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Eco WEEK

ECONOMIC RESEARCH DEPARTMENT

Summary

Also in :

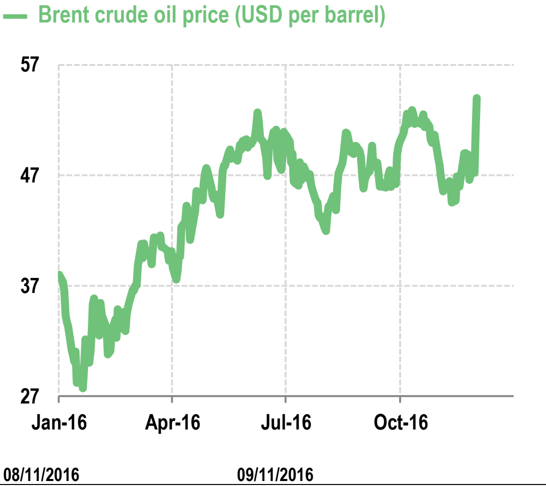
Eco TV WEEK

Oil back on front pages

■ OPEC countries cut production ■ Oil prices rebound markedly ■ Bad news for consumer spending ■ US production should limit the brake

At the end of September, OPEC had announced a deal was in the making. This week, it was officially announced. Production will be limited to 32.5 million barrels per day, a 1.2 million cut, between January 1st and June 30th, 2017, a deal that could be extended for an additional 6-month. The agreement was made possible thanks to some non-OPEC countries claiming a production cut of 600k barrels per day. Here, Russia was specifically mentioned. Oil prices rebounded accordingly. Starting the week at USD 48 per barrel, the Brent crude oil price gained 12.5% to USD 53 on Thursday closing. Still, one of the largest producers is conspicuously absent of the deal: the US. There, oil extraction is particularly flexible and responds quickly to price fluctuations, while the break even cost has been driven markedly down over the last few years. This means that oil prices have a de facto ceiling, most likely around USD 60 per barrel. That is good news. Indeed, the inelasticity of energy demand to prices, especially in winter time, will result in a lower purchasing power for households. In a context of depressed demand, this will come on top of rising interest rates, with a potential strong break on consumer spending.

OIL PRICES



Source: Macrobond

THE WEEK ON THE MARKETS

Week 25-11 16 > 1-12-16

↗ **CAC 40**	4 550	►	**4 561**	**+0.2**	%
↘ **S&P 500**	2 213	►	**2 191**	**-1.0**	%
↗ Volatility (VIX)	12.3	►	14.1	+1.7	%
↗ **Euribor 3M** (%)	-0.31	►	**-0.31**	**+0.1**	bp
↘ Libor $ 3M (%)	0.94	►	0.93	-0.3	bp
↗ OAT 10y (%)	0.78	►	0.79	+0.7	bp
↗ Bund 10y (%)	0.16	►	0.28	+11.8	bp
↗ US Tr. 10y (%)	2.37	►	2.46	+8.4	bp
↗ **Euro vs dollar**	1.06	►	**1.06**	**+0.1**	%
↘ Gold (ounce, $)	1 185	►	1 168	-1.4	%
↗ **Oil (Brent, $)**	47.3	►	**54.3**	**+14.9**	%

Source: Thomson Reuters

France

Inflation picks up slightly

- **Inflation continues to rise gradually, driven by the contribution of energy prices, now slightly positive. Core inflation continues to trend slightly downwards.**
- **We expect these trends to continue in 2017 and forecast a mild increase in inflation (from +0.5% today to +1.3% year-on-year at end-2017).**
- **Inflation, less low, will reduce household purchasing power gains. As a result, consumer spending is expected to slow down significantly, placing a drag on growth.**

At this time last year, we observed that inflation in France remained uncomfortably low, even more so than growth. This observation is still true today. At 1.1% year-on-year in Q3 2016, growth was identical to the Q3 2015 pace. On the inflation front, things appear to be a bit better: Inflation rose from 0% year-on-year in November 2015 to 0.5% a year later according to preliminary INSEE estimates. Yet this mild acceleration is mainly due to energy prices, the contribution of which was less and less negative over the course of the year before becoming slightly positive (-0.5 percentage points in November 2015, +0.2 points in November 2016). However, core inflation slowed slightly over the period, to 0.5% year-on-year in November 2016 from 0.8% in November 2015.

