



## ECONOMIC RESEARCH DEPARTMENT

### Emerging countries: mainly clear skies but some patchy cloud

- Growth in emerging-market countries accelerated in the first half of 2017, particularly in Central Europe and Turkey, which is the only region seeing a resurgence in inflation. However, for Turkey, unlike the other countries, that does not represent a catch-up effect but reflects an economy growing above potential and a fragile currency. India is the only emerging country where growth is disappointing, because of weak private-sector investment and a negative contribution of net external trade.
- Growth across all emerging countries could weaken slightly in the second half, in line with the slowdown in foreign trade, although the positive trend looks robust.
- In the last few months, the main developments in the global environment have been the decline in oil prices and the contrasting rise in metals prices, along with the weak dollar, which is positive for emerging markets. The contrast between oil and metals prices is due to significant upward revisions of oil supply. As a result, the expected upturn in growth in oil-producing countries in Africa and the Middle East remains highly uncertain, particularly for Saudi Arabia.
- In terms of domestic demand, bank credit has either made a greater contribution to growth, or has stopped dragging it down, since the start of the year in most countries. China finds itself somewhere in the middle: credit growth to households and corporates has been stable since the beginning of the year. However, the growth of bank's claims to non-bank financial institutions (shadow banking) has decelerated markedly which is good news for financial stability, although the price is slower growth

The macroeconomic situation in emerging-market countries as a whole is fairly reassuring as we enter autumn. We have not seen any major financial stress as we did in the summer of 2015, when the yuan underwent a mini-devaluation. On the contrary, once the tension arising from Donald Trump's election victory in late 2016 and the rise in US long yields had faded, the lack of visibility on the new president's economic and fiscal policy, the cautious of the FED and the weak dollar have been beneficial for emerging financial markets. External financing terms remain very favourable because of firm portfolio investment flows.

#### ■ Growth strengthening ...

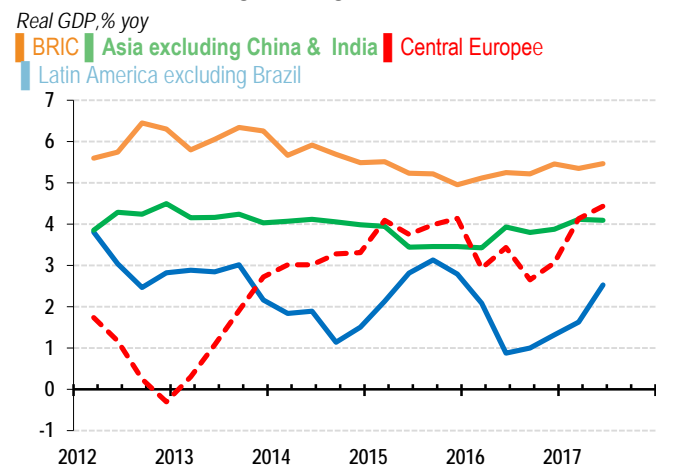


Chart 1 Sources: Macrobond – BNP Paribas

#### ■ ... except in India

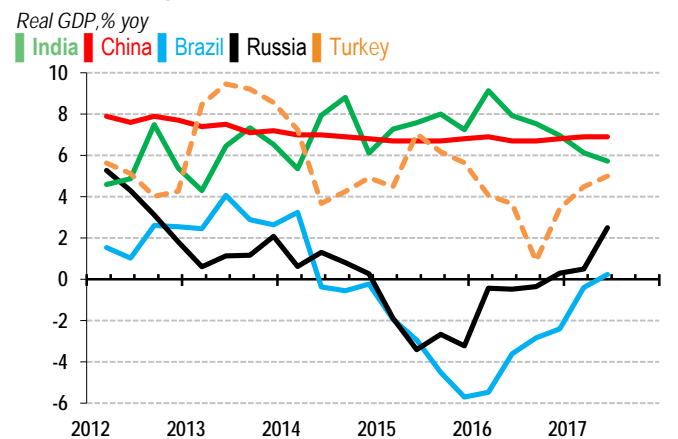


Chart 2 Sources: Macrobond – BNP Paribas

Chinese growth has also stopped slowing because of support from fiscal policy and an upturn in exports. Current concerns are focused on GCC countries because of the decline in oil prices since the start of the year, combined with geopolitical tensions.



