ECO EMERGING

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Eco EMERGING

ECONOMIC RESEARCH DEPARTMENT

BNP PARIBAS

The bank for a changing world

Editorial

Birth of the eco: essentially a symbolic change

The end of the CFA franc and its replacement with the eco scheduled for next June address the legitimate desire of WAEMU member countries to manage what is already their single currency. Governance of the currency regime will change as the French Treasury pulls out of WAEMU entities, although it will still serve as the lender of last resort. Though the euro peg will limit monetary policy's independence, it is necessary to shore up the macroeconomic stability of WAEMU, which is still fragile.

The CFA franc officially ends

On 21 December 2019, the presidents of Ivory Coast and France announced the end of the CFA franc and the operational reform of the West Africa Economic and Monetary Union (WAEMU). This is the first step towards creating a single currency for the 15 countries of the Economic Community of West African States (ECOWAS), comprising the 8 WAEMU countries plus Nigeria, Ghana, Gambia, Liberia, Guinea, Cape Verde and Sierra Leone. In June 2020, the eco will officially replace the CFA franc, and France will no longer participate in the governance of WAEMU, although it will still serve as the lender of last resort, at least initially. This reform reflects the perfectly legitimate desire of WAEMU countries to manage what is already their single currency. Its success will depend on maintaining its peg to the euro.

Change of governance

In addition to the name change, the decisions made by France and the WAEMU countries end the requirement that the Central Bank of the West African States (BCEAO) deposit at least 50% of its foreign reserves with the French Treasury[1]. French representatives also withdrew from the decision-making bodies and management of the region's monetary policy.

Yet France will continue to guarantee the unlimited convertibility of the new currency at the same fixed exchange rate of 655.957 eco for 1 euro. Technical details have not been released yet, especially the support mechanisms in case foreign reserves come under pressure. An unlimited credit line will probably be set up. Yet over the course of its existence, WAEMU has already demonstrated its resilience in the face of political and financial shocks: the state guarantee has only been activated once since its creation, just prior to the 50% devaluation of the CFA franc in 1994[2]. It resisted the 2002-2003 political crisis in Ivory Coast (the zone's biggest country) and the drop-off in commodity prices in 2015-2016. WAEMU has since rebuilt its foreign reserves to a suitable level (EUR 13 bn, the equivalent of 5.1 months of imports of goods and services at Q3 2019), thanks in part to Eurobond issues by Ivory Coast and Senegal over the past two years (totalling USD 5 bn).

Obstacles to greater flexibility

In practice, gaining monetary sovereignty will not give the region more freedom to conduct monetary policy. Although the exchange rate is fixed, the BCEAO will have to maintain the spread that already exists between its key rate (2.5%) and that of the eurozone, even though most WAEMU member countries already comply with all of the convergence criteria defined in the monetary union proposal for the ECOWAS region[3].

It is worth asking, however, if the WAEMU countries shouldn't have seized the occasion to introduce more flexibility into the currency regime, by adopting a peg to a basket of currencies with a fluctuation band. This would have given it more manoeuvring room to conduct monetary policy.

The main reason for the peg is to secure financial stability of WAEMU, which is still fragile. Since 2016, the region's current account deficit has exceeded 6% of GDP, and the IMF does not foresee any improvements before 2022, with the start-up of oil production in Senegal. Above all, public debt has increased rapidly in recent years. From 35% of GDP in 2014, the region's public debt rose to 47.6% of GDP in 2019 despite robust growth. Debt in foreign currency has followed a similar trend, gaining 11 percentage points of GDP over the past five years to 33% of GDP in 2019. Interest charges have also increased rapidly to more than 10% of the public revenues (including aid) of the Ivory Coast and Senegal.

Moreover, the price elasticity of export and import volumes is low[4] due to the high proportion of non-transformable commodity exports to total exports (54%) and an insufficient industrial base to serve as a substitute for imports. In other words, their economies are not diversified enough for currency depreciation to have a positive impact. The CFA franc's stability relative to the euro has neutralised fluctuations in oil prices (which are largely imported) given their negative correlation to the dollar. Most importantly, the states have extremely high foreign currency debts: external debt accounts for 70% of the region's total debt.

Stephane Alby - François Faure

[1] BCEAO will lose revenues on half of its foreign reserves, since the ECB paid a preferential deposit rate of 0.75%.

[2] Before 1994, it was called WAMU (West Africa Monetary Union) but the main operating principles and modes were the same (unlimited convertibility, guaranteed by the French state, existence of "comptes d'operations").

[3] Inflation of less than 10%, a fiscal deficit of less than 3% of GDP, monetary financing of the fiscal deficit of less than 10% of fiscal revenues, and a reserve coverage ratio of at least 3 months of imports.

[4] See M. Diarra "Is the balance of payments restricting economic growth in the WAEMU countries? BCEAO Economic and Monetary Review, June 2014.

China

The year starts with a reprieve

In 2019, economic growth slowed to 6.1%. Total exports contracted and domestic demand continued to weaken. The year 2020 is getting off to a better start as activity shows a few signs of recovering and a preliminary trade agreement was just signed with the United States. Yet economic growth prospects are still looking downbeat in 2020. The rebalancing of China's growth sources is proving to be a long and hard process, and economic policy is increasingly complex to manage. Faced with this situation, Beijing might decide to give new impetus to the structural reform process, the only solution that will maintain the newfound optimism and boost economic prospects in the medium term.

Real GDP growth slowed to 6.1% in 2019 from 6.6% in 2018. This slowdown can be attributed to both declining exports and sluggish domestic demand (charts 1 and 2). Although the most recent activity indicators and the first trade agreement signed between the US and China provide some ground for optimism as the year gets underway, economic growth should continue to slow in 2020.

While economic policy has become increasingly accommodative over the past two years, the authorities have remained very prudent. They have very little manoeuvring room given the economy's debt excess and the need for ongoing efforts to clean up the financial system, state-owned enterprises and the housing market. In response to deteriorating economic growth prospects and the increasing difficulties of basing a stimulus policy on credit, the authorities have resorted to fiscal measures to support corporates and households. Might trade tensions with the US and the difficult process of rebalancing the sources of growth also encourage the authorities to give priority to structural reforms?

2019: external shock and the difficult transformation of China's growth model

Chinese exports were hard hit by higher US tariffs and the decline in global demand in 2019. Merchandise exports to the United States plunged by 12.9% (in USD value terms) compared to 2018, while total exports remained virtually flat (-0.1%). Although foreign trade made a positive contribution to GDP growth in full-year 2019, the export sector's troubles have had a big impact on the rest of the economy. Investment in the manufacturing sector rose only 3.1% in value terms in 2019: the investment growth slowdown sharpened due to worsening prospects for sales and weakening earnings. Meanwhile, private consumption has been hit by the industrial slowdown's impact on the job market and confidence. Average real household income slowed to 5.8% in 2019 from 6.5% in 2018, especially since consumer price inflation accelerated (reaching 4.3% y/y in Q4 2019). Inflationary pressures mainly reflected the surge in pork prices, which doubled between Q4 2018 and Q4 2019, driving up food price inflation (+17.3% over the same period). In contrast, core inflation eased from 1.8% y/y in Q4 2018 to only 1.4% in Q4 2019, a sign of sluggish domestic demand.

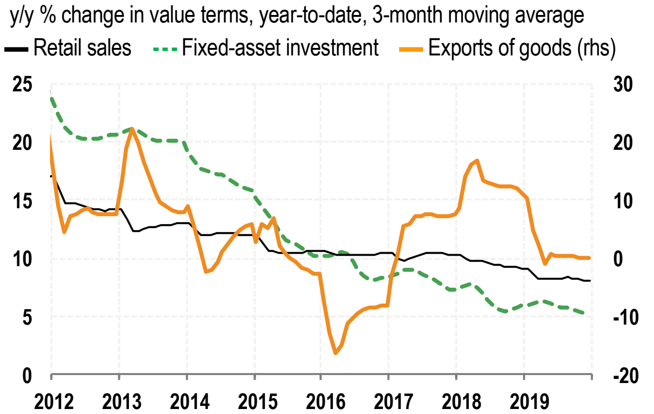
Households were also hit by tighter credit conditions, at a time when debt servicing charges are placing an increasingly heavy burden on their budgets (this reflects the steady increase in household debt, which rose from 28% of GDP at year-end 2011 to 55% at year-end 2019).

1- Forecasts

	2018	2019e	2020e	2021e
Real GDP growth (%)	6.6	6.1	5.7	5.8
Inflation (CPI, year average, %)	2.1	2.9	3.5	1.5
Fiscal balance / GDP (%)	-4.2	-4.5	-3.8	-3.5
Central government debt / GDP (%)	16.6	17.0	19.0	20.0
Current account balance / GDP (%)	0.4	1.7	1.4	1.0
Total external debt / GDP (%)	14.5	14.9	14.8	14.7
Forex reserves (USD bn)	3 073	3 108	2 980	2 930
Forex reserves, in months of imports	14.5	15.1	14.8	14.5
Exchange rate USDCNY (year end)	6.9	7.0	6.9	6.7

e: BNP Paribas Group Economic Research estimates and forecasts

2- Economic growth slowdown is broad-based



Source: NBS, General Administration of Customs

The accumulation of these negative factors explain why household spending growth has not picked up much in recent months despite fiscal stimulus measures. As a result, growth in retail sales volumes and online sales of goods and services barely levelled off in November-December 2019 (at 4.9% y/y and 12%, respectively). Automobile sales, which account for about 10% of total retail sales, have continued to decline albeit at a slower pace than at the beginning of the year (-2.5% y/y in Q4 2019, vs. -12.5% in H1).

Truce in the trade war

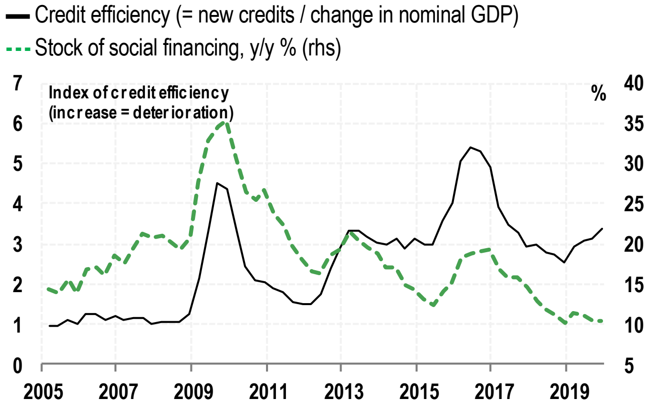
Yet China's economic performance seems to have improved slightly in recent weeks. Industrial production growth accelerated to 6.2% y/y in November 2019 and 6.9% in December, vs 4.9% in July-October. This timid recovery is in keeping with the rebound in exports, which rose by 7.4% y/y in December after several months of decline. The economy should remain somewhat more dynamic in the short term. China's National Bureau of Statistics (NBS) reported an uptick in manufacturing PMI (from 49.3 in October to 50.2 in November and December), which was largely driven by the rebound in the "export orders" component (which rose from 47 in October to 50.3 in December).

The United States and China have called a truce in their trade war since December and signing a preliminary trade agreement on January 15th. This contributed to the better industrial growth performance and renewed confidence of corporates and the markets. The fundamental problems behind US-China trade tensions are still in place and the next rounds of negotiations promise to be very complicated. Nevertheless, the "phase 1" agreement signed mid-January considerably reduces the risk of another increase in US tariffs in 2020. Under the phase 1 agreement, China has to increase its imports of US goods and services by USD 200 bn over the next two years (compared to 2017 purchases of USD 186 bn), including USD 78 bn in manufacturing, USD 52 bn in energy, USD 32 bn in agriculture and USD 38 bn in services. China also seems to be ready to make some concessions in terms of intellectual property rights and the access of foreign enterprises to its domestic market (looser regulations on technology transfers, and opening of the financial sector, for example). In exchange, the United States simply renounced the introduction of new tariffs, and reduced by half the amount of the last tariff increase, in effect since September 2019 (from 15% to 7.5% on about USD 120 bn in imports). The other tariffs introduced over the past two years will be maintained. As a result, the weighted average tariff imposed by the US on imports of Chinese goods will decline only slightly, from 21% at year-end 2019 to about 19% (vs 3% before the outbreak of the trade war). Tariffs will continue to be levied on two thirds of these imports.

Greater impetus for reforms?

Since 2018, the authorities have loosened their monetary and fiscal policies in order to stimulate activity. At the same time, they have remained cautious, and still pursued efforts to strengthen financial-sector regulations, contain the increase in household debt and try to reduce the debt of the most fragile corporates. Last year, in a particularly unfavourable international environment coupled with disappointingly sluggish domestic demand and growing corporate financial difficulties, the authorities were faced with the ever-growing dilemma of stimulating growth or reducing debt and pursuing reforms[1]. The authorities opted to make greater use of fiscal stimulus measures and to continue prudent monetary easing actions. The most recent measure, effective on January 6th, 2020, aims to stimulate bank loans to corporates via another cut in reserve requirement ratios (by 50 basis points to 10% for small and mid-sized banks and to 12.5% for the big banks).

3- Credit efficiency deteriorated again in 2019



Source : NBS, BNP Paribas

Further stimulus measures might help boost economic growth in the short term, but they would also delay the process of cleaning up the economy while undermining medium-term growth prospects, notably due to the risk of financial instability and the declining efficiency of credit and investment. This danger was highlighted by the erosion of credit efficiency in 2019, after two years of improvement (chart 3). Stepping up structural reforms, in contrast, should limit these risks.

The most recently announced structural reforms aim to accelerate the opening of the financial sector. For example, foreign investors would benefit from greater access to asset markets and the limit on foreign ownership of certain asset managers and securities firms is to be lifted by the end of 2020. Faced with the need to make progress in negotiations with the US, but above all given the growing difficulties of rebalancing China's growth sources, Beijing might seek to give new impetus to structural reforms in 2020. In particular, the continued restructuring of state-owned enterprises (deleveraging, end of implicit state guarantees) and the strengthening of the financial system should help pave the way for better capital allocation and stronger medium-term economic growth prospects.

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[1] See EcoPerspectives: *China: what lies behind the rise in corporate defaults?",* Q2 2019 and *"China: difficult policy choices,* Q4 2019.