We expect these trends to continue in 2017. Headline inflation is expected to pick up from an average annual rate of 0.2% in 2016 to 1% in 2017, due solely to the impact of the expected rebound in oil prices. Core inflation should, however, slow down slightly, from 0.6% in 2016 to 0.4% in 2017. Two factors are contributing to the low level of core inflation. First, there is a currency effect: for a few more months, the past appreciation of the euro will continue to have a downward impact on durable core goods prices. The opposite, inflationary, effects of the very recent depreciation of the euro will materialize later, and in a context still characterised by significant slack in the economy. This is the second explanation of low inflation.

Granted, it is impossible to measure with any precision the size of the output gap (the difference between real and potential GDP), as illustrated by the wide range of estimates for 2016 (-1.4% according to the European Commission; -1.8% according to the IMF and -2.3% according to the OECD). The true scope of the output gap raises a lot of questions, especially since some consider that the 2008-2009 economic and financial crisis and the following sluggish recovery lowered not only potential growth, but also the level of potential GDP. In this case, the output gap might not be as negative as commonly thought. Yet the low level of inflation argues, to the contrary, that the output gap is still fairly wide. Besides, according to our forecasts, it will remain this negative in 2017, since the growth rate is expected to be more or less equal to the potential growth rate (average annual rate of 1.1%).

Weak inflation

Consumer price index, year-on-year, %

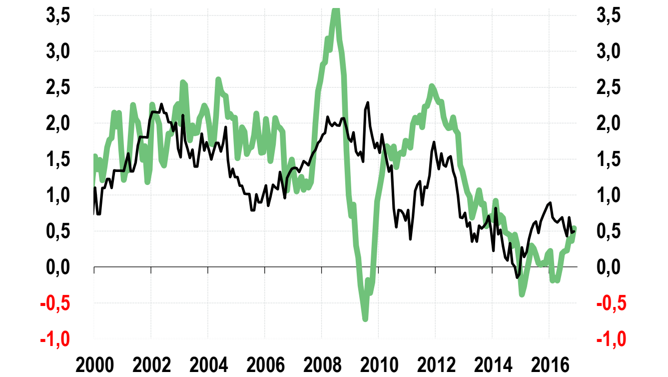


Chart Source: INSEE

The large degree of slack in the economy can also be seen in the labour market. Unemployment has begun declining but it is still high. Consequently, wage growth is also expected to remain subdued (1.2% a year for the monthly base wage in Q3 2016, an all-time low). Besides, wages will get only limited support from the automatic annual revaluation of the minimum wage (each 1st January). Given the weakness of inflation and limited wage increases, we estimate it at +0.9%, with no extra boost assuming the government follows the expert committee's recommendation. The wage-price loop is functioning in slow motion, with low inflation and wage moderation influencing each other.

Low inflation can be seen in two different lights: as a symptom of sluggish growth, and as a support factor for household purchasing power, consumer consumption and thus growth. The absence of inflation is, indeed, the main reason for the purchasing power gains observed since 2014 (average annual gains of +0.7% in 2014, +1.6% in 2015 and +2% year-on-year in Q2 2016). Consequently, we expect the upturn in inflation, as mild as it may be, to reduce purchasing power gains (to +1.2% in 2017, according to our estimates), which will only get limited support from employment and wage growth. For this reason, our central scenario calls for a significant slowdown in household consumption (up 1% in 2017 in annual average terms compared to +1.5% in 2016). The dip in purchasing power gains could be absorbed by a decline in the personal saving rate, but this seems unlikely in an environment of high unemployment. We think the most likely hypothesis is that the personal saving rate will remain more or less steady at about its current level of 15% of gross disposable income.

This scenario is highly dependent on oil prices trends, which introduces a lot of uncertainty. Yet, beyond their recent rise, the balance of risks seems to lean towards lower-than-expected oil prices, in which case, all other factors being the same, growth might be stronger in 2017.

