May the other in September, for a total of USD 3 billion. Given that its bonds trade freely on the secondary market, the government could make greater use of this means of financing its deficit.

The 2017 budget will be officially presented on 13 October and submitted to the Duma on 1 November, alongside the revised 2016 budget. However, the headline items have already been announced.

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

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

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

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

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

**Consolidation of the balance of payments**

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

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

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

**Substantial victory in parliamentary elections**

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

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

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1 The budget has been drawn up assuming oil at USD 40/barrel and a RUB/USD exchange rate of 69.1 on average over the next three years.
India
A major advance

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

- Economic slowdown

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

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

- Budget overruns

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

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

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

### 1- Summary of forecasts

<table>
<thead>
<tr>
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<th>2014</th>
<th>2015</th>
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<th>2017f</th>
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<tr>
<td>Real GDP growth(1) (%)</td>
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<td>7.2</td>
<td>7.6</td>
<td>8.2</td>
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<td>Real GDP growth(2) (%)</td>
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<td>7.2</td>
<td>7.9</td>
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<td>Inflation(3) (CPI, year average, %)</td>
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<td>4.9</td>
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<td>Central Gov. Balance(1) / GDP (%)</td>
<td>-4.5</td>
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<td>-3.5</td>
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<tr>
<td>Central Gov. Debt(3) / GDP (%)</td>
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<td>46.4</td>
<td>47.6</td>
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<td>Current account balance(4) / GDP (%)</td>
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<td>-1.3</td>
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<td>Forex reserves(3), in months of imports</td>
<td>283</td>
<td>322</td>
<td>336</td>
<td>332</td>
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<tr>
<td>Exchange rate INR/USD (year end)</td>
<td>63.0</td>
<td>66.2</td>
<td>68.2</td>
<td>70.0</td>
</tr>
</tbody>
</table>

1: fiscal year from 1 April of year n-1 to 31 March of year n
2: Calendar year

### 2- Economic growth decelerated

GDP growth (yoy) and components (percentage points)

- Public expenditure
- Households’ consumption
- Net exports
- GFCF
- Statistical discrepancies
- GDP

Sources: CEIC

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

- The new unified VAT bill: a major turning point

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

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

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

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

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

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

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

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

External vulnerability has declined

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

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

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

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

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China

Credit risks still rising

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

Corporate breathing a little easier

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

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

In the real estate sector, similarly, the situation has improved but remains fragile. After the authorities loosened monetary policy and macroprudential rules on real estate transactions and lending, growth in sales volumes has accelerated (+25.5% y/y in the first eight months of 2016 vs. 6.5% in 2015) and house prices have rebounded in a growing number of cities. The average increase in house prices in China’s 70 largest cities was 7.3% y/y in August 2016 vs. 0.2% in December 2015. Of those 70 cities, only six showed a year-on-year decline in August 2016, vs. 48 in December 2015. In fact, major regional variations weigh on the sector’s prospects. Signs of a property bubble have already emerged in several large cities, prompting the authorities to tighten macroprudential rules, while smaller cities are seeing very moderate price growth and some even still have a stockpile of unsold homes. In the short term, however, the upturn in activity and prices in the property market should give corporates operating in the sector some breathing space, and support real estate investment (+6.2% y/y in the first eight months of 2016 vs. +2.4% in 2015).

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

The recent stabilisation in economic growth and the upturn in the real estate market, along with monetary loosening (with the weighted average interest rate on loans falling from 5.9% in 2015 to 5.3% in H1 2016), should give certain banks and local governments some respite by reducing their liquidity constraints in the very short term. However, their solvency is not improving. Their debt levels have become even more excessive, with domestic credit growth accelerating again since mid-2015. This rebound has remained moderate, and credit growth even slowed in Q2 2016, showing that the monetary authorities and creditors are more cautious given the excess debt of borrowers and loan quality deterioration. However, credit outstanding still grows much faster than nominal GDP (see chart). This means that the domestic debt-to-GDP ratio has continued to rise, reaching 210% at the end of Q2 2016 vs. 200% one year before. The debt ratio includes the private sector, local government and their financing vehicles, but excludes the central government. Within that total ratio, household debt accounts for only 40% of GDP.

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

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

The banking sector's performance is deteriorating

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

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

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Japan

The end justifies the means

Abenomics has been beefed up again. The government has announced new spending efforts and the Bank of Japan has made a firmer commitment to boosting inflation via new measures, notably by controlling long-term yields and the slope of the yield curve. The government and the monetary authorities are going all out to raise inflation expectations by being “credibly irresponsible” to use the words of Paul Krugman. The government more or less announced that cleaning up public finances could wait, while the Bank of Japan promised greater inflation. This should help strengthen the preference for the present, i.e. for consumption over savings.