India

Gloomy prospects

India's real GDP growth remains far below its long-term potential, and economic indicators do not suggest a significant turnaround in the short term. The government has little manoeuvring room to stimulate the economy. In the first eight months of the fiscal year, the budget deficit already amounted to 115% of the full-year target, and the central bank must deal with rising inflationary pressures, which are hampering its monetary easing policy (which is not very effective anyway). The prospects of materially lower economic growth has led the rating agency Moody's to downgrade its outlook to negative. Yet it is the financing of the economy as a whole that is at stake.

Growth falls far short of potential

In the second quarter of the current fiscal year (July-September 2019), India's GDP growth slowed sharply to only 4.5% year-on-year (y/y). This brings growth in the first half of 2019/20 (fiscal year ending 31 March 2020) to 4.8%, down from 5.4% in the year-earlier period. This is the sharpest slowdown since 2013, even though conditions are much more favourable now than in the past. In the first six months of the fiscal year, inflationary pressures were under tight control (+3.3% vs +11.3% in 2013/14) and the monetary authorities cut the key rate by 135 basis points (bp), even though the move was only very partially carried over to interest rates on new loans. Oil prices are also much lower than in 2013 (-43%) and international investors have shown confidence in the new Modi government. Yet despite government and central bank measures, growth has been hard hit by the sharp slowdown in household consumption (the main growth engine) and investment, albeit to a lesser extent. Although net exports continue to make a positive contribution to growth (due to the decline in imports), exports contracted in the current fiscal Q2. Lastly, Q3 economic indicators do not suggest a strong rebound in activity in the short term. In October, power generation and coal production contracted for the third consecutive month. In manufacturing, production capacity utilisation rates have dropped to the lowest level since 2013, and production of capital goods and consumer goods have declined by 21.9% and 18% y/y, respectively.

Scant means to boost growth in the short term

The monetary and fiscal manoeuvring room to stimulate growth is extremely limited.

The big problem for the monetary authorities is that the monetary policy transmission channel is not working well. Moreover, the rise in inflationary pressures since September (+5.5% y/y in November 2019, compared to a target of 4% give or take 2 percentage points) is now limiting its policy to stimulate growth. Citing price increases, the monetary policy committee opted to keep key rates unchanged at its most recent meeting in December. The authorities must also support the financing of non-banking financial companies, the main source of the big surge in lending since 2017.

Using fiscal policy to stimulate growth is also heavily restricted by the risk of deficit slippage in the current year and fears that its sovereign rating would be downgraded by the international rating agencies. In the first eight months of the fiscal year (April to November), the fiscal deficit already amounted to 115% of the full-year target. Even though the government frequently reports a surplus in the fourth-quarter of the fiscal year, it will not suffice to reach the government's deficit target of 3.3% of GDP.

Faced with these constraints, the government adopted other strong measures, including a significant cut in the corporate tax rate, the privatisation of four major state-owned companies and labour market reform. Although these measures are major advances, they will not stimulate growth in the short term. Corporate investment will

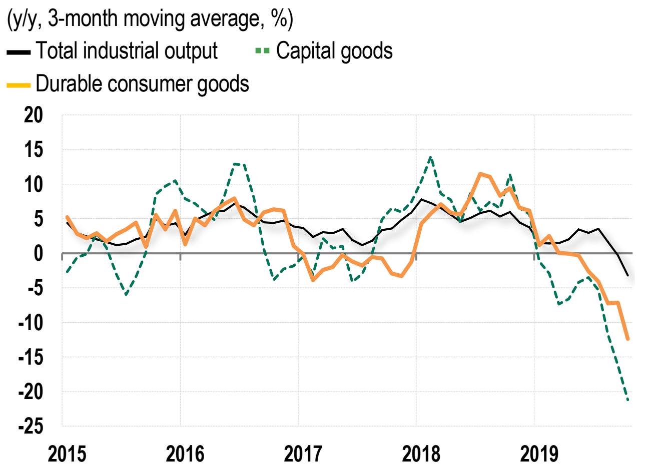
1-Forecasts

	2018	2019e	2020e	2021e
Real GDP growth(1) (%)	6.8	4.8	5.5	6.0
Inflation (1) (CPI, year average, %)	3.4	4.3	4.5	4.5
General Gov. Balance(1) / GDP (%)	-6.3	-7.2	-6.9	-6.7
General Gov. Debt(1)/ GDP (%)	69.8	70.7	70.8	70.6
Current account balance(1) / GDP (%)	-2.1	-2.1	-2.2	-2.4
External debt(1)/ GDP (%)	20.0	19.9	20.0	20.0
Forex reserves (USD bn)	393	457	493	530
Forex reserves, in months of imports	9.1	9.4	9.6	9.8
Exchange rate USDINR (year end)	71.0	71.3	73.5	73.9

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

e: BNP Paribas Group Economic Research estimates and forecasts

2- Industrial output



Source: CEIC

continue to hinge on a recovery in household consumption, which in turn depends on a significant improvement in lending conditions, notably for non-banking financial companies.

Faced with this environment, growth forecasts have been revised sharply downwards for the next two fiscal years. Growth could fall below 6% after averaging 7.5% over the past five years. A lasting slowdown in growth would not only hamper job creations, which already fail to cover new entrants to the job market, it would also strain the consolidation of public finances, Indian companies (underway since 2014) and the banking sector. As things currently stand, fears of materially lower economic growth led the rating agency Moody's to downgrade India's sovereign rating to a negative outlook.

What are the risks in terms of debt sustainability?

Public debt could exceed 70% of GDP as of fiscal year 2019/20. For the moment, however, refinancing risks still seem to be limited.

At year-end 2018/19, public debt already amounted to 69.8% of GDP (i.e. 285% of the annual revenues of the central and state governments), a 2.8-point increase compared to 2013/14, even though the fiscal deficit of all public administrations declined (to 6.3% of GDP in 2018/19 from 7.5% in 2013/14). This increase reflects the increase in "off budget" expenditure, notably by the States.

As part of its public finance consolidation programme, the government is aiming to reduce the public debt ratio to only 60% of GDP by 2024/25. Yet this target does not seem feasible in the light of current growth prospects.

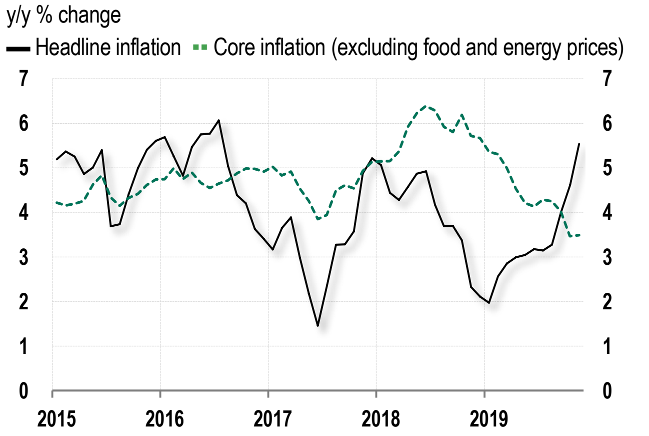
If growth were to hold below 6% on average through 2022/23, the public debt ratio would exceed 70% of GDP over the next three years, assuming the government manages to hold the primary deficit below the threshold of 2% of GDP (1.4% of GDP in 2018/19).

Yet even though India's public debt is among the highest in the emerging countries, its structure is not very risky and refinancing risks are limited. India's debt has long maturities (averaging 10 years), is held mainly by residents (more than 96%) and is denominated in the local currency (97%). Yet the government still has major financing needs that are straining growth. The IMF estimated its needs at 11.4% of GDP in 2019. Moreover, for fiscal year 2018/19, interest payments amounted to 5.3% of GDP, the equivalent of 21.7% of total revenue. Although refinancing risks are limited, any increase in government financing needs could squeeze out financing for the rest of the economy. Banks are the main buyers of public debt securities (39.1%) and financing has been lastingly reduced for non-financial companies.

Banking and financial sector: downturn in the housing market creates new risks

Faced with the sharp increase in the cost of financing, due notably to outflows from mutual funds following the bankruptcy of IL&FS in September 2018, loans granted by non-banking financial companies (NBFC) have dropped off sharply since Q3 2019 (-36% y/y). On the whole, the NBFC still boast a solid financial position, which is much better than for the state-owned banks. Although the share of doubtful loans was rising in Q3 2019, it was still limited to 6.3% of loans outstanding, and the solvency ratio was 19.5% (well above the regulatory threshold of 15%). The central bank has also adopted a regulation that requires NBFC to comply with a liquidity ratio of 100% as of December 2020. The main risk, other than a severe and lasting slowdown in economic growth, is a downturn in the housing sector. The exposure of NBFC as a whole is not very high (6% of loans outstanding), but this is not the case for *Housing Financing Companies* (HFC) specialising in mortgage loans for the real estate sector. Commercial banks, which are still very fragile, are also highly exposed to the real-estate sector (22.5% of lending) which is in the midst of a downturn. In 2018/19, new housing starts contracted for the third consecutive year. Sales reported by listed real-estate companies contracted by 27.8% in Q3 2019, and house prices continued to slow (+2.8% y/y in Q3 2019).

3- Rising inflationary pressures



Source : RBI

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Brazil

Trying to build momentum

Despite a more challenging global environment and a deterioration in the country's external accounts, Brazil's economic recovery is gaining some traction on the back of a strengthening domestic demand. In 2020, GDP growth is forecast to improve but questions remain nonetheless regarding the economy's ability to build up and keep up momentum. The easing of monetary and financial conditions should help support the credit market but should continue to have a weakening impact on the currency. During his first year in office, President Jair Bolsonaro's losses in terms of approval ratings contrast with his government's notable gains on the public finance front.

Shifting gears?… not just yet but promising

Brazil's internal engines of growth are strengthening. In the third quarter of 2019, real GDP grew by a robust 2.5% (q/q) in seasonally adjusted annualized terms (saar) and by 1.2% year-on-year (y/y), even though net exports continued to act as a strong drag on growth.

The growth figure – which surprised most observers to the upside – benefited from (i) a sharp rebound in production in the mining sector (+57.4% q/q saar) and (ii) a salutary upturn in activity in the construction sector. Heavily affected by the crisis, the construction sector posted two successive quarters of growth for the first time since 2013. On the demand side, growth was driven by consumer spending (0.5 p.p) and investment (0.4 p.p) – the latter confirming its healthy progression observed in Q2. Meanwhile, public spending fell (-1.7% q/q saar) in line with the government's continuous fiscal adjustment. It is worth noting that a breakdown of economic activity by state and by region shows that growth tends to be more dynamic in areas where – on the supply side – public services make up a smaller share of local GDP. Regions where growth is less reliant on public sector spending are currently expanding at rates of 2.5% or more while their more dependent counterparts are growing by 0.5%. This observation supports the thesis that Brazil is undergoing a two-speed recovery which also raises questions about the evolution of regional inequalities over time if the gap does not close.

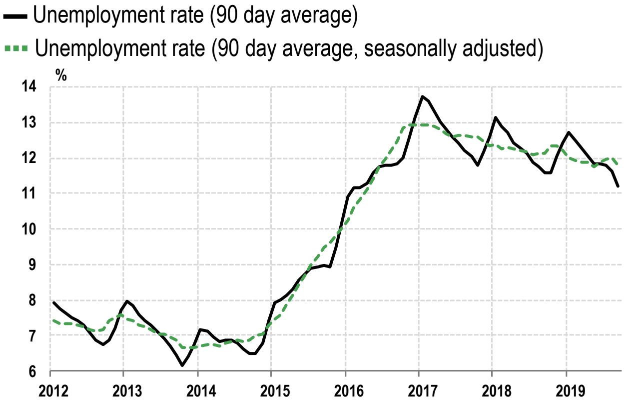
While the economy is showing more concrete signs of recovery, the latest available indicators do point to a slight deceleration of the economy in the last quarter of 2019. Indeed, if retail sales remained solid in November (+ 0.6% m/m, sa), posting yet another positive print since May 2019, services slowed down (-0.1% m/m) while industrial production fell again (-1.2% m/m) after three consecutive months of increase (driven in large part by mining giant Vale resuming production and Petrobras registering record petroleum output in Q3). It appears that industrial production may have suffered from a slowdown in the manufacturing sector (~11% of GDP). The manufacturing PMI – while still in expansion territory in December (50.2) – has indeed fallen since September (53.4) despite improving confidence indicators in the sector. Finally, while the Central Bank's IBC-Br index (a proxy for GDP) shows an expansion of economic activity in both October and November there is a noticeable slowdown in pace compared to the previous two months. Increased spending during the year-end holidays, the release of funds from FGTS accounts (cf EcoEmerging Q4 2019) and the relatively steady production in mining should nonetheless help contain the slowdown.

1- Forecasts

	2018	2019e	2020e	2021e
Real GDP growth (%)	1.3	1.0	2.0	3.0
Inflation (CPI, year average, %)	3.4	3.7	3.4	3.7
Fiscal balance / GDP (%)	-7.1	-6.0	-5.4	-5.7
Gross public debt / GDP (%)	77	77	80	81
Current account balance / GDP (%)	-2.2	-3.2	-3.5	-3.4
External debt / GDP (%)	36	38	42	45
Forex reserves (USD bn)	374	357	340	333
Forex reserves, in months of imports	18	17	17	16
Exchange rate USDBRL (year end)	3.9	4.0	4.0	3.8

e: BNP Paribas Group Economic Research estimates and forecasts
Note: The national statistical office, IBGE, has revised growth figures for 2017 and 2018 from 1.1% to 1.3% for both years.

2- Labour market



Source: IBGE, GSP

Monetary policy : the main lever of growth

In 2020, monetary policy will remain the main lever to stimulate economic activity. The easing cycle initiated in the summer (the SELIC has been cut by 200 basis points since August 2019) should help offset the unfavourable effects on growth of continued fiscal austerity and a less buoyant external environment. The lagged effects of monetary policy are indeed expected to manifest themselves more strongly over the next few quarters, and allow for a more vigorous expansion of credit. For the time being, credit growth continues to be driven by households (58% of total lending and 10.8% growth y/y in November), but there has been an uptick in lending to businesses (2.5% y/y in November). Meanwhile, the gradual decline in unemployment (11.8% in seasonally adjusted terms in November, from 12.3% in January), the recent increase in formal employment and the rise in real wages (1.2% y/y in November) should help boost consumer spending, while the flattening of the yield curve through its effects on long term rates should help support investment.