Portugal

The European Commission shows some flexibility

■ **Portugal's budget proposal, presented in mid-October, considers that it responds to the EC's demands, by aiming to reduce the budget deficit to 2.4% of GDP this year. Moreover the government is forecasting to reduce it to 1.6% of GDP in 2017.**

■ **Yet the draft budget's growth assumptions are more favourable than those of the European Commission. The Commission is also less optimistic than the government concerning the expected impact of certain measures on the budget balance.**

■ **While pointing out the risk that Portugal might fail to meet its commitments in 2017, the Commission nonetheless approved its budget proposal.**

Last July, the European Commission opted not to sanction Portugal for failing to sufficiently reduce its deficit in 2015, on condition that the country fulfils its deficit reduction targets this year. In the budget proposal presented to the European Commission in mid-October, Portugal considers that it responds to the EC's demands. Indeed, the draft budget calls for a budget deficit of 2.4% of GDP in 2016 (down from 4.4% of GDP in 2015). Moreover the government is forecasting to reduce it to 1.6% of GDP in 2017.

Overly optimistic growth assumptions

Even so, the European Commission issued a few reserves. Indeed, the government's budget outlook must be treated with caution as it is based on more optimistic growth assumptions than those of the European Commission. The Portuguese government is forecasting GDP growth of 1.2% in 2016 and 1.5% in 2017, compared to the Commission's estimates of 0.9% and 1.2%, respectively (see table and chart 1).

The Portuguese economy should benefit from a slightly stronger global economy and a bigger increase in exports next year. The European Commission and the government both expect investment to accelerate despite troubles in the banking sector.

Yet the assumptions from the government and the European Commission differ concerning the size of this increase. The European Commission foresees a bigger increase in investment expenditure. It expects the use of European Structural and Investment funds (ESI) to carry over to the rest of the economy. For the Commission, however, this growth will be accompanied by a bigger increase in imports, which means that foreign trade would make a negative contribution to growth.

The European Commission also expects private consumption's contribution to growth to be smaller than the government's forecast. Both expect private consumption to grow at a slower pace in the months ahead due to the upturn in inflation, but the European Commission is more cautious than the government when it comes to wage trends. Also, according to the EC, the especially high level of

The recovery is still mild

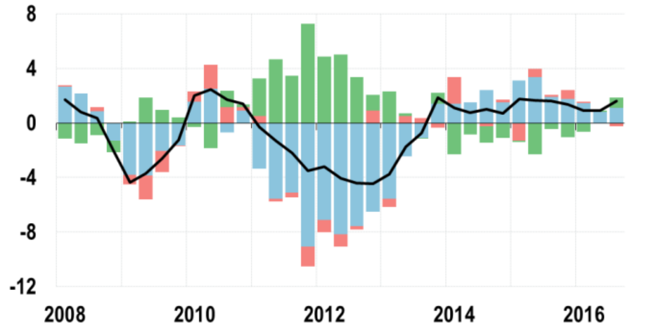


Chart 1 — Source: INE

Budget forecast

	2015	2016 Draft Budgetary Plan	2016 European Commission	2017 Draft Budgetary Plan	2017 European Commission
GDP (y/y, %)	1.6	1.2	0.9	1.5	1.2
% of GDP					
Primary balance	0.2	1.9	1.7	2.8	2.2
Structural balance	-2.3	-2.2	-2.4	-1.9	-2.4
General government balance	-4.4	-2.4	-2.7	-1.6	-2.2
Gross debt ratio	129	129.7	130.3	128.3	129.5

Source: European Commission

household debt (75.7% of GDP in Q2 2016) should place a bigger strain on consumer spending.

Insufficient fiscal efforts

For the European Commission, this growth differential results in fewer revenues and more spending. The European Commission is also less optimistic than the government concerning the expected impact of certain measures on the budget balance.

In its budget proposal, the government calls for discretionary revenues to increase by 0.3% of GDP in 2017. Next year, the government intends to levy a 0.3% real-estate tax on "luxury" residences valued at more than EUR600,000, and to introduce a soda tax. Transferring the gasoline tax to diesel is also expected to bring in additional revenues. The government will also benefit from one-off revenues, including the recovery of the Banco Privado

Português (BPP) bank guarantee (0.2% of GDP) and higher dividend payments by the Banco de Portugal (0.2% of GDP).