Japanese growth has been fairly vigorous lately, averaging 0.3% in the first two quarters of 2016. With an annualised average growth rate of 1.4%, it is increasingly clear that the Japanese economy is growing significantly faster than its long-term potential, which is generally estimated to be just barely positive. This strong growth was also driven by final domestic demand, notably household consumption and public spending.

Abenomics

Can Japan pull out of its deflationary spiral? Since 2013, that has been the goal of Abenomics, a package of fiscal, monetary and structural policies that were supposed to create a growth shock. It is now customary to conclude that they were ineffective. It is often argued that structural reforms, the third arrow of Abenomics, were underused, and that the other two arrows proved to have reached their limit of effectiveness. Unsurprisingly, the Bank of Japan’s latest effort drew sharp criticism. On 21 September, Japan’s central bank announced a new phase in its monetary easing policy, including the introduction of yield curve controls, notably with a 10-year bond yield target, and a pledge to overshoot its 2% inflation target by increasing the monetary base by as much and as long as it deemed necessary.

The task at hand is complex. Japanese society is aging rapidly. Despite an increase in the labour participation ratio for the 15-64 age group, the growing proportion of seniors has led to a decline in the labour force. Japan is also suffering from decades of underinvestment: gross fixed capital formation as a share of potential GDP declined by more than 14 points between 1990 and 2010, while productive capital has stagnated since 2009. In addition to these two specific problems, Japan, like the other advanced countries, has also been hit by dwindling productivity gains since the 2007-2009 economic and financial crisis. All in all, Japan’s potential growth rate is virtually nil.

This constraint is compounded by another one: a heavy public debt load. According to the IMF’s most recent data, the public debt ratio stands at 248% of GDP. Net of assets, Japan’s public debt is much smaller, but still “too” high at 125% of GDP. Yet we should not attach too much importance to these measures. First, Japan’s debt is held domestically (non-residents hold only 10% of JGBs), and what are liabilities for some are assets for others: between 1980 and 2014, the net liabilities of the government sector increased by 130 points of GDP, while the net financial assets of Japanese households increased by 125 points of GDP. Consequently, Japan’s public debt is not so much a matter of solvency, but a redistribution question. More importantly, we should not forget that 35% of JGBs are now held by the BoJ, a proportion that should continue to rise in the years ahead, since the BoJ’s plans for net purchases exceed the government’s projected financing needs. It is also worth noting the relative stability of debt servicing as a share of spending (4.7% of GDP). The BoJ’s new targets pertaining to the slope of the yield curve and the level of long-term rates ensure that the government will be able to continue borrowing at reduced rates. The average maturity of Japanese debt is currently a little more than 8 years, and the yield on securities maturing in 8 years is -0.17%. Without changing its debt management policy, the Japanese government

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1 The over-60 age group accounts for 33% of the Japanese population, compared to 13% in the early 1980s.
could continue to borrow at a rate below its nominal potential growth rate. Moreover, this spread is bound to widen as the BoJ approaches its inflation target. This means the apparent debt rate, currently at 0.95%, would narrow even further, thereby improving debt sustainability.

Ricardian equivalence

Seen in this light, the success of Abenomics largely depends on the effectiveness of BoJ policy. Rather than jump to the conclusion that the monetary arrow has been used disproportionately, we can better understand the central bank’s activism. What is crucial today is its capacity to raise inflation expectations, a challenge the BoJ willingly admits. The credibility of new measures is an essential factor, notably the stated goal of overshooting the 2% inflation target for as long as necessary. Some wish the bank had announced a new inflation target – 4% for example – as this would be synonymous with an irreversible increase in money supply. The BoJ has chosen not be so specific, at least for the time being. Although we cannot be certain, we can imagine that the BoJ is worried about its credibility, which might be lastingly damaged if it were to fail to reach an overly ambitious target, the realisation of which also depends on such exogenous factors as energy prices and the yen’s external value.

There will always be time to specify a new target later, should that prove to be necessary.