External accounts : under pressure

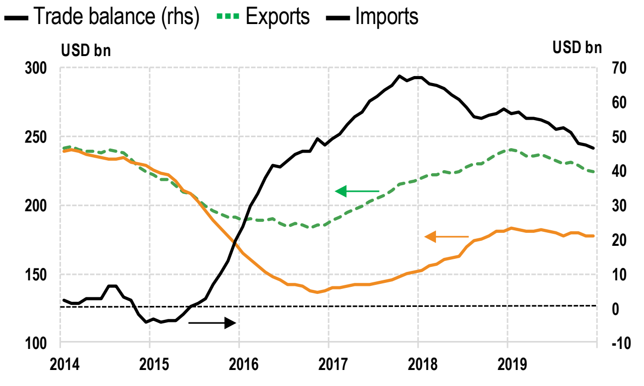
In 2019, the Central Bank of Brazil (BCB) made important methodological changes to the country's balance of payments statistics. Following the revisions, a somewhat darker picture of Brazil's external accounts has emerged. The current account deficit for 2018 rose from USD 15 bn (-0.8% of GDP) to USD 42 bn (-2.2% of GDP) due to a larger than expected deficit on the income balance (USD 19.6 bn). In 2019, the current account deficit widened further (-2.8% of GDP over 12 months in November) as a result of the sharp decline in the trade surplus which fell by 20%.

The trade balance suffered from a fall in the country's leading export, soybeans (-21% y/y), due to a drop in Chinese demand following an epidemic of swine flu. China - which absorbs around 80% of Brazilian soybean exports and uses the plant primarily as a source of animal feed – has in the intervening time stepped up its imports of Brazilian pork, beef and chicken. The resulting increase in meat exports combined with that of iron ores was however not sufficient to offset the decline in soybeans and petroleum exports as well as the sharp drop in vehicle sales (-27.5% y/y). In 2020, a less favorable external environment, marked by the deceleration of two of the country's main trading partners (China and the United States), should adversely weigh on Brazilian exports. In addition, the latter (i) should continue to suffer from the continued macroeconomic adjustment in Argentina (whose imports fell by USD 5.2 billion in 2019), and (ii) could end up benefitting only marginally from a weak BRL, according to a study by the IIF. [1]

Turning to the financial account, the flow of foreign direct investment (FDI) was also revised downwards (on the basis of new survey data) from USD 88 bn to USD 78 bn. In 2019, FDI held steady (USD 77 bn in the 12 months to November), but their composition changed: intercompany loans fell sharply (down USD 17 bn), whilst greenfield investments and other mergers and acquisitions increased (up USD16 billion). While net FDI continues to finance the current account deficit, the coverage ratio has shrunk (2.9% GDP in November vs 4% of GDP in 2018). Meanwhile, the net selling position of non-residents in portfolio investments has increased (USD 10.9 bn over 12 months in November 2019 compared to USD 6.4 bn at the end of 2018) in large part due to narrowing interest rate differentials with developed markets. Therefore, while the B3-Ibovespa stock market index gained 31% in 2019, the participation of foreign investors in the equity market dropped from 52% in 2018 to 44% in 2019. Non-resident holdings of sovereign debt in the local market also fell to a new low in November, at just 11.1%.

[1] *Weak currencies are failing to lift exports*, November 2019, Institute of International Finance.

3- Trade balance



Source: BCB

More generally, net FX outflows reached a record USD 44.8 bn over the year, helping to explain some of the downward pressure on the BRL. The currency, which hit a historic low against the dollar at 4.27, missed out on some upside towards the end of the year: first, the weak interest from foreign companies in the auctions of oil rights in Q4 limited FDI flows compared to what was initially expected. Meanwhile, companies with exports earnings held offshore accelerated the amortization of their liabilities to non-residents rather than repatriating the hard currency. To contain the pressures on the currency and reduce its volatility, the BCB sold USD 36.9 bn on the FX spot market in 2019. The USA – whose agricultural sector is in strong competition with Brazil – accused Brazil of "massive devaluation" and in response has since reinstated tariffs on imports of Brazilian steel (25%) and aluminium (10%).

Jair Bolsonaro: year 1

Jair Bolsonaro's first year in office as Brazil's President has been marked by a rapid deterioration of the head of state's image. President Bolsonaro's approval ratings have dropped to 30%, the lowest ever figure for a president during his first year in office. President Bolsonaro's government can nonetheless claim some important improvements in terms of the state of public finances. When finalized, the consolidated public sector's primary deficit for 2019 will be cut, in all likelihood, by at least 0.4 points of GDP compared to 2018 (-1.6% of GDP). Also, after carrying out an ambitious pension reform, additional fiscal measures were presented to Congress in early November (the so-called *Mais Brasil* plan) destined to stem the growth of mandatory spending, reform the public service, decentralize revenues in favour of regions, simplify the tax system and strengthen fiscal responsibility at all levels of government. As a result, the rating agency S&P raised its outlook on its sovereign debt rating (BB-) from stable to positive, suggesting that an upgrade for Brazil may be in the cards in the near future – the first time since 2011.

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Russia

Still large surpluses

In 2019, despite weak growth and a drop in oil revenues, Russia's macroeconomic fundamentals remained sound. This said, growth prospects remain weak despite disinflation and a relaxation of monetary policy. Standards of living are still low and the poverty rate has increased. The main threat to economic growth is a tightening of sanctions, even though the sharp increase in foreign exchange reserves, the rebuilding of the national wealth fund and the significant reduction in external debt are all factors that reduce the country's dollar financing requirement. A toughening of sanctions could hit foreign direct investment, which has fallen sharply over the last five years.

Growth prospects remain weak

Economic growth in Q3 2019 accelerated significantly to 1.7% (y/y) after growth of just 0.7% y/y in the first half. The agricultural sector has seen the strongest growth. Domestic demand recovered slightly, notably under the impetus of an increase in consumer spending, whilst exports continued to suffer from unfavourable global conditions. This upturn has been helped by a sharp fall in inflation and the resulting relaxation of monetary conditions. In November 2019, prices rose by only 3.5% y/y, below the 4% target rate set by the monetary authorities. Against this background, in December 2019, the central bank made its fifth consecutive cut to its policy rate, taking it to just 6.25%, its lowest level since 2014. Lending rates (in both nominal and real terms) and rates on government 10-year bonds both fell significantly over the course of last year. Ten-year rates were just 6.5% in mid-December (from 8.8% a year earlier), lower than they were before the crisis of 2014.

Although growth consolidated in Q4, it is unlikely to have exceeded 1.1% over the whole of 2019 (from 2.3% in 2018).

In 2020, economic growth is likely to benefit from a favourable basis of comparison. More fundamentally, the fall in inflation and the continuation of monetary relaxation in the first half of 2020 will continue to boost private investment and, to a lesser degree, consumer spending. Labour market conditions will continue to be favourable. Similarly, government investment should continue to increase, as the result of the introduction of development projects. However, the net contribution of exports to growth is likely to remain negative. Under the latest agreements with OPEC, signed in December 2019, Russian oil production is likely to be cut by 95,000 barrels per day in Q1 2020 relative to November 2019 production levels (an 8.4% cut).

Other than a sharp fall in oil prices, the main threat to the Russian economy is a tightening of sanctions, which would affect investment.

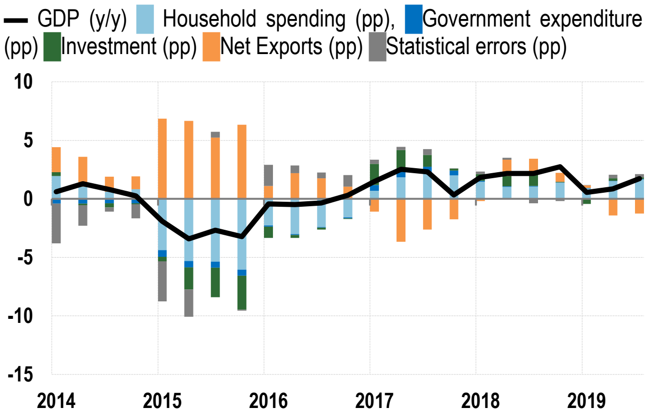
Predicted growth (1.6% in 2020 and 1.8% in 2021) remains too low to bring any significant increase in income levels for Russia's population. According to the IMF, per capita income in USD terms in 2021 will still be 26% below pre-crisis levels. Meanwhile, although the unemployment rate has hit a low point, at just 4.4% in Q3 2019, the increase in real income has slowed following the increase in VAT. In Q2 2019 there were 19.8 million people living in poverty (some 13.5% of the population), compared to 16.1 million in 2014 (11.2%).

1- Forecasts

	2018	2019e	2020e	2021e
Real GDP growth (%)	2.3	1.1	1.6	1.8
Inflation (CPI, year average, %)	2.9	4.5	3.7	4.0
Central Gov. balance / GDP (%)	2.9	1.6	1.0	0.6
Public debt / GDP (%)	14.3	14.9	15.2	15.5
Current account balance / GDP (%)	6.9	4.3	3.3	3.0
External debt / GDP (%)	27.5	28.5	29.0	29.5
Forex reserves (USD bn)	375	433	470	510
Forex reserves, in months of imports	12.8	13.0	13.2	13.3
Exchange rate USDRUB (year end)	69.4	61.9	65.0	66.5

e: BNP Paribas Group Economic Research estimates and forecasts

2- Growth remains weak



Source: CBR, CEIC

Demographic change and the weakness of productive investment have structurally depressed growth. The active population has fallen steadily since 2012 and, according to the World Bank, this trend is likely to continue through to 2027, despite the raising of the retirement age.

Meanwhile, the rate of investment growth has slowed sharply since 2009 (2% per year on average between 2009 and 2018, from 12.5% from 2000 to 2008). In addition, although the level of investment has remained relatively stable, at 23% of GDP, the structure of investments has changed. According to the Conference Board, the share of productive investment has fallen in favour of construction investment, holding back technological progress. The stock of private capital had fallen to 159% of GDP by 2017, from 282% of GDP in 2000.

Public finances will remain robust

Over the first ten months of 2019, the government's fiscal surplus was 3.5% of GDP, despite a drop of more than 1 percentage point (pp) in income from oil and gas sources (7.6% of GDP). This strong performance in the public finances was made possible by the big jump in VAT receipts (up 16.7%) which contributed to the 1pp increase in non-oil and gas receipts, taking them to 11.3% of GDP, a level not seen since the period from 2000 to 2008 (when growth was running at an average of 7%). Spending remained controlled over the first ten months of the year (up 6%), despite the increase in investment in October. This took investment to 66.1% of the annual target set under the medium-term development programme.

For 2019 as a whole, the government is likely to record a surplus of 1.6% of GDP, which will gradually fall to 0.6% of GDP by 2021 as oil revenues fall and spending rises.

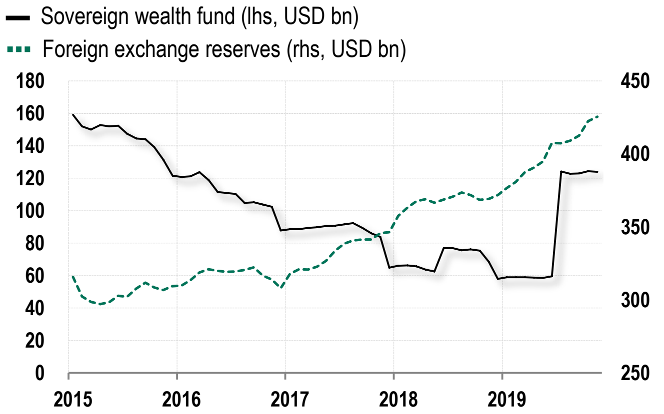
Having fallen steadily since 2015, government debt stood at only 14.9% of GDP in Q2 2019. This is likely to rise gradually over the next five years, as part of the investment between 2019 and 2024 (estimated at 1.1% of GDP per year) will be financed by debt issuance. The structure of debt remains low-risk and has been little affected by the sanctions introduced in August 2019. Although the government's external debt (i.e. that held by non-residents in both local and foreign currencies) has risen, it stood at only USD 64.5 billion in Q3 2019, with more than 63% of the total denominated in rubles (USD-denominated debt was just USD 22.9 billion, or 36% of the total). Moreover, the government can always draw on its sovereign wealth fund, the National Wealth Fund, to finance part of its investment spending. This has been rebuilt, to some extent, and stood at USD 124 billion on 1 December 2019, the equivalent of 7.3% of GDP, from 4.4% of GDP in December 2018.

External accounts also remain strong

Since the crisis of 2014-15, Russia's external accounts have strengthened. External debt has fallen by 34% from its high point of 2013 (taking it to just USD 471 billion in Q3 2019), the dependence on dollar financing has eased (the share of dollar-denominated external debt was 49% in Q2 2019, from 61% in 2013) and the ruble and the oil price are no longer as tightly correlated. However, diversification of Russian exports is still limited and FDI has fallen significantly over the past five years, in line with the introduction of international sanctions.

Foreign exchange reserves reached USD 436 billion in November 2019, an increase of USD57 billion on a year earlier. They are now back close to their highs of 2013 (USD 486 billion) and cover external debt service costs 4.5 times over. This increase in reserves came mainly from foreign currency purchases by the central bank (for a total of USD 42 billion over the first eleven months of 2019), with a smaller contribution coming from the current account surplus.

3- Foreign currency reserves and sovereign wealth fund



Source: CBR

The current account stayed in surplus over the first nine months of 2019, albeit at a lower level than in 2018. It was equivalent to 4.7% of GDP, from 6.2% at the same point of 2018. This slight reduction reflected the shrinking of the trade surplus in Q2 and Q3 2019, resulting from lower exports of oil and gas (price and volume effects).

Over the first nine months of the year, net outflows of capital fell sharply from their level in the same period of 2018 when the tightening of US sanctions triggered sizeable precautionary movements by foreign investors. Over the second and third quarters of 2019, the financial account recorded net capital inflows.