According to the government, these additional revenues should offset the reduction in the VAT rate on food services (from 23% previously to 13% since July 2016), as well as certain spending increases, notably for public sector wages, since Q2 2016. The government also plans to increase state pensions for low-income households, to index pensions and new social welfare benefits for persons with disabilities, and to return to a 35-hour workweek in the healthcare sector.

The Commission is taking a more cautious approach. The replacement of only one public sector worker for every two would have a smaller impact on spending than the government expects.

The European Commission and the government have also made different forecasts for the deficit as well. Let us first look at the structural deficit [1], which reached 2.3% of GDP in 2015. The European Commission expects the structural deficit to widen by 0.1 points this year before levelling off in 2017, unlike the government, which is looking for reductions of 0.1 points and 0.3 points of GDP, respectively, in 2016 and 2017. All in all, the Commission expects Portugal's budget deficit to come to 2.7% of GDP in 2016 and 2.2% in 2017, compared to the budget proposal's figures of 2.4% and 1.6%, respectively.

The same can be said about the outlook for the public debt. According to the European Commission, primary surpluses and one-off revenues on the disposal of certain financial assets will be smaller than the government's forecasts. From 129% of GDP in 2015, it expects the public debt ratio to peak at 130.3% in 2016 before levelling off at 129.5% in 2017 (see chart 2).

Portugal is spared the suspension of structural funds

Portugal did not meet the European Commission's demands, notably in terms of reducing the structural deficit. This one would like Portugal to reduce its structural deficit by 0.6 points of GDP a year between 2016 and 2020, and to generate a medium-term structural surplus of at least 0.3% of GDP. The budget deficit, which is to be reduced primarily via ongoing growth, is unlikely to fall below the Commission's target of 2.5% of GDP which it set this summer. The Commission also pointed out the risks for public finances of the uncertainty surrounding the recapitalisation of the public bank Caixa Geral Depositos (CGD) [2]. Portugal is still vulnerable to any new shocks, especially those arising from its banking system, which remains fragile given the high stock of non-performing loans.

Despite these reservations, the European Commission nonetheless approved Portugal's draft budget proposal. It took into account the efforts Portugal has made in recent years and its capacity to reduce the budget deficit below the Stability and Growth Pact's threshold of 3% of GDP this year. The Commission mainly wants to avoid weakening a country that has already undertaken major fiscal adjustment efforts.

Portugal is weakened by a heavy debt burden

% of GDP

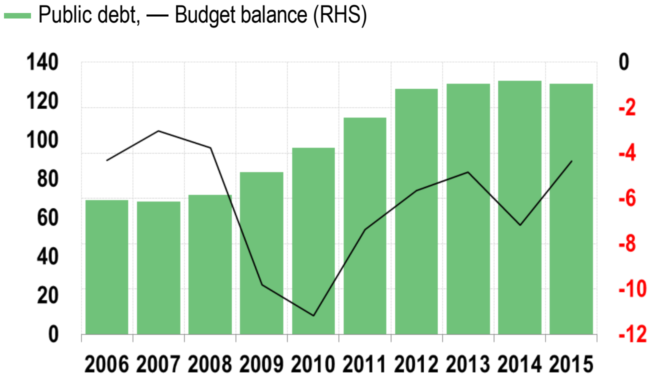


Chart 2 Source: Ameco

This decision bolsters the minority government that has been in power for almost a year. Prime Minister Antonio Costa's Socialist government must work with political parties openly hostile to further austerity measures, namely the Portuguese Communist Party (PCP), the Greens (PEV) and the radical Left Block (BE).

Portugal has been spared any sanctions and the suspension of European structural and investment funds, which are vital for its development. Between 2014 and 2020, the overall ESI funds will account for nearly 15% of 2015 GDP.