### Faster growth with no inflationary pressure in the first half of 2017

Growth in the main emerging-market countries continued to accelerate in Q2 2017. Year-on-year real GDP growth in the 26 leading emerging-market countries was close to 5% (3.7% excluding the BRIC countries), 0.7 points higher than in 2016. The acceleration was strongest for the six Central and Eastern Europe (CEE) countries in our sample, as well as Turkey (charts 1 & 2).

India is the exception, with growth continuing to slow and falling below 6% in Q2 for the first time since Q4-14. Indian growth is suffering from the lingering effects of demonetisation in late 2016 but also from weak private-sector investment and a negative contribution of net external trade.

The CEE countries and Turkey have also been the only ones seeing an increase in inflationary pressure (charts 3 & 4), reflecting the rise in oil prices in 2016 and higher core inflation. Since the start of 2017, however, inflation has stabilised in CEE countries as the effect of higher oil prices has faded.

Overall, and with the exception of these countries and some highly specific cases – particularly Egypt with its devaluation in November 2016, and Argentina with its loosening of capital controls in late 2015 and unification of exchange rates, accompanied by a major devaluation – faster growth is not stoking inflation. Aside from the impact of oil prices, two factors are balancing each other out. On the one hand, output gaps, measured against an estimated trend using a Hodrick-Prescott filter, have turned positive or widened since mid-2016 in Asia and Central and Eastern Europe. On the other hand, the cyclical acceleration in productivity is tempering higher unit labour costs in places where wages are rising faster. In addition, the weak dollar is having a disinflationary effect. The situation is different in some Central European countries, where rapid wage inflation is outpacing productivity growth. As expected, inflation has continued to fall since the start of 2017 in Brazil, India and Russia. For Brazil and Russia, their economies are just emerging from recession, monetary policy is tight and their currencies have seen the largest gains against the dollar since the start of 2016.

### Growth set to slow slightly but remain buoyant in H2 2017

Growth was underpinned by foreign trade in the first half of 2017. According to figures from the Netherlands Bureau for Economic Policy Analysis (CPB), real export growth across all emerging-market countries was 4.5% year-on-year in H1-17 after a sluggish 2% in H2-16. Eastern Europe led the pack with a 10% increase, followed by Asia (5%) and Latin America (3%). The only region where export growth was negative (-0.5%) was Africa and the Middle East, due to slowing or falling activity in oil-producing countries. In South Africa, real growth in goods and services exports seems to have strengthened after a year of stagnation, and the trade balance has turned positive again because of improved terms of trade in H1-17. However, the upturn in growth remains fragile (only 1% in H1-17) against the background of the battle for the presidency of the ANC, which will hold its 54rd national conference in the second half of