This improvement in external accounts since the 2014-15 crisis needs to be seen in context. First, excluding oil and gas, the current account was in deficit to the tune of 9.8% of GDP over the first three quarters of 2019, reflecting the economy's high level of dependence on energy exports. In 2018, raw materials still represented 67% of Russian exports. Secondly, FDI has fallen steeply since sanctions were introduced in 2014. Between 2014 and 2019, new investment (excluding reinvestment of profits) ran at an average of only USD 4.9 billion per year, compared to USD 32.5 billion per year between 2008 and 2013. It is hard to identify the origin of FDI into Russia, given the substantial movements of capital that come via Cyprus and the Netherlands. Even so, FDI from Europe and the USA fell by 88% and 41% respectively between 2015 and 2018, whilst investment from Asia increased by a factor of 5.2. However, the rapid decline in FDI from the west has hampered the diversification of the economy. FDI from Asia is tightly focused on the energy sector, whilst that from Europe and the US was spread across several sectors.

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Mexico

Investment has stalled

Having more or less stagnated in 2019, economic growth is likely to bounce back a little in 2020, boosted by private consumption and net exports. Despite an infrastructure programme that is largely open to the private sector, the outlook for investment is struggling to improve. One year after Andres Manuel Lopez Obrador, generally known as AMLO, came to power, his economic policy is still hard to decipher. The lack of clarity on energy sector reform is also affecting investor sentiment. At the same time, the risk of a loss of control of the public finances is growing: against a background of low growth, maintaining the austerity programme favoured by the government will prove more difficult from 2021.

A small improvement in growth in 2020

Having more or less stagnated in 2019, growth is likely to bounce back a little in 2020. Private consumption will remain the main engine of growth, boosted by the increase in real wages and remittances from foreign workers (up nearly 9% y/y over the first three quarters of 2019). As in 2019, exports are likely to make a positive contribution to growth, despite a slight slowing in the US economy.

However, the outlook for investment has not seen any clear improvement. Over the first three quarters of 2019 private investment fell by nearly 4% year-on-year. This fall reflects investors' caution with regard to the AMLO administration since it was elected in July 2018, and their wait-and-see attitude to the policies to be pursued during his term of office.

With the aim of providing some reassurance and improving prospects for investment, the government announced a massive infrastructure programme at the end of November. This includes a total of nearly 150 projects for a total budget of USD 43 billion, or nearly 4% of GDP, which is very broadly open to the private sector. The first phase, covering the transport and telecoms sectors, is likely to begin in the first quarter of 2020. However, several of the projects announced were already planned and partly financed, and operational difficulties could significantly delay their progress. Meanwhile, the second phase of the plan, due to provide project details, particularly in the energy sector, has yet to be published. All in all, even if several projects do get under way in the first quarter of 2020, the increase in investment will remain limited.

The energy sector has a central role

Announcements regarding the energy sector are eagerly awaited. First, because changes in the future involvement of private investors in the sector remain very uncertain. When he came to power in December 2018, AMLO announced the cancellation of the energy reforms introduced by the previous government and his intention of putting two publicly-owned companies, PEMEX (responsible for oil industry operations) and CFE (the national electricity company) at the heart of the sector. Under this approach, the involvement of private-sector operators is likely to be reduced gradually over the course of his term.

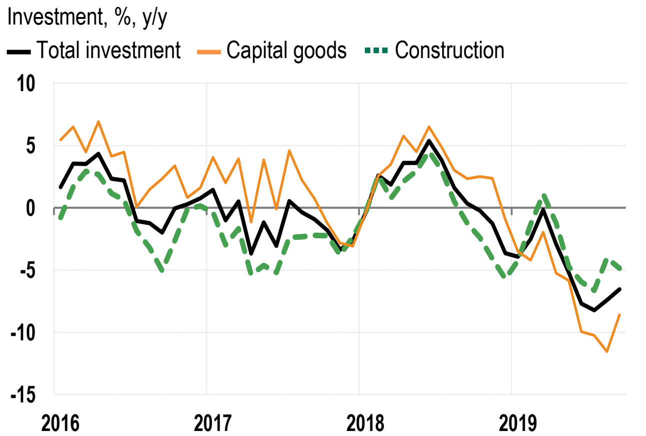
Since the end of 2018, the government has effectively brought an end to private tenders for the project to build a new refinery and suspended the planned tenders to supply power to CFE. In October

1- Forecasts

	2018	2019e	2020e	2021e
Real GDP growth (%)	2,0	0,1	0,6	1,7
Inflation (CPI, year average, %)	4,9	3,7	3,1	3,4
Budget balance / GDP (%)	-2,1	-3,2	-3,7	-3,8
Public debt / GDP (%)	53,8	47,8	50,3	53,5
Current account balance / GDP (%)	-1,8	-0,9	-1,1	-1,2
External debt / GDP (%)	36,5	37.0	39,6	39,8
Forex reserves (USD bn)	174,8	180	178	178
Forex reserves, in months of imports	3,8	3,5	3,6	3,6
Exchange rate USDMXN (year-end)	20,0	18,9	18,5	18,3

e: BNP Paribas Group Economic Research estimates and forecasts

2- Investment in decline



Source: INEGI

2019, the government also indicated a change in the rules governing the "clean energy certificates" mechanism, with the aim of limiting the involvement of private investors in this market, encouraging the development of the electrical power market and thus increasing the weight of CFE.

As with the cancellation, a year earlier, of the construction of a new airport, this decision took investors by surprise and served to increase investor caution with regard to the government.

At the same time, the operational and financial position of public companies, particularly PEMEX, represents a significant source of vulnerability for the Mexican economy. In July of last year, the government presented a fairly unconvincing five-year business plan based on very optimistic assumptions (both for production growth and forecasts of reserves), which further limited cooperation with private investors and called for substantial investment in refining, a loss-making business. The government also announced an increase in financial support to the company (again, this was probably underestimated), together with a reduction in tax on oil revenues.

Recent capital injections (USD 5 million in September 2019) have helped improve the short-term financial position, but this remains very fragile for the medium term. According to IMF estimates, even assuming a stabilisation of production over the next five years and the investment that has been announced under the development plan, the company is likely to continue to make losses, which will no doubt require fresh injections of capital, which would hit the public finances. In addition to which, the possible difficulties experienced in refinancing the debt would bring further pressure.

Fiscal austerity maintained

When it presented its 2020 budget, the government renewed its commitment to supporting growth without degrading the public finances or increasing taxes and duties during the first part of its term (i.e. up to 2021).

Under this framework, the budget incorporates an increase in spending of only 1% (in real terms, relative to the 2019 budget). As indicated by AMLO, the Energy Minister (whose budget has increased 20-fold) and the state oil company PEMEX (whose budget has increased by nearly 9%) have been particularly favoured, to the detriment of several social programmes and the budgets of the federated states. According to government forecasts, the primary surplus and the government deficit are likely to be 0.7% and 2.6% of GDP respectively (from a projected 1% and 2.7% in 2019) and the government debt ratio will stabilise at 46% of GDP.

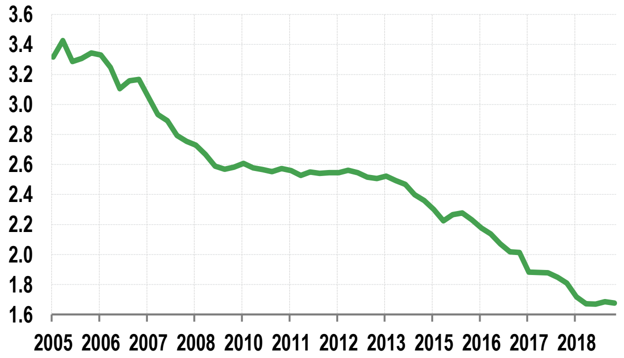
The government's commitment might, however, be hard to meet, as the assumptions made in the budget look over-optimistic. The government is expecting GDP growth of 2% in 2020, and an increase in oil production (combining production from the state oil firm PEMEX and private production) rising to 1.95 million barrels per day.

However, since the beginning of 2019, oil production has stabilised at around 1.7 million barrels per day (see Chart) and the Mexican National Hydrocarbons Commission forecasts a fall in production of around 5% in 2020. On this assumption, the loss of revenue is likely to be around 0.5% of GDP, or a figure close to that estimated by the Ministry of Finance for 2019.

The government indicated that the loss of revenue for 2019 would be offset by drawing on the reserves of the Oil Revenues Stabilisation Fund (FEIP) to the tune of 0.6% of GDP. According to the IMF, these reserves were the equivalent of around 1.3% of GDP, which means that the government could repeat the exercise in 2020.

3- Oil production has stabilised at low levels

PEMEX oil production, millions of barrels per day



Source: PEMEX

But for how long?

The government's contradictions are weighing on medium-term prospects. The country remains exposed to a change in investor sentiment, and the lack of clarity in economic policy, particularly concerning energy reforms, has reinforced the wait-and-see attitude adopted since the election. At the same time, the risk of a loss of control of the public finances is growing: against a background of low growth, maintaining the austerity programme favoured by the government will prove more difficult from 2021. Spending had already been cut significantly by the previous government (close to 13% of GDP in 2019, from 17% in 2015), leaving little room for manoeuvre, and FEIP reserves will not be enough to cover the shortfall in revenues (and financing requirements at PEMEX) over the whole of the government's term. Lastly, the informal economy remains very large in Mexico (58% according to INEGI), suggesting that even if the fiscal reform promised by AMLO is introduced in 2021, revenues would not increase by enough to offset the fall in revenues resulting from the weakness of growth.

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Chile

Crisis times

With violent protests rocking Chile since October, the government announced a series of measures to combat inequality and proposed a new version of its pension system reform. Above all, the government signed an agreement with the main opposition parties to draw up a new constitution. Yet persistently fierce political and social tensions are bound to curtail growth. Forecasts for the next two years have been revised largely downwards. The public debt and deficit are also expected to swell over the next five years.

Political model called into question

The violent protests that have swept Chile since October largely surpass simple opposition to the reform measures proposed by Sebastian Piñera's government, a coalition of centre-right parties in power since March 2018. Protest movements have sprung up spontaneously, bringing together a wide range of demands. According to several surveys, the protests are mainly motivated by frustration over rising inequality, the government's determination to drive through pension and healthcare system reforms and the lack of confidence in institutions. The government's initial response was very repressive, which only threw oil on the flames and reinforced the amplitude of protests. Sebastian Piñera then announced several vague economic and social measures.

The proposed "social programme" amounts to a total of USD 1 bn in 2019 and USD 1.4 bn in 2020. The main measures comprise a higher minimum wage and an increase in the minimum old-age pension, easier access to healthcare and greater public spending in several areas (support for the elderly and students; and infrastructure maintenance). Another USD 5.5 bn in measures were announced in December. To the best of its ability, the government is trying to limit the protest movement's impact on economic activity by stimulating private consumption (notably via transfers to low-income families) and investment (including measures to support small and mid-sized enterprises, and to restore infrastructure damaged during the protests, notably in the capital).

As fiscal measures failed to calm the protests, the opposition parties proposed to elaborate a new constitution together to replace the existing one dating back to the Pinochet dictatorship in 1980. In late November, the government signed an "agreement for peace and a new constitution" with the main opposition parties.

As a result, a referendum will be held next April to answer two questions. First, whether or not the constitution should be replaced, and if yes, what type of body should be in charge of elaborating the constitution: 1) a constituent assembly comprised exclusively of acting members of parliament, or 2) a mixed constitutional commission comprised of acting members of parliament and new, specially elected commission members. Next October, members will be elected to write the new constitution. Once the commission proposes a new text (within 12 months of their election), a final referendum will be held to decide whether or not to adopt the new constitution.

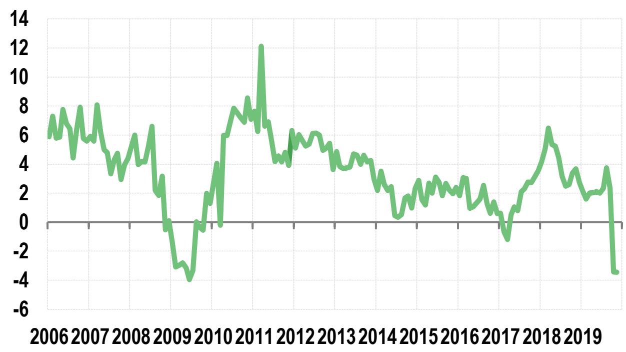
1-Forecasts

	2018	2019e	2020e	2021e
Real GDP growth (%)	4.0	1.0	1.3	2.0
Inflation (CPI, year average, %)	2.4	2.3	3.0	3.0
Central Gov. balance / GDP (%)	-1.7	-2.9	-4.7	-3.5
Public debt / GDP (%)	25.7	27.6	30.1	34.3
Current account balance / GDP (%)	-3.1	-3.4	-2.7	-2.1
External debt / GDP (%)	62.0	61.8	70.7	76.8
Forex reserves (USD bn)	39.9	36.9	32.3	34.1
Forex reserves, in months of imports	7.6	7.8	6.5	6.1
Exchange rate USDCLP (year end)	696	744	770	750

e: BNP Paribas Group Economic Research estimates and forecasts

2- Monthly GDP growth indicator has plummeted

Monthly GDP, % y/y, s.a.



Source: Central bank

Although a broad swath of the population seems to favour the proposal to draw up a new constitution, the political and social situation will remain extremely tense, especially with the approach of municipal and regional elections in March 2021, followed by presidential elections in November.

What about pension reform?

As the protest movement regained momentum in the beginning of the year, in mid-January the government proposed a new version of its pension system reform. According to the press release, the government proposes to raise payroll workers' pension contributions to 16% of monthly wages, from 15% in the initial version of the reform. The current rate of only 10% is much lower than the OECD average of 18%. The difference in contributions would be covered by the employer, with no change in net wages. Additional contributions would be distributed between individual savings accounts and a "solidarity fund". In both cases, the funds would be managed by a public administrator, which addresses criticisms of the current private management system, which is deemed to be too costly and inefficient. The reform would be implemented gradually, by increasing the contribution rate in steps of 0.5% a year, in order to ease the increase in the cost of labour.

The government affirms that the amount of pensions can no longer be less than the minimum wage, for all payroll workers having paid into the system for at least 30 years. Before it can be adopted, the new reform bill must first be presented to parliament.