[1] *The structural balance equals the balance that would be reached if GDP equalled its potential, adjusted for exceptional measures.*
[2] *In late August, the European Commission approved a EUR 2.7 bn injection in CGD by the Portuguese government in exchange for a restructuring plan and the disposal of EUR 1 bn in debt instruments on the market.*

Markets overview

The essentials

Week 25-11 16 > 1-12-16

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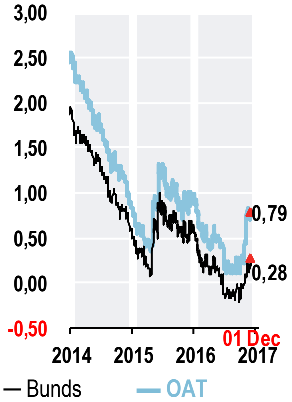
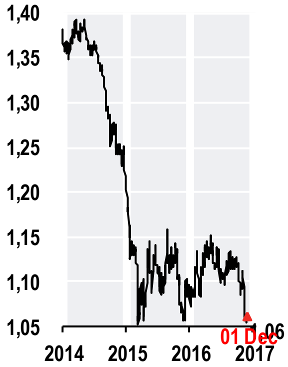
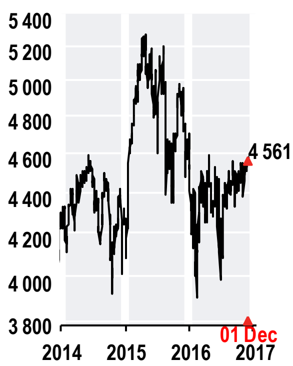
10 y bond yield, OAT vs Bund



Euro-dollar



CAC 40



Money & Bond Markets

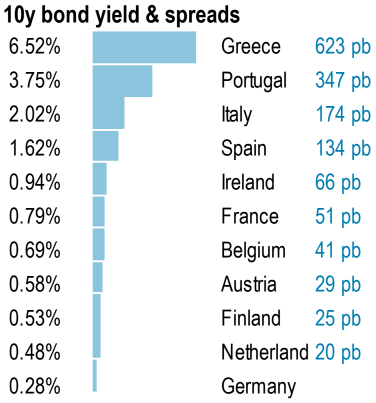
Interest Rates		highest' 16		lowest' 16	
€ ECB	**0.00**	0.05	at 01/01	0.00	at 16/03
Eonia	**-0.34**	-0.13	at 01/01	-0.36	at 26/05
Euribor 3M	**-0.31**	-0.13	at 01/01	-0.31	at 24/11
Euribor 12M	**-0.08**	0.06	at 01/01	-0.08	at 30/11
$ FED	**0.50**	0.50	at 01/01	0.50	at 01/01
Libor 3M	**0.93**	0.94	at 25/11	0.61	at 04/01
Libor 12M	**1.64**	1.65	at 25/11	1.12	at 12/02
£ BoE	**0.25**	0.50	at 01/01	0.25	at 04/08
Libor 3M	**0.38**	0.59	at 15/02	0.38	at 08/09
Libor 12M	**0.79**	1.07	at 01/01	0.72	at 10/08

At 1-12-16

Yield (%)		highest' 16		lowest' 16	
€ AVG 5-7y	**0.36**	0.49	at 12/01	-0.14	at 27/09
Bund 2y	**-0.76**	-0.34	at 01/01	-0.79	at 28/11
Bund 10y	**0.28**	0.63	at 01/01	-0.22	at 28/09
OAT 10y	**0.79**	0.98	at 01/01	0.10	at 27/09
Corp. BBB	**1.67**	2.50	at 20/01	1.14	at 07/09
$ Treas. 2y	**1.13**	1.14	at 25/11	0.56	at 05/07
Treas. 10y	**2.46**	2.46	at 01/12	1.36	at 08/07
Corp. BBB	**3.89**	4.50	at 12/02	3.24	at 18/08
£ Treas. 2y	**0.15**	0.65	at 01/01	0.07	at 29/09
Treas. 10y	**1.49**	1.96	at 01/01	0.61	at 12/08