### Inflation catch-up in Central Europe ...

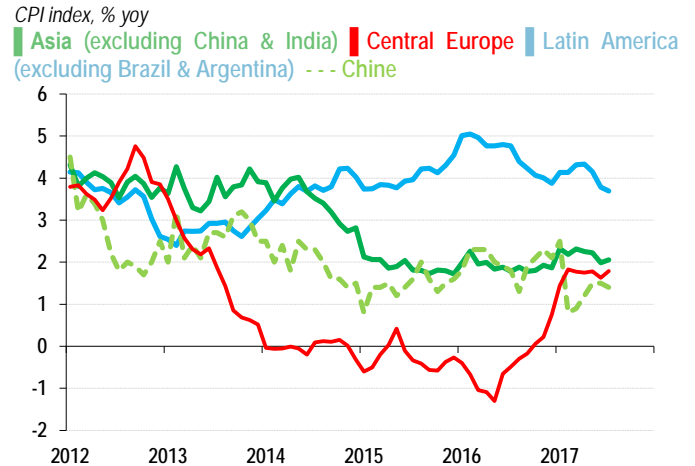


Chart 3 Sources: Macrobond - BNP Paribas

### ... and acceleration in Turkey

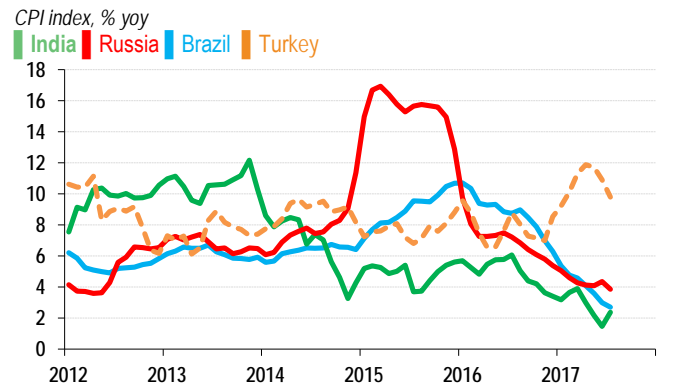


Chart 4 Sources: Macrobond - BNP Paribas

december. South Africa is showing both a deficit in its basic balance (sum of the current account balance and net FDI) that is the worst of all emerging-market countries (alongside Turkey), and high public-sector debts (direct and contingent liabilities) that are reducing its fiscal room for manoeuvre, since interest payments equal 3.5% of GDP.

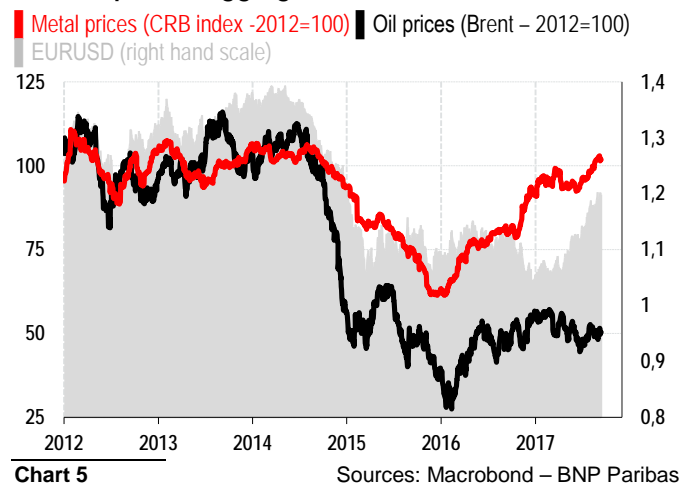
CPB statistics suggest a deceleration or a decline in recent months, depending on the region. The leading growth indicator calculated by the Institute of International Finance (IIF) has slowed sharply, falling from 6.7% (over three months annualised) in March to 5.1% in July. Its component based on "hard data" (exports, imports, industrial production, retail sales etc.) has fallen more than the component based on survey results and the component summarising financial variables. The pace of growth might have fallen after peaking in the second quarter, but that does not call into question the overall trend towards a consolidation in growth. According to the IIF's quarterly survey of around 100 banks regarding credit conditions, credit officers' expectations for supply and demand of trade finance remain very positive for Q3-17.



### Correlation between metals and oil prices

The diverging paths between metals and oil prices represent the main development in emerging-market countries' external environment in the last few months. Prices of industrial metals (iron ore, copper, aluminium) have surged, while oil prices have declined. Ordinarily, metals and oil prices are closely correlated. The rebound in metals prices reflects expectations regarding the Chinese economy, i.e. both strong demand arising from infrastructure investments and reduced production capacity for economic and/or environmental reasons. However, the increase has been magnified by high levels of dollar liquidity (keeping the cost of carry low) and the dollar's decline, because of the generally inverse correlation between metals/oil prices and the dollar (chart 5).

### Oil prices lagging behind



Weak oil prices are mainly the result of a sharp increase in the oil supply. Compliance with OPEC's production quota reductions was only 84% in June and July (according to OPEC's own figures) versus 99% in January 2017, because of the resumption of production in Nigeria and Libya. Although Russia complies with its production target in July, compliance with OPEC and non-OPEC production cuts was only 86% in July. All in all, in July 2017, OPEC and non-OPEC production (excluding the USA) had fallen by only 1.2 mbpd versus the 1.7 projected in December 2016. Moreover, US oil production forecasts for 2018 have also been raised sharply since the start of the year, because of renewed growth in new shale oil wells and improved technical extraction capability. According to the EIA, production is likely to hit 10 mbpd in 2018, 0.7 more than in 2017.