Economic growth slows

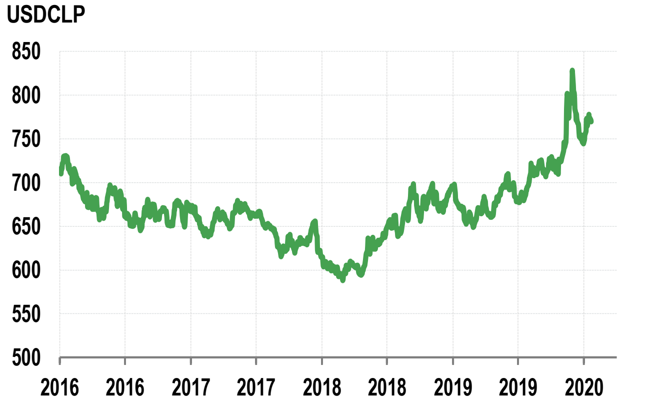
After rising 1.7% y/y in the first half of 2019 and then 3.3% in the third quarter, real GDP growth is expected to stall in the quarters ahead. The monthly growth index has already declined by 3.4% in October and November, after rising 2.3% in September. Government stimulus measures and low interest rates will not prevent household consumption and investment from declining. The consumer confidence index continues to erode and job market conditions have begun to deteriorate. At the same time, investor confidence continues to slump. According to the central bank's survey, several companies said they have postponed investment projects that were initially planned for 2020. In contrast, in the mining sector, which has been relatively sheltered so far, solid growth prospects should help reduce the decline in investment. All in all, real GDP growth is estimated at 1% in 2019 and 1.3% in 2020, down from 4% in 2018.

Economic policy support

The government's fiscal consolidation efforts are no longer on the agenda, at least not in the short term. According to Ministry of Finance projections released in December, public expenditure should increase by 1% in real terms between 2021 and 2024. The new version of the pension reform bill is unlikely to change this projection significantly. The fiscal deficit should exceed 4% of GDP in 2020 before narrowing gradually thereafter. The public debt would increase from 28% of GDP in 2019 to 38% in 2024.

At the same time, the central bank is expected to continue providing monetary policy support in 2020, after lowering its key rate by a total of 175 basis points, to 1.75%, in 2019. In its latest press release, the central bank indicated that monetary policy would remain accommodating "as long as inflation trends allow". Yet its latest forecasts call for inflation to rise to about 3.5% on average in 2020 (up from 2.3% in 2019), which is higher than its target rate of 3%. The central bank's scenario seems to be based on overly pessimistic assumptions. December's inflation was only 3% y/y, lower than the central bank's projection. The observed impact of currency depreciation was probably not as high as the central bank's figure, and was partially offset by the impact of the economic slowdown.

3- Mild depreciation of the peso



Source: Central bank

The economy's strong fundamentals have helped limit the peso's depreciation (8% since the outbreak of the crisis). Central bank communications have also helped reassure the markets, first via an early November press release in which the central bank stated that it had the necessary tools and adequate foreign reserves to contain any liquidity and volatility risks. Then in early December the central bank announced a currency sterilisation programme between early December 2019 and the end of May 2020. After hitting USDCLP 828 at the end of November, the exchange rate has returned closer to USDCLP 770 since early January (769 at 21 January). Under these conditions, we foresee at least one more key rate cut to stimulate economic growth in 2020.

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Taiwan

The economy gets a second wind

Taiwan's export sector has been hit by the slowdown in trade between China and the United States since spring 2018, but it has also benefited rapidly from some of the positive effects of the trade war. US importers have replaced certain Chinese products with goods purchased directly from Taiwan. Plus the US-China trade war provides Taiwanese manufacturing corporates an incentive to leave Mainland China and relocate production in Taiwan, with firm government support. Thanks to these developments, Taiwan's economy reported stronger than expected growth in 2019, and this trend should continue in 2020.

Real GDP growth slowed from 3.3% in 2017 to 2.7% in 2018 before holding at this level in 2019. Last year's economic performance was better than expected at this time a year ago. After a period of growth slowdown between mid-2018 and early 2019, triggered by US-China trade tensions and sluggish global demand, the economy has regained momentum. The manufacturing sector has rapidly benefited from a substitution effect as US importers replaced certain products with goods purchased directly from Taiwan. The US-China trade war has also provided Taiwanese export corporates with an incentive to leave Mainland China and relocate production in Taiwan.

Short-term prospects are still looking upbeat, and we are forecasting real GDP growth of 2.8% in 2020. The export sector should benefit from the expected rebound in the global electronics market and will continue to benefit from the reshaping of supply chains in Asia. Domestic demand is expected to remain robust, bolstered notably by solid investment growth and accommodative monetary and fiscal policies. The January 11th elections handed President Tsai Ing-wen a second four-year mandate, and her Democratic Progressive Party (DPP) held on to its parliamentary majority. This means the authorities should be able to pursue the economic program in place since 2016. Although the election results could aggravate tensions with Mainland China, they are unlikely to have a large impact on economic activity in the short term.

The economy is holding up well

Real GDP growth slowed from 3.3% year-on-year (y/y) in H1 2018 to 2.2% in H2 and 1.8% in Q1 2019, before picking up gradually thereafter (2.6% in Q2 and 3% in Q3). According to preliminary estimates by the Taiwan statistics office, real GDP growth reached 3.4% y/y in Q4 2019 (or 1.7% quarter-on-quarter, seasonally-adjusted). These trends in GDP growth can be attributed mainly to changes in the contribution of foreign trade – which dropped into negative territory in H2 2018 before swinging back into positive territory in 2019 – and to the strong upturn in investment. It began picking up in mid-2018 after several quarters of weak or negative growth. In the first three quarters of 2019, investment rose 7.4% y/y (compared to an average annual rate of 2.5% in 2014-2018), and it probably strengthened further in Q4 2019.

These trends were largely shaped by the US-China trade war. Given the economy's strong dependence on high-tech exports and large exposure to the US and Chinese markets, Taiwan was immediately hit by the knock-on effects of the slowdown in US-China trade. Merchandise exports increased by only 1% y/y in value in H2 2018 (compared to 11% in H1 2018) before contracting by 2% in full-year 2019 (chart 2). Initially, the manufacturing sector scaled back production (-1.2% y/y in the first 10 months of 2019). But soon Taiwan has also benefited from some of the positive effects of the US-China trade war.

US-China trade war benefits Taiwan's export sector

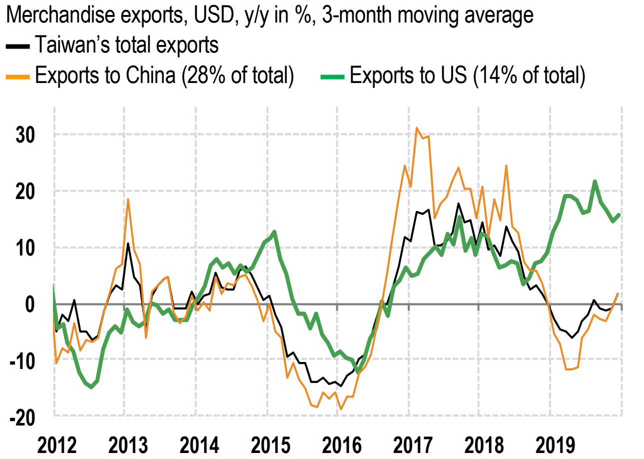
Firstly, the manufacturing sector benefits from a substitution effect as US importers replaced certain Chinese products by goods purchased directly from Taiwanese companies. Taiwanese exports to the United States jumped by 17% in 2019 (compared to an

1- Forecasts

	2018	2019e	2020e	2021e
Real GDP growth (%)	2.7	2.7	2.8	2.3
Inflation (CPI, year average, %)	1.4	0.6	1.2	1.0
Budget balance / GDP (%)	-1.9	-2.0	-2.2	-2.4
Gen. Gov. debt / GDP (%)	35.1	36.0	36.8	38.0
Current account balance / GDP (%)	11.6	11.4	11.5	12.0
External debt / GDP (%)	31.4	34.2	33.6	33.4
Forex reserves (USD bn)	462	478	490	500
Forex reserves, in months of imports	19.4	20.0	19.6	19.0
Exchange rate USDTWD (year end)	30.7	30.1	29.8	29.0

e: BNP Paribas Group Economic Research estimates and forecasts

2- Impact of US-China trade tensions on exports



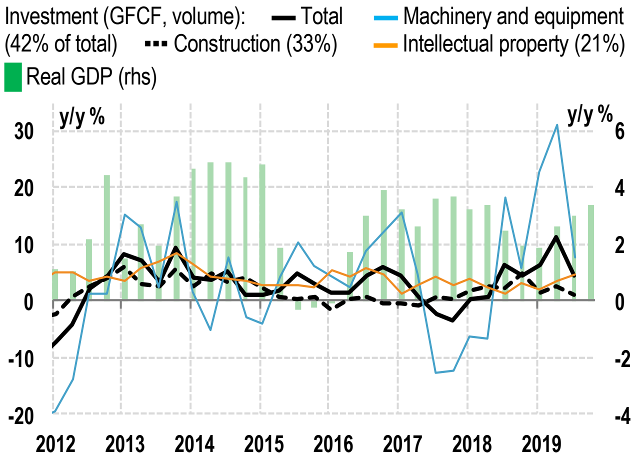
Source: Ministry of Finance

average annual increase of 4% in 2014-2018). This partially explains why Taiwan's total exports did not decline as much as South Korea's, for example (-10% in 2019). The performance of Taiwan's export sector is still highly correlated to China's total exports, which have picked up slightly over the past 2 months. Very short-term prospects have indeed improved somewhat following the signing of the "phase 1" trade agreement between Beijing and Washington (see pages 3-4). They should also get a boost from the expected rebound in the global electronics market. Taiwan's industrial output rebounded in late 2019 (+6.4% y/y in December), bolstered by stronger sales and the need for stock rebuilding (inventories were scaled back in the first three quarters of 2019). It should continue to pick up in the months ahead.

Secondly, and this is the most interesting positive effect, the US-China trade war has created an incentive for Taiwanese firms to invest in factories in Taiwan. Higher US tariffs on Chinese imports combined with the increase in China labor's costs encouraged a number of Taiwanese manufacturers to review their production strategies and to exit Mainland China by relocating production in Taiwan. The authorities have encouraged this strategic shift and set up an action plan in January 2019 (the "Action Plan for Welcoming Overseas Taiwanese Businesses to Return to Invest in Taiwan"), which aims to provide financial and logistical support to corporates that want to relocate production. The initial plan was complemented by two additional plans in July 2019 that aim to encourage investment by local small and mid-sized enterprises. At mid-January 2020, more than 300 Taiwanese companies had already signed up for one of the three government assistance plans, 169 of which were operating in China (mainly in the high-tech sector). Investment in machinery and equipment (90% of which is private) rebounded by 20% y/y in the first three quarters of 2019 (chart 3) and should continue to rise rapidly in the short term.

The recent trends of the export manufacturing sector (reshaping of trade flows in Asia, relocation of production) should continue in the short to medium term. Yet there are still some downside risks weighing on Taiwan's economic outlook. First, tensions between Taiwan and the Mainland could worsen following the re-election of President Tsai Ing-wen. So far tensions have not really had much of an impact on trade of manufactured goods. Yet Beijing could adopt measures to hurt sales in certain sectors, such as agriculture or tourism. Since China stopped issuing individual travel visas to Chinese mainlanders in August 2019, the inflow of Chinese tourists to Taiwan (38% of total tourists in 2018) fell by half. Yet the tourism sector accounts for only 2% of Taiwan's GDP. Consequently, the impact of tensions between Taiwan and the Mainland should have only a moderate impact on economic growth in the short term. However, pressure from Beijing is severely constraining the development of ties between Taiwan and the rest of the world. Moreover, Taiwan could also become the direct target of US protectionist measures while the increasing shift in focus of the US-China trade war towards technology could have major repercussions on the high-tech sector in Taiwan and the rest of Asia.

3- New investment in production facilities



Source: DGBAS

Robust domestic demand

The export sector's newfound momentum has had positive effects on the job market and private consumption. Real growth in household consumption has already accelerated from 1.7% y/y in H1 2019 to 2.3% in Q3. Public investment has also picked up (+5.9% y/y in the first three quarters of 2019), driven mainly by a vast infrastructure development plan. Accommodative monetary conditions are another factor supporting domestic demand growth.

Thanks to healthy public finances, the government has comfortable manoeuvring room to conduct an expansionist fiscal policy and implement programmes to stimulate private investment. By consolidating production facilities and raising the economy's competitiveness, these policies are an answer helping to address the decline in Taiwan's long-term growth potential registered in recent years, and reinforce the island's economic prospects in the medium term.

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Israel

Strong shekel creates monetary policy challenge

Economic growth was still robust in 2019 despite a less favourable local and international environment. Healthy external performances fuelled a significant upturn in the shekel, which in turn curbed inflationary pressures. The start-up of natural gas exports in 2020 should support this trend. Under this environment, the central bank has few policy instruments available. It resumed currency market interventions to try to curb the shekel's appreciation. After the budget overruns of 2019, however, we do not expect public finances to improve significantly given the high level of political uncertainty.

Robust economic growth

Despite an uncertain political situation locally and a less favourable economic environment internationally, GDP growth remained strong in 2019. According to the first official estimates, growth was 3.3% in real terms, which is practically the same level as in 2018 (3.4%). Household consumption and public expenditure were the main growth engines.

Two factors bolstered household purchasing power: the unemployment rate has fallen below 4% since July 2019, while real wage growth is still positive (+2.7% in October 2019) thanks to persistently low consumer price inflation (0.9% on average in the first 11 months of 2019). Public expenditure continued to increase at a regular pace (+4.1% in 2019). In contrast, investment barely grew in 2019 (+0.3%) due to a slump in productive investment, while housing investment continued going strong.

In 2020, GDP growth is expected to slow slightly, falling below 3%, due to the expected slowdown in the global economy and the constraints curbing public spending, at least in the first part of the year. Moreover, once a new government is formed, general budget policy trends are likely to increase fiscal pressure to reduce the deficit. This could have a mild impact on household consumption.

From a sector perspective, new developments in the natural gas sector should boost growth. Production started up at the Leviathan offshore gas field in late 2019. According to the central bank, its contribution to GDP growth is estimated at 0.3% in 2020. Since most of the local demand for natural gas is covered by the Tamar offshore gas field, Leviathan's production will be geared mainly towards exports to Egypt and Jordan. Production should be ramped up regularly through 2022.