At 1-12-16

10y bond yield & spreads

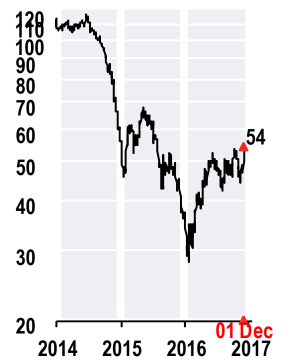


Commodities

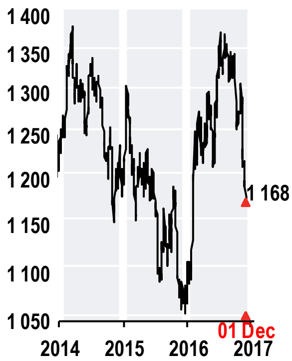
Spot price in dollars		lowest' 16			2016(€)
Oil, Brent	**54**	28	at	20/01	**+55.8%**
Gold (ounce)	**1 168**	1 062	at	01/01	**+12.5%**
Metals, LMEX	**2 787**	2 049	at	12/01	**+29.5%**
Copper (ton)	**5 788**	4 328	at	15/01	**+25.9%**
CRB Foods	**336**	322	at	09/11	**+2.8%**
w heat (ton)	**139**	126	at	16/08	**-8.1%**
Corn (ton)	**125**	113	at	31/08	**-7.3%**

At 1-12-16 *Variations*

Oil (Brent, $)



Gold (Ounce, $)



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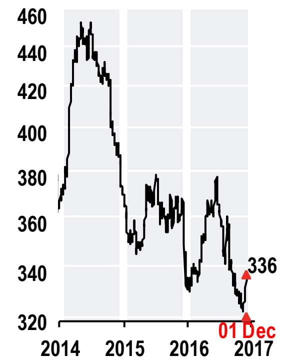

Exchange Rates

1€ =		highest' 16			lowest' 16			2016
USD	**1.06**	1.15	at	03/05	1.05	at	23/11	-2.3%
GBP	**0.84**	0.90	at	13/10	0.73	at	05/01	+14.1%
CHF	**1.08**	1.11	at	04/02	1.07	at	18/11	-1.1%
JPY	**121.40**	131.84	at	01/02	110.95	at	08/07	-7.1%
AUD	**1.43**	1.60	at	11/02	1.41	at	28/11	-4.0%
CNY	**7.32**	7.54	at	22/08	6.99	at	05/01	+3.7%
BRL	**3.68**	4.53	at	16/02	3.39	at	25/10	-14.4%
RUB	**67.65**	91.22	at	11/02	67.55	at	25/10	-14.7%
INR	**72.55**	77.50	at	11/02	71.42	at	05/01	+1.0%

At 1-12-16 *Variations*

Equity indices

	Index	highest' 16			lowest' 16			2016	2016(€)
CAC 40	**4 561**	4 637	at	01/01	3 897	at	11/02	-1.6%	**-1.6%**
S&P500	**2 191**	2 213	at	25/11	1 829	at	11/02	+7.2%	**+9.7%**
DAX	**10 534**	10 761	at	24/10	8 753	at	11/02	-1.9%	**-1.9%**
Nikkei	**18 513**	19 034	at	01/01	14 952	at	24/06	-2.7%	**+4.7%**
China*	**61**	65	at	22/09	48	at	12/02	+2.7%	**+5.1%**
India*	**446**	504	at	08/09	393	at	11/02	+0.3%	**-0.6%**
Brazil*	**1 564**	1 882	at	31/10	860	at	21/01	+32.3%	**+54.5%**
Russia*	**549**	549	at	01/12	331	at	20/01	+21.6%	**+38.7%**