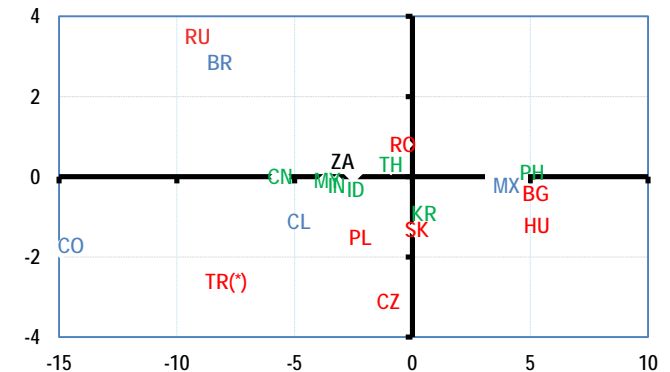
### Domestic credit: stronger momentum

As regards domestic demand, the new factor is the positive contribution of domestic credit momentum to growth in almost all Central European countries, Russia and Turkey, and its less negative contribution in the other main countries of Asia and Latin America, including Brazil (charts 6 & 7). The IIF survey of credit conditions also confirms strong demand for loans until Q2-17, not just in Europe but also in Asia, where the diffusion index was even higher than Europe's in Q2. In Latin America, the

### Credit momentum and growth momentum

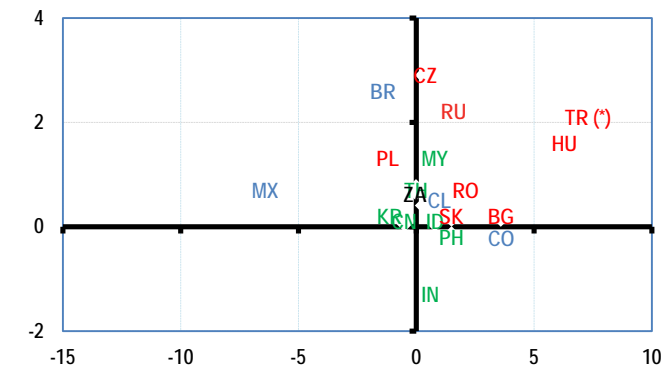
X-axis: change in yoy bank credit growth between end-2015 and end-2016

Y-axis: change in yoy real GDP growth between Q4 2015 and Q4 2016



X-axis: change in yoy bank credit growth between end-2016 and June 2017

Y-axis: change in yoy real GDP growth between Q4 2016 and Q2 2017



CN: China, IN: India, ID: Indonesia, KR: South Korea, MY: Malaysia, PH: Philippines, TH: Thailand, BU: Bulgaria, CZ: Czech Rep., HU: Hungary, PL: Poland, RO: Romania, RU: Russia, SK: Slovakia, TR: Turkey, BR: Brazil, CL: Chile, CO: Colombia, MX: Mexico, ZA: South Africa

(\*) Real GDP was set at 3% in Q4 2016 (i.e. the average growth in H2 2016 in order to smooth the very volatile quarterly profile that followed the missed coup during the summer 2016).

diffusion index is still in negative territory but should turn positive in Q3. In Africa and the Middle East, however, it remains negative and deteriorated until Q2.

Overall, monetary policies remain loose, justified by low inflation, although there is little room for manoeuvre left except in countries that were in recession until 2016 (Brazil and Russia) or stagnating (South Africa). Scope for further loosening is particularly limited in Argentina, where the decline in inflation has petered out, and in Turkey, where currency depreciation has pushed up core inflation.

It is unsurprising that Central Europe and Russia are showing positive and/or strong credit momentum. Firstly, Hungary, Romania and Bulgaria are still catching up after credit crunches



between 2012 and 2015, while Russia has recently emerged from recession, and is thus seeing renewed growth in credit. Secondly, real wages are accelerating and unemployment is falling in Central Europe.

In Turkey, the situation is markedly different. Economic growth has been driven by credit for several years now. Credit has followed stop and go periods, with slowdowns prompted by monetary tightening that was often justified by the exchange rate weakness. Nevertheless, monetary policy has been fairly loose since 2011, since when the central bank has only hit its inflation target once, in 2012. Unlike Central European countries, Turkey has not undergone a period of deleveraging. Its recent momentum is not the result of conventional monetary policy but various measures to loosen credit conditions, such as the rescheduling of repayments for certain consumer loans, an increase in the maximum loan-to-value ratio for mortgages, and moves to bolster the loan guarantee fund to stimulate lending to SMEs.