Low inflation

Despite quasi-full employment, consumer price inflation is still low and is expected to average 0.9% in 2019. Prices of tradeable goods are expected to be virtually flat on average in 2019 (+0.11% during the first 11 months of 2019), while prices of non-tradeable goods rose an average of 1.2% over the same period. Mild inflation can be attributed to lower oil prices, the shekel's appreciation against the currencies of its main trading partners (the nominal effective exchange rate rose 8.3% in 2019), and the steady deregulation of the economy in general. In 2020, consumer price inflation could increase slightly, thanks to a mild increase in oil prices, while holding near the lower end of the Bank of Israel's target range (1%-3%). Looking beyond cyclical factors, for the moment it is hard to discern what might trigger higher inflation in the short term. The expected improvement in the external accounts should bolster the shekel, while significant public finance overruns (via a sharp increase in current spending, for example) seem unlikely.

The shekel continues to look bullish

Israel has reported an almost structural current account surplus thanks to ongoing increases in exports of services, buoyed by the high tech sector, and tourism, albeit to a lesser extent. The service

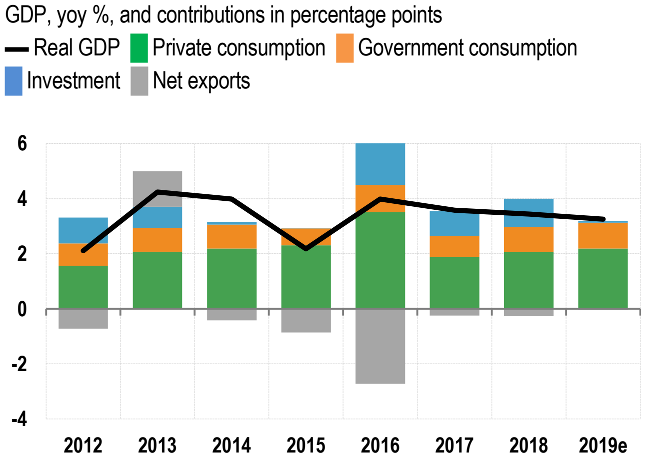
1-Forecasts

	2018e	2019e	2020e	2021e
Real GDP growth (%)	3.4	3.3	2.9	3.2
Inflation (CPI, year average, %)	0.8	0.9	1.0	1.2
Cent. Gov. balance / GDP (%)	-2.8	-3.6	-3.5	-3.0
Cent. Gov. debt / GDP (%)	59	62	64	65
Current account balance / GDP (%)	2.7	2.2	3.1	3.0
External debt / GDP (%)	25	25	26	25
Forex reserves (USD bn)	115	126	145	155
Forex reserves, in months of imports	13	12	13	13
Exchange rate USDILS (year end)	3.7	3.5	3.3	3.2

e: BNP Paribas Group Economic Research estimates and forecasts

2- Contributions to real GDP growth

GDP, yoy %, and contributions in percentage points



Source: BoI, BNP Paribas

sector surplus should offset the trade deficit. In 2019, we estimate the current account surplus at 2.2% of GDP (down from 2.7% in 2018). In the short term, the trade deficit could narrow thanks to higher natural gas exports. Even so, this impact should remain relatively small since gas exports represent only 1.6% of total exports of goods.

The Israeli market is still highly attractive for non-resident investors, especially in high technology. Foreign direct investment (FDI) in Israel amounted to more than 5% of GDP in 2017 and 2018, and is expected to remain strong in the medium term. Portfolio investment flows are more volatile and harder to predict. As of April 2020, domestic sovereign bonds will be incorporated in the WGBI[1], which should have a positive impact on capital inflows. All in all, the balance of payments surplus is likely to be maintained, fuelling the shekel's appreciation. Although portfolio flows risk making the shekel fluctuate more erratically in the short term, several factors are likely to facilitate the appreciation of the Israeli currency: a narrower spread between the Bank of Israel's key rate and the US Fed funds rate, ongoing monetary easing in the eurozone, and the US dollar's downward slide against the main OECD currencies. Consequently, structural and short term factors both seem to be working to drive up the shekel.

Monetary policy

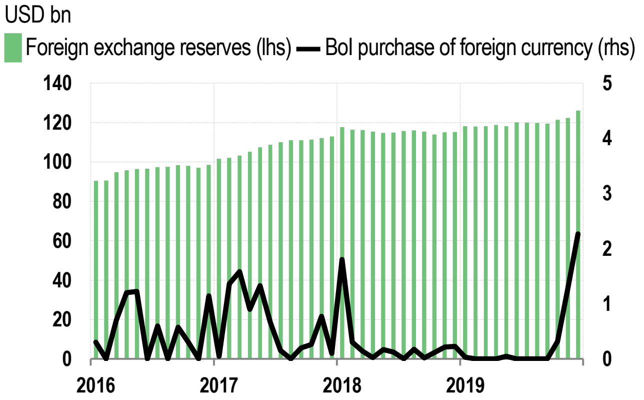
As in previous years, the inflation rate is still fluctuating outside of the Bank of Israel's target range. The central bank must decide whether to take measures that would let inflation rise towards the middle of its target range, without jeopardising the economy's dynamic momentum. According to the OECD, the output gap was slightly positive in 2019 (+0.4% higher than the potential growth rate).

The Bank of Israel has maintained its key rate at 0.25% since November 2018. The central bank barely intervened in the foreign exchange market in the first 10 months of the year[2]. Whereas monthly purchases averaged more than USD 500 m between 2013 and 2017, they amounted to only USD 277 m in 2018 and USD 40 m in the first 10 months of 2019. Given the significant appreciation of the shekel during this period and its impact on domestic prices, the Bank of Israel began making currency purchases again in November and December 2019 (USD 1.3 bn and USD 2.3 bn, respectively). To neutralise the impact of these currency purchases on money supply growth, the central bank uses open market operations and the time deposits of the commercial banks with the BoI. These forex market interventions are expected to continue this year to ease some of the upward pressure on the shekel.

Budget uncertainty

The 2019 fiscal year was marked by a notable surge in the public deficit to 3.6% of GDP, from 2.8% in 2018. According to government estimates, revenues increased by 2.5% while public expenditure rose by 5.9%. In the absence of a government before the March 2020 elections, the finance bill cannot be adopted and a system of provisional twelfths must be set up. Given the high political uncertainty and renewed regional tensions, a significant reduction in the deficit seems unlikely. Our scenario calls for the deficit to level off at 3.5% of GDP this year. Under these conditions, government debt should increase to about 64% of GDP in 2020. Most of the deficit is financed locally. About 85% of the total debt is local, and about two thirds is owned by institutional investors.

3-Bank of Israel foreign exchange assets



Sources: BoI, BNP Paribas

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[1] World Government Bond Index
[2] The Bank of Israel set up a currency purchasing programme in 2013 to reduce the impact of natural gas production on the shekel via the trade balance.

Ukraine

Favourable conjonction

Ukrainian growth accelerated rapidly in the first nine months of 2019, driven notably by the agricultural sector and household consumption, the latter being largely stimulated by borrowing. The appreciation of the hryvnia (UAH) triggered a sharp drop in inflation, which facilitated greater monetary policy easing. In the short term, monetary policy support should offset the impact of the global economic slowdown, which has already eroded industrial activity. At the same time, the announcement of a new IMF agreement is bound to reassure foreign investors. The central bank will have to deal with a classic dilemma: it needs to ease monetary policy to curb portfolio investment inflows, but doing so risks triggering a credit boom.

Since his inauguration in May 2019, President Volodymyr Zelensky has consolidated his position on the domestic political scene by winning a majority in the house of deputies while distancing himself from the oligarch Igor Kolomoisky, one of his main backers during the presidential campaign. Internationally, he proved he could be firm with his Russian counterpart on the Donbas and Crimea questions during the quadripartite summit, with France and Germany serving as mediators, while remaining open to dialogue. He has also benefited from the ongoing improvement in the economic situation. Lastly, healthy public accounts and his commitment to structural reform (draft law to lift the moratorium on the sale of farm land) convinced the IMF to grant the country another credit line.

Private demand fuels growth

In the first nine months of 2019, Ukrainian GDP rose 3.8% compared to the same period in 2018 (+4% in Q3, the most recently available quarter). On the supply side, all sectors contributed to growth, notably agricultural production – which accounts for about 10% of GDP, roughly the same as industrial output – with bumper grain harvests, thanks not only to favourable weather conditions but also to the improvement in sector productivity.

As to demand, growth has been fairly well balanced so far, buoyed by private demand: household consumption, investment and exports have all grown at roughly the same robust pace (10%, 13% and 9%, respectively). Over the same period, public spending declined by 5%.

Household consumption benefits from persistently strong real wage growth (9.7%, after 12.6% in 2018), falling unemployment (7.8% of the active population) despite an increase in the participation rate, and a sharp upturn in consumer credit (+19% in real terms). Investment, in contrast, was largely funded through cash flow as lending to companies eased after rebounding in 2018. The acceleration in GDP growth can also be attributed to vigorous exports, notably of farm produce.

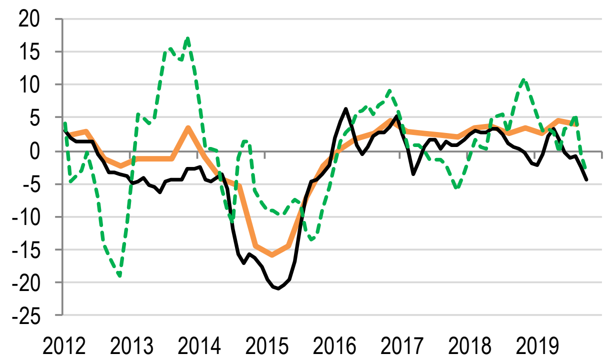
This momentum probably ran out of steam in Q4, as reflected by the slowdown in industrial output (chart 2). Yet monetary policy easing and the announcement of IMF financial support should trigger a sharper easing of domestic and external financing conditions, which should facilitate an upturn in investment lending. Although 2020 is likely to be a slow year compared to 2019, the country's macroeconomic fundamentals are improving (inflation, external accounts, public finances).

1- Forecasts

	2018	2019e	2020e	2021e
Real GDP growth (%)	3.3	3.5	3.2	3.8
Inflation (CPI, year average, %)	10.9	7.9	5.0	5.2
Gen. Gov. balance / GDP (%)	-2.1	-2.2	-2.1	-2.0
Gen. Gov. debt / GDP (%)	61.9	50.0	48.0	47.0
Current account balance / GDP (%)	-3.3	-2.8	-3.2	-3.8
External debt / GDP (%)	87.7	80.1	76.1	75.0
Forex reserves (USD bn)	20,8	25,3	27,0	29,0
Forex reserves, in months of imports	3.5	4.0	3.8	3.8
Exchange rate USDUAH (year end)	30.0	26.6	27.0	28.0

e: BNP Paribas Group Economic Research estimates and forecasts

2- Stable growth since 2016



Source: Ukrstat, BNP Paribas

Liquidity swells

As the country's external liquidity continues to rise, official foreign exchange reserves reached USD 25.3 bn at the end of December, the equivalent of nearly 4 months of imports of goods and services. The current account deficit narrowed to USD 3.4 bn in Jan.-Nov. 2019, down from USD 4.2 bn over the same period in 2018, while net FDI flows amounted to USD 2.5 bn. The basic balance has thus improved, but continues to show a deficit. The consolidation of foreign reserves is mainly due to non-resident portfolio investment, which doubled to USD 5 bn in Jan-Nov 2019 compared to the year-earlier period, but also to Gazprom's USD 2.9 bn pay-out to

Naftogaz as part of the renegotiation of its natural gas supply contract.

At year-end 2019, the normalisation of relations between Naftogaz and Gazprom had a positive impact on the balance of payments in the short term. In late December, the two companies signed an agreement under which Gazprom pledged to deliver a cumulative total of USD 7 bn in natural gas through the end of 2024. In exchange, Naftogaz agreed to write off Gazprom's arrears, with the exception of a USD 2.9 bn pay-out in late December. This pay-out will largely offset the decline in Naftogaz's transit revenues in 2020.

Considering that the hryvnia's appreciation was due more to speculation than to a fundamental improvement in the balance of payments, the central bank made major net currency purchases (USD 7.9 bn), which facilitated the payment of external debt servicing charges for the government and the central bank.

Looking beyond these positive short-term trends, the improvement in external liquidity makes the country more vulnerable to foreign investors who hold now 14.5% of total domestic debt compared with only 1% at end-2018. The announcement of the IMF's USD 5.5 bn Extended Fund Facility surely reassured investors. But foreign reserves are still relatively low compared to the annual external debt servicing charge (USD 15 bn excluding trade debt and intra-group debt in 2020). Fragile external accounts require fiscal austerity, which the authorities have maintained so far.

Public finance targets met

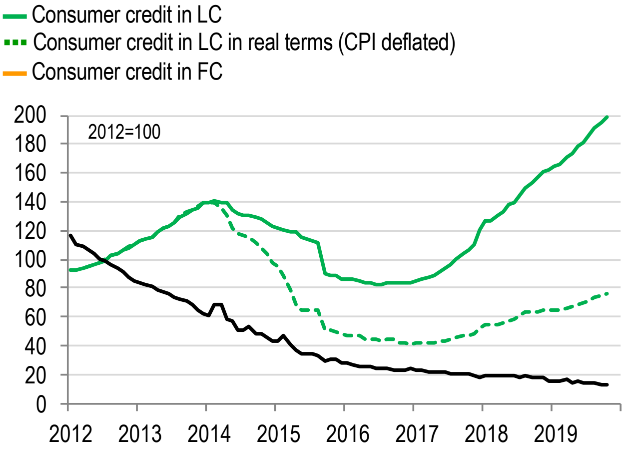
In Jan-Oct 2019, the central government deficit was capped at 2% of GDP, below the target of 2.3%, the primary surplus narrowed slightly to 1.1% from 1.5% in 2018, and interest payments shrank from 3.3% to 3.1%.