Just as crucial is the Japanese authorities’ capacity to overcome the Ricardian equivalence, which claims that rational households increase their savings in reaction to a higher fiscal deficit, anticipating higher taxation in the future to ultimately restore a public finance equilibrium. If households are Ricardian, then a fiscal stimulus, regardless whether or not it is justified by cyclical conditions, is bound to be ineffective: the sums unleashed would be saved, and demand would remain unchanged. In contrast, if certain conditions arise that call into question the Ricardian equivalence, a wider fiscal deficit could end up stimulating the economy. The Ricardian equivalence is often the deciding argument for those who conclude in the inevitable ineffectiveness of Abenomics: if the Japanese believe in the government’s pledge to begin generating primary surpluses again by 2020, then any fiscal stimulus measures will be offset by higher savings.

A recent IMF article challenges the assumption that Japan is more Ricardian than other countries, notably by demonstrating that two conditions are not met. The author concludes that Japanese households are less Ricardian than they are generally assumed to be, and that they are increasingly less so. The author, and the IMF in general, also believe that fiscal multipliers are maximised when interest rates are close to their effective lower bound. In this case, the JPY 28,100 bn in new spending measures recently announced by the government – of which only JPY 7,500 bn (1.5 points of GDP) is additional spending to finance infrastructure – could trigger a (slight) acceleration in growth.

Call for being irresponsible

Just as welcome, if not more so, is the announcement that the next consumption tax hike would be postponed from April 2017 to year-end 2019. We would even encourage further fiscal “irresponsibility”, as long as it is conditioned on the BoJ respecting its inflation target, and the government abandons its increasingly unrealistic target of generating a primary surplus by 2020. It would simply suffice to admit that the debt problem is not one, or at least, that it can only be resolved by pulling out of the deflationary spiral.

Another IMF article makes even bigger recommendations. In terms of fiscal policy, it avoids anathema: the final goal of reducing debt is not called into question, although it must be conducted through a more gradual increase in the consumption tax (according to a credible, visible calendar). The authors nonetheless call for public sector wage increases and larger transfers to low-income households. In terms of monetary policy, the authors recommend targeting inflation forecasts (the article was published before the BoJ’s September announcement): if the cyclical environment forces the BoJ to lower its inflation outlook, this downward revision must be accompanied by new monetary support measures capable of pushing up inflation by as much. In the end, it is the structural arrow that has the most appeal, as the authors recommend an income policy. This entails introducing or strengthening tax incentives for raising wages, more resolute increases and demand would remain unchanged.


3 Households, at least low-income households, are hit by a liquidity squeeze and the spread between lending and borrowing rates is too high to be ignored.

Portugal

Weak growth

The Portuguese economy will suffer from weak growth among some of its main trading partners, particularly within the eurozone. Reduced job creation and higher inflation will drag down consumer spending, which had previously been the main growth driver from mid-2013. Portugal is likely to post growth of only around 1% in 2016 and 2017, and is facing a number of challenges including limited potential growth and the need to shore up its public finances. The government has managed to reduce the government deficit substantially in the last few years, but it remains too high for the European Commission.

- Limited contribution from foreign demand

The Portuguese economy is likely to continue growing at close to the rate seen in early 2016, i.e. around 0.3% sequentially in the next few quarters. Growth will be dragged down by a number of factors, starting with weak exports.

Portugal should benefit from a slight upturn in some emerging economies. Having suffered since early 2015 from lower exports to Angola – which accounted for 2.4% of goods exports in H1-16 versus 4.2% in 2015 and 6.3% in 2014 – Portugal now could be boosted by a slight upturn in Angola’s economy. However, Portugal’s main trading partners are continuing to see weak growth. Growth will remain sluggish in the eurozone – Portugal’s main market, accounting for almost 65% of its goods exports – and this will continue to put pressure on its foreign trade in the next few quarters. In addition, uncertainty about the type of trade deals that the UK will be able to strike with the European Union post-Brexit, along with the decline in sterling and the expected slowdown in UK growth, could hit trade with Portugal, which exports just over 7% of its goods to the UK.

This unpromising environment is likely to affect the whole economy. Investment was held back by poor weather conditions in the first half of 2016 and there should be a positive catch-up effect, but the upturn will remain limited because debt levels among companies are very high (141.9% of GDP in Q1 2016 according to the ECB) and the growth outlook is unexciting.

- Consumer spending hesitant

Only fiscal policy, which is now looser than before, seems capable of supporting consumer spending. The government is gradually unwinding previous cuts to public-sector wages. It has also partially reversed the surtax on income, increased some social benefits and agreed to bring VAT on restaurants back down to 13% from the current 23%. In addition, increasing the minimum wage by 5% in 2016 and 2017 should boost households’ real incomes.

However, fiscal policy cannot overcome the decline in job creation and the further increases in inflation that seem likely in the next few months. The downward pressure on inflation caused by past declines in oil prices will fade, and annual consumer price inflation is set to rise from 0.8% in August to around 1% by year-end.