Since the failed coup in summer 2016, Turkey's growth has been propped up by credit – although credit growth slowed in summer 2017 – and by an expansionary fiscal policy. Foreign trade only started to contribute to growth in late 2016 (chart 8).

So far, the deterioration in Turkey's external accounts has been limited, whereas spending on oil has increased and central-bank currency reserves have been stable since March 2017. However, core inflation has risen close to 10%, forcing the central bank to keep its average refinancing rate at a significant level in real terms, at a time when the public-sector debt rollover ratio is well above 100% as opposed to 85% on average between mid-2012 and mid-2016.

In other regions, re leveraging remains a long way off however.

In China, authorities are focusing on reducing financial risks through tightening in monetary policy and regulations. Credit growth to households and corporates has been stable since the beginning of the year. However, the growth of bank's claims to non-bank financial institutions (shadow banking) has decelerated markedly (chart 9), indicating a deceleration in the components of the shadow banking the least supervised and the reduction in interconnections between those institutions. In addition, it has become more expensive for companies to borrow in the bond market as monetary policy has tightened. If these developments are confirmed, they are likely to drag growth lower in the short term, although they are good news in terms of financial stability.

In Brazil, bank credit to corporates has reduced since early 2015, and the trend accelerated in early 2016. However, according to a recent report on listed companies by Brazil's Center for Capital Market Studies, despite debt reduction, interest cover (coverage of interest expense by EBITDA) has continued to deteriorate, taking the proportion of companies unable to service their debts to 52.3% in March 2017. Because of very high real interest rates, Brazil's private sector (consumers and businesses) has seen a particularly large increase in debt service costs relative to debt levels in the last five years (chart 10). Nevertheless, credit to households is recovering slowly. Monetary loosening has resulted in only a marginal reduction in real interest rates, which

### Turkey : a credit-push growth

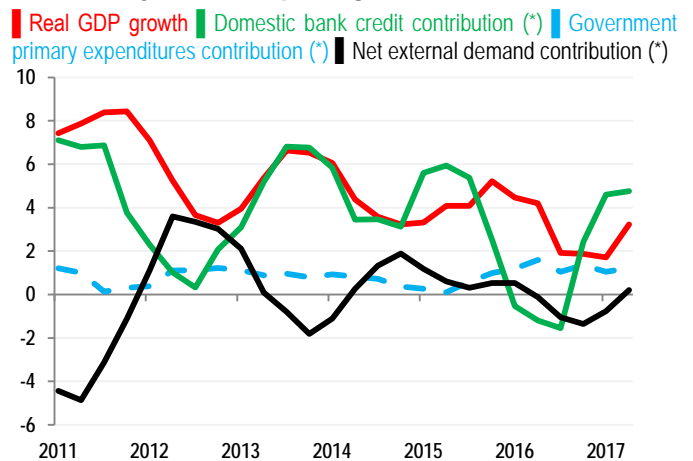


Chart 8

Sources: Macrobond – BNP Paribas

(\*) Change between T-4 and T in % of GDP in T-4. Flows data (GDP, primary expenditures, exports, imports) are smoothed using a 4-quarter moving average.

### China : shadow banking slowdown

Bank claims (% yoy) on:

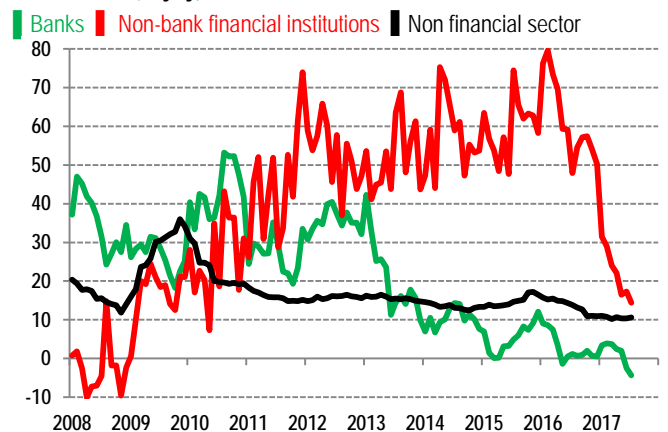


Chart 9

Sources: CEIC – BNP Paribas

are literally prohibitive for consumers. The reasons behind the credit recovery is an incipient upturn in the labour market, with 293,000 jobs created between February and July, taking the unemployment rate down from 13.1% to 12.6% and disinflation.