For the year 2020, parliament adopted a budget with a projected deficit of UAH 94 bn (USD 3.5 bn), or 2.1% of GDP. For the government, the big risk is not in underestimating spending but in overestimating revenues, due to the appreciation in the exchange rate: 30% of revenues are denominated in USD, compared to only 5% for spending (all other factors being the same, a stronger currency increases the deficit). Yet the budget was based on a conservative assumption of a USDUAH exchange rate of 27, compared to 24 currently. This is another argument for curbing the hryvnia's appreciation. Yet the risks of budget overruns are very small, and the IMF will be keeping a close watch.

Currency appreciation triggered a share decline in the central government's debt ratio, from 62% of GDP at year-end 2018 (including guaranteed debt) to 50% in November 2019 (nearly 60% of which is denominated in foreign currency).

The financing plan is very cautious. The government intends to issue USD 5 bn in international bonds solely to cover the payment of its external debt. Given the expected pay-outs by the IFIs and the EU, the need for international bond issues should be limited to USD 2 bn.

3- Consumer credit boom



Source: NBU, BNP Paribas

Monetary policy dilemma

The hryvnia's appreciation against the dollar since early 2019 has fuelled disinflation: consumer price increases fell back to 4.1% yoy in December, from 9.8% at the end of 2018. The central bank was able to lower its key policy rate to 13.5%, from 18% at year-end 2018, and this trend has accelerated since October (the key policy rate was cut by a cumulative total of 300 bp). Until mid-2019, monetary policy was very conservative with a key rate of more than 10% in real terms. This policy was justified by the political uncertainty that reigned ahead of legislative elections.

Now that this uncertainty has been lifted, the central bank has more manoeuvring room, but it will soon be faced with a classic dilemma for the emerging countries: with further monetary easing, the economy risks overheating, notably via a credit boom, but maintaining a very positive domestic interest rate spread risks attracting portfolio investment, which could lead to an overvalued currency.

Even the central bank believes that consumer credit is catching up too quickly. Fortunately, lending has become highly de-dollarized in recent years. Moreover, as of 2021, the central bank intends to require banks to apply a higher weighting to consumer loans when calculating the weighted average assets used in capital adequacy ratios.

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Saudi Arabia

Growth-friendly fiscal policy

Non-oil GDP growth rebounded strongly in 2019 after three years of disappointing performances. Household consumption and public sector investment spending are the main growth engines driving the recovery. Economic prospects are still positive in the short term due to the slowdown in the pace of fiscal reforms. The fiscal deficit will remain high, although exceptional one-off income and the transfer of spending to extra-budgetary entities should help hold it down. Potential growth is hampered by the erratic pace of fiscal reforms and the mixed outlook for the oil market.

Rebound in non-oil activity confirmed

Non-oil GDP growth has accelerated rapidly since Q2 2019. According to our estimates, non-oil GDP rose 4.3% in Q3 2019, compared to 3.1% in Q2 and a 2018 average of 2%. The driving force behind this recovery is above all the rebound in household consumption. Retail sales (9% of GDP) rose 8%. Construction and the combined real estate and finance sectors also contributed to growth, rising 4.6% and 6.3%, respectively. Together they account for about 15% of GDP. These trends were confirmed by the increase in household mortgage loans (12% of total private sector loans), which have increased significantly since 2018. In Q3 2019, they were up by a third year-on-year. In contrast, the manufacturing sector (excluding refining) continued to contract for the third consecutive quarter (-0.8%).

According to preliminary estimates, fiscal expenditure declined by 2.8% in 2019. Yet the total wage bill (50% of total spending) increased by 4.1% in 2019. Moreover, the Saudi sovereign fund PIF (Public Investment Fund) increasingly intervened in the government's investment policy, largely offsetting cutbacks in government investment. Despite the nominal decline in government spending, public spending, as a whole, held to an upward trajectory and had a positive impact on economic activity.

According to our leading indicator for the non-oil sector[1], the recovery is confirmed in the quarters ahead. The indicator has trended upwards for the past two quarters, after declining for 14 consecutive quarters. On the whole, we estimate non-oil GDP growth at 3.5% in 2019. For the economy as a whole, GDP is expected to increase slightly (+0.7%) and will continue to be hampered by the decline in oil GDP (-3.4% in 2019).

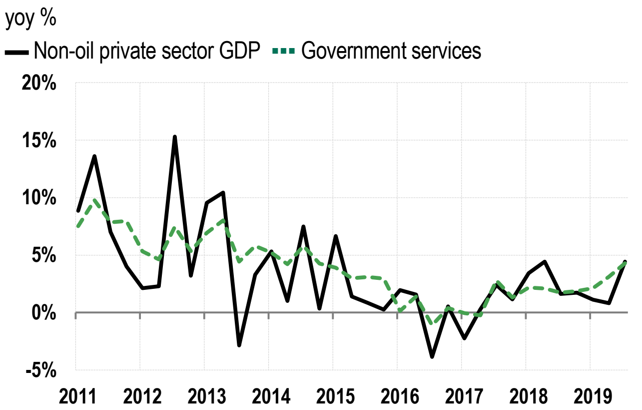
Non-oil GDP is expected to remain robust in 2020. The government's fiscal plan calls for current account spending to be cut by 3% while the total wage bill is expected to hold steady. After averaging -1.2% in 2019, driven by the ongoing decline in rent[2], inflation is expected to swing back into positive territory and average 0.6%, which means the public sector wage bill should decline in real terms.

1-Forecasts

	2018e	2019e	2020e	2021e
Real GDP growth (%)	2.2	0.7	1.2	1.6
Inflation (CPI, year average, %)	2.5	-1.2	0.6	1.2
Central. Gov. balance / GDP (%)	-5.9	-4.6	-7.4	-7.1
Central. Gov. debt / GDP (%)	19	24	26	30
Current account balance / GDP (%)	9.0	4.8	1.8	4.0
External debt / GDP (%)	25	30	34	36
Forex reserves (USD bn)	498	458	382	314
Forex reserves, in months of imports	28	24	20	16
Exchange rate USDSAR (year end)	3.75	3.75	3.75	3.75

e: BNP Paribas Group Economic Research estimates and forecasts

2- Real non-oil GDP growth



Source: General Authority for Statistics, BNP Paribas

Yet, recent labour market trends are likely to boost private demand. The unemployment rate for Saudi nationals should continue to decline and the participation rate to rise (notably among the young) in 2020. Moreover, the leaving of foreign workers from the labour market (net departures of roughly 2 million foreigners since 2017) has dwindled sharply since mid-2019.

Although government investment spending is expected to remain flat at best, public investment spending by PIF should reach cruising speed and make another positive contribution to the construction and real-estate sectors. We expect hydrocarbon GDP to stabilise as

[1] Based on the following indicators: cement production, number of letters of credit and ATM cash withdrawals.
[2] The "rent, water and energy" component of the consumer price index has a weighting of 25%.

any new cutbacks in crude oil production could be offset by an increase in other hydrocarbon production.

All in all, in 2020 we are looking for non-oil GDP growth of 3%, which should bring total GDP growth to 1.2%.

Contrasting fiscal trends

Fiscal deficits have been recurrent and rather significant since 2014. The public finance situation has deteriorated due to troubles controlling spending and the poor diversification of revenues at a time when the oil market is depressed. According to preliminary estimates for fiscal year 2019, the fiscal deficit is narrowing even without the implementation of reform measures. This improvement was made possible by exceptional one-off operations and the use of non-budgetary funding.

In 2019, the fiscal deficit amounted to 4.6% of GDP, down from 5.9% in 2018. Debt servicing charges increased by 40%, but only account for 2% of total spending. A large part of the adjustment was made through a 9% cut in capital expenditure (which accounts for 16% of total spending). Indispensable for the modernisation of the economy, capital expenditure is now assured in part by the state Public Investment Fund. Diversification of fiscal revenue is progressing very slowly in the absence of new reforms. Non-oil revenue increased by 7% and still accounts for a third of total fiscal revenue. Although Brent crude oil prices fell by 11% on average in 2019, oil revenue was virtually flat (-1%). Revenue levelled off thanks to an exceptional dividend from Aramco, the national oil company. This means the improvement in the public accounts in 2019 was partially artificial.

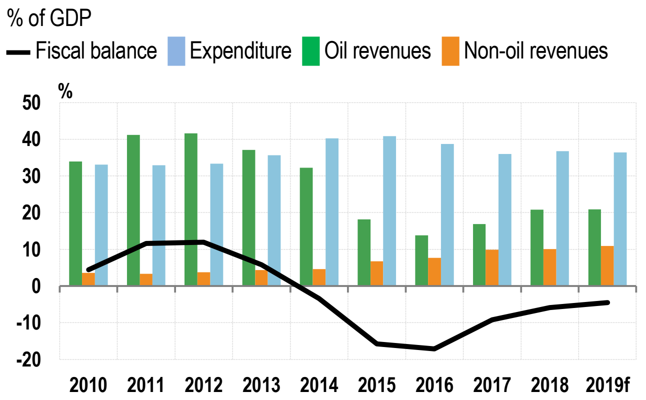
In 2020, the draft fiscal bill calls for spending cuts roughly equivalent to the 3% reported in 2019, with a decline in current account spending (except the debt service, which will increase by 48%) and virtually flat investment spending. At a time when a fiscal stimulus is needed to boost domestic demand, we think it is more realistic to expect current account expenditures to remain flat at best. As to revenue, no reform measures were announced that would increase the share of non-oil revenue. The government is forecasting a 2% increase in non-oil revenue. To estimate oil revenue, the government used an average price of Brent crude oil of USD 64 per barrel, bringing the decline in oil revenue to 16%. We expect the average oil price to be lower, which means an even sharper decline in oil revenue (-20%).

Our central scenario calls for a fiscal deficit of 7.4% of GDP in 2020. The main uncertainty is whether Aramco's 2019 dividend pay-out to the government was exceptional or not. If it is repeated in 2020, the fiscal deficit would narrow to 4.2% of GDP.

Public debt increases moderately

The fiscal deficit is traditionally financed through debt issues and the withdrawal of assets from the government's account with the Saudi Arabian Monetary Authority (SAMA). In 2020, according to official statements, about 35% of the deficit will be debt financed, including 45% on international markets. Consequently, we expect government debt to increase to 26% of GDP by year-end 2020.

3- Fiscal balance



Source: MoF, BNP Paribas

Government assets held with SAMA should amount to USD 142 bn (18% of GDP). Assuming greater recourse to debt financing in the years ahead, government debt could swell to 34% of GDP in 2022 while assets held with SAMA would be equivalent to 14% of GDP. The government's solvency does not seem to be at risk in the short to medium term, especially if we include PIF assets, which are valued at about 50% of GDP.

Even so, public finances are still highly vulnerable to oil price fluctuations. Economic activity continues to depend on public expenditure. The potential growth rate is hampered by the erratic pace of fiscal reforms and the mixed outlook for the oil market.

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Algeria

Economic transition, the other challenge

With anaemic growth, strong pressure on hydrocarbon revenue and substantial twin deficits, the macroeconomic situation is worrying. For the time being, forex reserves remain at comfortable levels but the speed and scale of their contraction is a major source of vulnerability over the short to medium term. Meanwhile, although certain decisions suggest a change of tack in the government's position after years of economic protectionism, this progress is still too hesitant given the challenges. It is also of limited effectiveness whilst the business climate has not yet stabilised.

2019 ended with presidential elections, won in the first round by Mr Tebboune against a background of low turnout and continued mass demonstrations. Although they filled a constitutional vacuum, these elections have not brought to an end the transitional period into which Algeria plunged following the resignation of President Bouteflika on 22 February 2019, under pressure from the street. The authorities, in addition to reshape the political system, face another major task: restoring the sustainability of an economic model that has been undermined by the collapse in hydrocarbon revenue and a loss of investor confidence. The period that is now beginning will therefore be decisive and full of uncertainty.

The economy has stalled

According to the ONS, economic growth reached only 1.2% in Q3 2019, having all but stagnated at 0.3% in Q2. This slight uptick came mainly from the 1.4% increase in hydrocarbon real GDP, which had previously seen eight successive quarters of contraction. At an average of 1.03 million barrels per day over the first nine months of the year, crude oil output had thus been at its lowest level since 2003, whilst gas output posted a 7.5% contraction compared to 2018. Given the fall in global oil prices, hydrocarbon nominal GDP thus declined by 18% in Q3 despite the dinar's stability against the dollar. It is hard, therefore, to see the hydrocarbon sector providing much support at a time when whole sections of the economy are suffering from political uncertainty.

Non-hydrocarbon real GDP growth decelerated to 1.4% in Q3 2019, from 3.7% a year earlier (chart 2). All sectors have been affected with the exception of manufacturing activity, which has shown surprising resilience (+ 4.7% on average over the first nine months of the year) but which makes up only a small part of the economy (5% of nominal GDP). For the rest, growth in construction (12% of GDP) was halved to 3%, whilst those in non-tradable services (15%) fell by nearly three-quarters, from 3.4% in Q3 2018 to 0.9% in Q3 2019. Despite inflation of just 2% over the year as a whole thanks to the significant role played by subsidised products (26% of the consumer basket) and the high level of imports, tradable-services were also hit by the marked slowdown in consumer spending (+0.3% in Q3 2019, from 3.1% a year earlier).

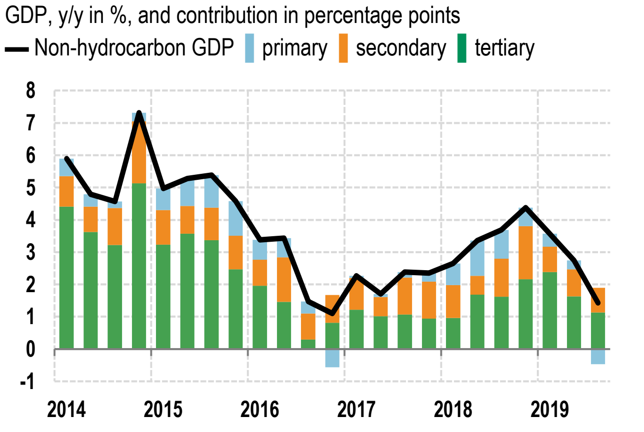
Most importantly, investment has been sluggish over the period (+0.9% in Q2 and +0.7% in Q3), preventing any prospect of recovery until the business climate stabilises. All the more so the 2020 budget includes significant cuts in public investment (see below). At 1.7% in 2020 from 1.1% in 2019, economic growth will thus only improve thanks to a slight increase in gas production, with non-hydrocarbon GDP growth barely exceeding 1.5%. But beyond the difficulties of reviving the economy, the deterioration of public finances and external accounts is a great cause for concern.