Together, these factors are likely to drag down growth in households’ real disposable incomes – which was 1.5% year-on-year in the second quarter – along with consumer spending.

We expect the economy to grow only 1% in 2016 and 1.1% in 2017, which is not enough for Portugal to meet all the challenges it faces.

1- Summary of forecasts

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Note: BNP Paribas Group Economic Research estimates and forecasts

2- Moderate growth

| Contribution to annual growth (points of GDP) |  |  |  |
| Change in inventories | Net exports | Domestic demand excluding inventories | GDP |

In Q2 2016, GDP was still 5.6% lower than its previous peak in Q1 2008, and the unemployment rate was 10.8%, 3.6 points higher than the early-2008 figure. In addition, years of recession have reduced the economy’s potential growth (which the OECD estimates was 0.1% in 2015). The country’s capital stock is suffering from ongoing low levels of spending on capital goods, which is down almost 20% from its previous peak. The deterioration in labour-market conditions in the last few years has gone hand-in-hand with an increase in migration outflows, with 138,400 people leaving the country between 2010 and 2014 out of an estimated population of 10.6 million at end-2010. The outflow of workers, combined with
ongoing high levels of long-term unemployment, is dragging down potential GDP.

- **Slow improvement in the public finances**

The Portuguese economy’s limited growth is also reducing the government’s room for manoeuvre as it faces the continuing task of shoring up the public finances.

The public-sector deficit is likely to fall from 4.4% of GDP in 2015\(^1\) to below 3% this year. The economy is only growing at 1% per year, that is above its potential growth rate. However, the European Commission believes that Portugal’s deficit is not coming down fast enough, and it may exceed the Commission’s limit of 2.5% of GDP. In July, the European Commission decided not to punish Portugal for failing to reduce its deficit enough in 2015, provided that it met its targets in 2016. The reduction in Portugal’s deficit is especially disappointing since the structural deficit\(^2\), equal to 2% of GDP in 2015, could increase slightly this year to 2.2% of GDP according to the Commission.

The European Commission is likely to keep up the pressure on Portugal, which is still under close observation and has been subject to the corrective arm of the stability and growth pact since December 2009. However, the Commission could take a lenient approach again in mid-October, when Portugal submits its 2017 budgetary plan. It might refrain from suspending part of the European Structural and Investment Funds pledged to Portugal for 2017. The European Commission wants to avoid the increase in public resentment towards European institutions that would arise if it punished a country that has already had to make major efforts to recover from the crisis. It could take into account Portugal’s efforts over the last few years and the improvement in its public finances, even if it has been slower than expected.

However, given Portugal’s high levels of public debt (123% of GDP in 2015), it will remain vulnerable to any new shock, particularly from its banking sector. The banking sector is continuing to stabilise, but it remains vulnerable because of large amounts of non-performing loans. The fragility of the Portuguese banking system is increasing the uncertainty about how the sale of Novo Banco – which received EUR 4.9 bn of fresh capital from the Portuguese Resolution Fund in 2014 – will affect the public debt. The government, which granted the Resolution Fund a EUR 3.9 bn loan at the time Novo Banco was rescued, could realise a loss when the bank is sold. The effect of recapitalising state-owned bank Caixa Geral de Depositos (CGD) is also unclear. In late August, the European Commission approved a EUR 2.7 bn injection into CGD by the Portuguese government in return for a restructuring plan and the sale of EUR 1 bn of debt securities in the market. The Commission believes that the sale, which must take place on market terms, will give the government a sufficiently high rate of return for the transaction not to qualify as state aid. Again, it is unclear what return the government will make on the money it invests. However, Portugal needs to act in order to mitigate these risks. Only one of the rating agencies recognised by the European Central Bank still has an investment-grade rating on Portuguese government bonds, and it is that rating that allows Portugal to benefit from the ECB’s asset purchase programme.

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\(^1\) The government granted financial aid estimated at 1.4% of GDP when selling the bank Banif, and the resulting increase in the 2015 deficit was therefore only temporary.

\(^2\) The structural deficit is the deficit that would arise if GDP were equal to its potential, adjusted for exceptional measures.

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Catherine Stephan
Catherine.Stephan@bnpparibas.com
Economic forecasts

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<tr>
<th></th>
<th>GDP Growth</th>
<th>Inflation</th>
<th>Curr. account / GDP</th>
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Emerging Markets

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World

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Financial forecasts

Interest rates

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