In India, credit growth has slowed, reflecting increased credit risk for public-sector banks caused by the deteriorating financial position of companies in several industrial sectors (metals, construction, energy and infrastructure). The momentum remains positive because of faster growth in consumer credit whereas lending to industry is continuing to fall. On the positive note, the reduction in the central bank's policy interest rate is translating more quickly and more fully into reduced borrowing costs for companies and consumers: since September 2016, the average borrowing rate has fallen by 42 basis points to 10.6% in response to the central bank's 50bp cut in the repo rate, raising hopes that credit growth will accelerate again, at least among private-sector banks.



Private debt burden

X-axis: change in the private sector debt-to-GDP ratio between end-2012 and end-2016

Y-axis: change in the debt service ratio (in % of income) between end-2012 and end-2016

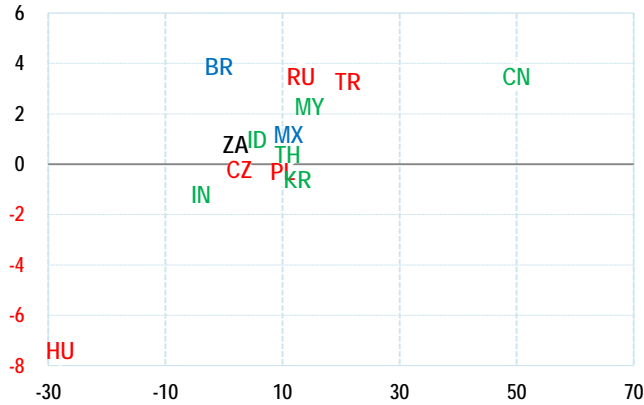


Chart 10 Sources: BIS – BNP Paribas

CN: China, IN: India, ID: Indonesia, KR: South Korea, MY: Malaysia, TH: Thailand, CZ: Czech Rep., HU: Hungary, PL: Poland, RU: Russia, TR: Turkey, BR: Brazil, MX: Mexico, ZA: South Africa

GCC countries in the spotlight

Oil-producing countries are still the most fragile by far. Growth in the Africa and Middle East region has lagged behind in 2017 and will probably continue to do so in 2018, with potential for further downgrades in countries' credit ratings. That is particularly the case for GCC countries.

In Saudi Arabia, activity is currently "paying the price" of the country's compliance with production quotas – oil production fell

by around 0.5 mbpd or 5% between October 2016 and July 2017 – as well as low oil prices and the resulting fall in public spending. The recession is getting worse, as shown by the contraction in private-sector credit, the decline in letters of credit opened to importers and the fall in cement production to a historic low. The desire for fiscal consolidation is becoming weaker. Already, in April 2017, the government restored public-sector pay to its previous level after cutting it by 20% in October 2016. It is now intending to amend its "Vision 2030" reform plan so as not to damage activity too much. The budget deficit is likely to fall to 10% of GDP in 2017 from 16.8% in 2016.

In Qatar, the political crisis is not currently having a major impact on the economy, because the country is finding ways to circumvent the embargo introduced by Saudi Arabia, the United Arab Emirates and Egypt. Alternative trade routes are being used – with the opening of Hamad Port, close to Doha – while exports of liquefied natural gas are unaffected and production is increasing. On the financial side, central bank advances and cash held by the sovereign investment fund are being used to support liquidity in the banking system, which was adversely affected until June by the decline in private-sector deposits and liabilities to foreign banks. At the moment, Saudi, UAE and Bahraini banks have not issued official guidelines regarding relations with Qatar's banks. Some credit facilities have been suspended and short-term loans are not being renewed, but no financial sanctions have been applied. However, even if things remain as they are, tighter financing terms will inevitably drag down Qatar's growth.

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