1- Forecasts

	2018	2019e	2020e	2021e
Real GDP growth (%)	1.5	1.1	1.7	2.0
Inflation (CPI, year average, %)	4.3	2.0	3.5	4.0
Gen. Gov. balance / GDP (%)	-8.1	-9.9	-10.8	-10.0
Central. Gov. debt / GDP (%)	44.3	51.5	57.2	61.2
Current account balance / GDP (%)	-9.4	-11.5	-11.7	-11.3
External debt / GDP (%)	2.4	2.3	2.7	3.4
Forex reserves (USD bn)	80	61	42	25
Forex reserves, in months of imports	16.1	12.6	8.7	5.3
Exchange rate USDDZD (year end)	119.0	121.9	125.0	130.5

e: BNP Paribas Group Economic Research estimates and forecasts

2- Non-hydrocarbon GDP growth, contribution by sector



Source: ONS, BNP Paribas

Worrying deterioration of forex reserves

According to the IMF, Algeria will need a Brent at USD106/barrel to balance its current account in 2020. Not only is this unattainable in the current climate, but it is also a much higher figure than for other oil exporters in the region. There are many reasons for this, starting with the difficulty in reducing the country's import bill. Imports have been relatively stable since 2016, at USD 46 bn, and customs statistics do not suggest any change of trend in 2019, despite the 16% fall in imports of industrial capital goods. More significantly, exports have also come under pressure. Exports, more than 90% of which are hydrocarbons, contracted by 12.5% in the first 10 months of 2019 due to the combined effect of falling hydrocarbon price and lower volume exported especially for gas (saturation of European market, strong domestic demand). For the first time in decades, therefore, Algeria probably consumed more gas at home in 2019 than it sold abroad (chart 3).

With a current account deficit of around USD 20 bn (11% of GDP) and no significant capital flows (net foreign direct investment fluctuates around USD 1 bn), external liquidity will continue to erode rapidly. FX reserves fell from a peak of USD 195 bn at the end of 2013 to USD 60 billion at the end of 2019. They are still comfortable, covering 12.6 months of imports of goods and services. However, they could just reach USD 25 bn at end-2021, which would be a worrying development given the Algerian economy's dependence on imports.

Public finances remain under pressure

Public finances are hardly in a more comfortable situation. With a fiscal 'break-even point' estimated at USD 109/barrel for 2020 (IMF), Algeria compares unfavourably to regional peers despite the fiscal consolidation measures included in the budget. The authorities plan a 9% cut in spending this year driven entirely by a 20% cut in capital spending. Current spending will remain fairly stable (down 1.2%), which creates a number of problems.

With the fiscal adjustment only supported by public investment, the adverse impact on the economy is expected to be significant. Moreover, even after these measures the budgetary deficit will remain high, at 10% of GDP, due to downward pressure on hydrocarbon revenues. Thus the question of how the deficit is to be financed will soon rear its head, particularly as the authorities have indicated that they will not reactivate its non-conventional financing policy introduced at the end of 2017. Of the USD 55 bn injected by the central bank, less than half was truly spent. Of the remaining USD 26 bn, the Treasury has a creditor account of USD 8 bn at the central bank, half of the expected budget deficit for 2020, whilst the lack of depth in the Algerian capital market raises doubts about its ability to absorb significant financing needs.

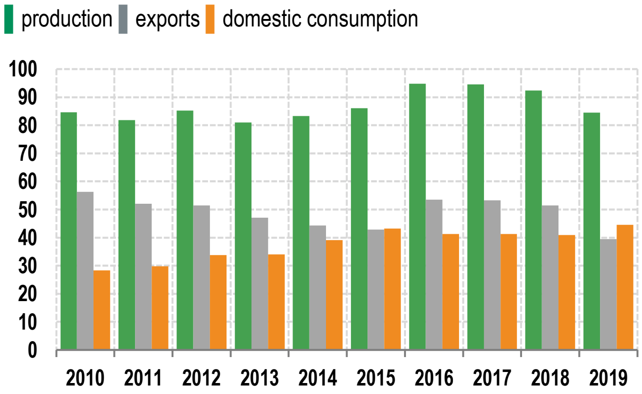
Last but not least, government debt looks set to continue its rapid growth and could rise above 60% of GDP in 2021, from just 7% in 2014. Debt servicing costs remain manageable thanks to the very favourable conditions enjoyed by the government under the "non-conventional financing" programme and the negligible level of external debt. But the current debt dynamic is yet another reminder that an overhaul of the Algerian economic model is crucial.

Reforms making progress, but timidly

The government appears to have woken up to the dangers of the situation. Red lines are moving. From this year, the government could borrow abroad to finance key projects. The "51/49" rule limiting foreign investors to a minority position in any investment project has also been relaxed for non-strategic sectors, and a new

3- Gas sector performance

Billion cubic meters



Source: JODI, MEES

hydrocarbon law has just been approved to increase the attractiveness of the sector. After years of protectionist policies this seems like a change of direction.

However, the scope of these measures is limited given the number of constraints that still weigh on the attractiveness of Algeria and, more generally, the development of the private sector. Most importantly, challenges linked to macroeconomic stabilization are far from being addressed. The reform of the subsidy system, particularly for energy, is a priority but one that is difficult to carry out in the current climate. In the absence of any lasting solution, the authorities could thus be obliged to reduce imports through the introduction of tariffs measures, or even through tighter capital controls. A depreciation of the dinar would be another option to limit the erosion of external liquidity and increase hydrocarbon revenues in local currency, but would bring considerable inflation risks. In any event, decisions need to be made in order to protect Algeria from a severe macroeconomic adjustment over the short to medium term.

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Ethiopia

Strategy change

In order to support economic growth, the Ethiopian government is transitioning from the traditional debt investment strategy to a foreign equity-based one, by privatizing some state-owned entities and removing foreign investments' barriers. The recently approved IMF program is targeted to address foreign-exchange shortages as well as to contain debt vulnerabilities by strengthening state-owned enterprises management. Nevertheless, the moving towards a more liberalized exchange rate will be done gradually to avoid triggering inflationary pressures and consequent social unrests.

Ethiopia has experienced a public investment-driven strong growth model for the last 15 years. This model has definitively reached its limits and has now resulted in high vulnerabilities, principally forex shortage and increasing external debt and servicing costs. To tackle them, the authorities have designed a new economic program (the Homegrown Economic Reform Plan) and obtained the IMF financial support. This might speed up the long-awaited transition towards a more flexible exchange rate regime. But in a context of high inflation and given that general elections are approaching, this is likely to be cautiously implemented.

Economic growth weakening and inflationary pressures

After a period of double-digit growth between 2004 and 2017, the economy has been experiencing a slowdown since 2018 because of a steady deterioration in the terms of trade. Indeed, dipping coffee prices (around 40% of total exports) and rising oil prices (+31% in 2018 for the Brent) have strongly weighted on external accounts so far. Due to external account weakness, foreign exchange restrictions hamper economic growth and contribute to flagging industrial growth. Nevertheless, economic growth remains robust, supported by solid private consumption, fostered by strong demographic growth[1] as well as gradual poverty reduction[2].

Investment is another engine of the economic activity. Important public infrastructure investments are in progress, while foreign direct investments (FDI) remain sustained. They are currently above 4% of GDP and are mainly focused on manufacturing industries. The energy sector concentrates the bulk of national investment efforts. In a country where only 30% of population have access to electricity, needs are huge. Several power supply projects have been launched since 2018 for an amount of USD 6 bn. Moreover, a USD 1.8 bn agreement has been reached with a Chinese public company to complete the electricity distribution network.

Consumer price inflation has reached 20% at November – its five-year higher point – reflecting food shortages, owing to lower agricultural output in the harvest season. On average, it should remain above 10% in 2020.

Looking for stronger private sector participation

The authorities have settled their economic policy over two main axes: i) stimulate private-sector contribution thanks to their new economic program, and ii) reduce macroeconomic imbalances through the IMF support.

Opening the economy to foreign investors is a priority. Parliament is finalizing the new investment law enabling foreign companies to enter joint ventures with Ethiopian companies, up to a maximum 49% share of ownership. Sectors involved are aviation, energy, logistics and telecommunications.

At the end of November, the government announced that it will remove barriers to investment in the mining sector and that it will privatize six sugar projects in Q1 2020. Industry should also benefit

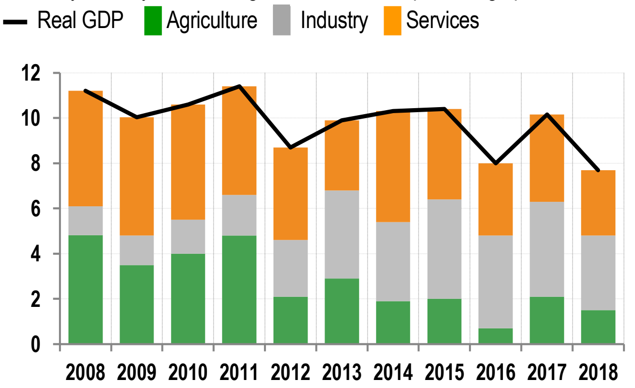
1- Forecasts

	2018	2019e	2020e	2021e
Real GDP growth (%)	7.7	7.4	7.2	7.1
Inflation (CPI, year average, %)	13.8	14.6	12.7	9.3
Cent. Gov. balance / GDP (%)	-3.2	-2.8	-3.0	-3.0
Cent. Gov. debt / GDP (%)	61.0	59.1	54.4	52.2
Current account balance / GDP (%)	-6.5	-6.0	-5.3	-4.7
External debt / GDP (%)	35.8	34.5	33.6	32.2
Forex reserves (USD bn)	4.0	3.6	3.5	3.3
Forex reserves, in months of imports	2.0	2.2	2.1	2.0
Exchange rate USDETB (year end)	28.4	31.4	33.5	35.1

e: BNP Paribas Group Economic Research estimates and forecasts

2- Real GDP growth and contributions by sector

GDP in year-on-year % change, contributions in percentage points



Source: IMF

[1] It has averaged +1.6% per year over the past 10 years.
[2] GDP per capita has tripled in 10 years, and stood at USD 950 in 2019.

from an improving power supply and some fiscal incentives, including the elimination of import duty on capital goods, income tax exemption for companies operating or developing industrial parks and export tax exemptions.

In the financial sector, the rule forcing banks to divert 27% of their loan book to the public sector has also been lifted.

On December 20th, the IMF Board approved a three-year USD 3 billion financing package (around 3% of GDP), with an immediate disbursement of USD 308 million. The program aims to address foreign exchange shortages, reform state-owned enterprises and strengthen fiscal revenue (currently at 10% of GDP only).

Regarding public finances, the fiscal deficit strongly increased after 2016. It averaged 2.8% of GDP between 2016 and 2018. It is expected to decrease slightly in 2019 thanks to a more conservative current spending policy while capital expenditure should be limited to already committed projects. This should allow the debt-to-GDP ratio to decline (it was around 61% of GDP in 2018). Debt ratios will also benefit from the privatization of some state-owned enterprises.

Easing pressure on foreign exchange liquidity

If fiscal deficits seem to be under control, external accounts remain a major weakness of the Ethiopian economy. The large trade deficit (-14% of GDP) contributes to large deficits in the current account balance despite the positive contribution of transfers from private funds and public donors. In net value, these total transfers represent 55% of total current account receipts. The current account deficit reached an average of 8.6% of GDP between 2014 and 2018.

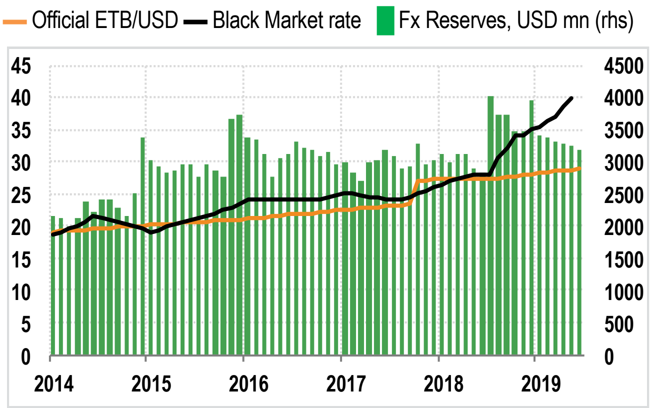
Even though the country continues to attract the largest share of FDI in East Africa, net FDI has recently moderated and covers about 70% of the current account deficit. The rest is financed through external debt, mostly on concessional terms. Foreign exchange reserves are also partly channeled to service external debt (around 8% of total foreign-exchange earnings in 2018).

The central bank's purpose is to maintain currency depreciation under control. It thus draws on its foreign reserves to contain exchange rate fluctuations. The Birr depreciated by around 10% against the USD in 2019. However, central bank's resources are limited as foreign exchange reserves are below the warning level of three months of g&s imports. At end-2019, forex reserves were around USD 3.6 bn, covering only 2.2 months of g&s imports. As a result, capital controls are also in place, which strongly constrain imports. Pressures on the Birr thus remain considerable, and the gap between official and black markets is around 40%.

The IMF agreement might help to catalyze concessional financing from other development partners. An additional World Bank support package by USD3 billion is being considered, which would support the country's reforms substantially.

To foster foreign-currency inflow, the government has also decided to mobilize the Ethiopian diaspora, estimated at around 3 billion people. To support their investment into several economic sectors, a government fund was created in October 2018, the Ethiopian

3- Exchange rate and forex reserves



Source: IMF, BNP Paribas

Diaspora Trust Fund, in charge of raising their funds. In September, the central bank relaxed exchange control regulations on foreign-currency accounts held by the diaspora to simplify their transfers to the country. For the moment, the amount raised is quite symbolic (about USD 5.4 million in 2019).

We therefore note that the macroeconomic situation is still weak, but international financial support might ease tensions on fx liquidity, at least temporarily. In 2020, central bank's foreign exchange reserves should reach USD 4.3 bn, covering 3.2 months of imports. This positive trend should keep on in 2021. Nevertheless, external accounts will remain vulnerable to commodity price volatility and high import needs.

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