At 1-12-16 *Variations*

* MSCI index

Economic forecasts

En %	GDP Growth 2016 e	GDP Growth 2017 e	GDP Growth 2018 e	Inflation 2016 e	Inflation 2017 e	Inflation 2018 e	Curr. account / GDP 2016 e	Curr. account / GDP 2017 e	Curr. account / GDP 2018 e	Fiscal balances / GDP 2016 e	Fiscal balances / GDP 2017 e	Fiscal balances / GDP 2018 e
Advanced	**1.6**	**1.7**	**2.1**	**0.8**	**1.7**	**1.9**						
United States	**1.5**	**2.2**	**2.8**	**1.2**	**2.2**	**2.6**	**-2.5**	**-2.4**	**-2.4**	**-3.4**	**-4.2**	**-5.0**
Japan	0.8	0.9	0.7	-0.1	1.1	1.0	3.8	4.0	4.4	-4.6	-4.2	-4.1
United Kingdom	2.1	1.1	1.6	0.6	2.4	2.6	-5.5	-4.6	-3.5	-3.7	-4.0	-4.1
Euro Area	**1.6**	**1.2**	**1.5**	**0.2**	**1.2**	**1.3**	**3.2**	**2.9**	**2.9**	**-1.8**	**-1.6**	**-1.4**
Germany	1.8	1.5	1.8	0.4	1.6	1.5	8.9	8.1	8.4	0.6	0.6	0.5
France	1.3	1.1	1.5	0.3	1.0	1.1	-0.9	-0.6	-0.8	-3.4	-3.1	-2.8
Italy	0.8	0.4	0.7	-0.1	0.9	1.0	2.0	2.2	2.0	-2.5	-2.6	-2.6
Spain	3.2	2.1	1.9	-0.4	1.6	1.6	1.1	1.6	1.6	-4.6	-3.8	-3.2
Netherlands	2.2	1.5	1.4	0.1	0.8	1.2	8.5	8.2	7.9	-1.1	-0.5	-0.2
Belgium	1.4	1.2	1.4	1.8	1.6	1.6	0.8	0.6	0.6	-2.9	-1.6	-1.9
Emerging	**4.3**	**4.6**	**5.1**	**4.8**	**4.4**	**4.2**						
China	6.7	6.2	6.4	2.0	2.3	2.5	2.2	1.7	1.5	-3.0	-3.3	-3.5
India	7.5	8.1	8.3	5.0	5.7	4.9	-1.1	-0.5	-1.3	-3.9	-3.5	-3.5
Brazil	-3.7	1.0	3.0	8.8	4.9	4.4	-1.2	-1.7	-2.5	-9.6	-10.4	-8.4
Russia	-0.5	1.0	2.5	7.0	4.6	4.2	2.5	2.7	3.2	-3.9	-3.0	-1.9
World	**3.1**	**3.3**	**3.8**	**3.1**	**3.3**	**3.3**						

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

Financial forecasts

Interest rates		2016				2017						
End period		Q1	Q2	Q3	Q4e	Q1e	Q2e	Q3e	Q4e	**2016e**	**2017e**	**2018e**
US	Fed Funds	0.25-0.5	0.25-0.5	0.25-0.5	0.50-0.75	0.50-0.75	0.50-0.75	0.75-1.00	1.00-1.25	0.50-0.75	1.00-1.25	2.00-2.25
	3-month Libor $	0.63	0.65	0.85	0.91	0.90	0.90	0.95	1.10	0.91	1.10	2.45
	10-year T-notes	1.79	1.49	1.61	2.35	2.55	2.75	2.85	3.00	2.35	3.00	3.50
EMU	Refinancing rate	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
	3-month Euribor	-0.24	-0.29	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.30	-0.15
	10-year Bund	0.16	-0.13	-0.19	0.30	0.40	0.50	0.60	0.70	0.30	0.70	1.20
	10-year OAT	0.41	0.20	0.12	0.75	0.90	0.90	1.00	1.10	0.75	1.10	1.70
	10-year BTP	1.23	1.35	1.19	2.05	1.90	2.10	2.30	2.50	2.05	2.50	3.00
UK	Base rate	0.50	0.50	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25
	3-month Libor £	0.59	0.56	0.38	0.40	0.40	0.40	0.40	0.40	0.40	0.40	0.40
	10-year Gilt	1.42	1.02	0.76	1.55	1.70	1.65	1.75	1.90	1.55	1.90	2.15
Japan	Overnight call rate	-0.00	-0.06	-0.06	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
	3-month JPY Libor	0.10	0.06	0.06	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05
	10-year JGB	-0.04	-0.23	-0.08	0.00	0.05	0.05	0.10	0.15	0.00	0.15	0.15

Exchange rates		2016				2017						
End period		Q1	Q2	Q3	Q4e	Q1e	Q2e	Q3e	Q4e	**2016e**	**2017e**	**2018e**
USD	EUR / USD	1.14	1.11	1.12	1.07	1.04	1.02	1.02	1.00	1.07	1.00	1.09
	USD / JPY	112	103	101	110	115	120	125	128	110	128	135
EUR	EUR / GBP	0.79	0.83	0.87	0.86	0.84	0.82	0.82	0.80	0.86	0.80	0.76
	EUR / CHF	1.09	1.08	1.09	1.07	1.08	1.10	1.12	1.12	1.07	1.12	1.15
	EUR/JPY	128	114	114	118	120	122	128	128	118	128	147

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

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