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ECONOMIC RESEARCH DEPARTMENT

Eco EMERGING

Editorial

Justified caution

The "Trump tantrum" has left few traces on the financial conditions of emerging countries, with the exception of Mexico and Turkey. Oil and metal prices continue to recover and foreign trade seems to be picking up. Even so, the IMF and the World Bank have revised downwards their growth forecasts for 2017. Are they being overly cautious after years of systematic downward revisions? It is hard to be so certain given the kaleidoscope of potential risks.

Editorial

Justified caution

The "Trump tantrum" has left few traces on the financial conditions of emerging countries, with the exception of Mexico and Turkey. Despite higher US long-term rates, the cost of corporate financing in dollars is at an all-time low. Oil and metal prices continue to recover and foreign trade seems to be picking up. Even so, the IMF and the World Bank have revised downwards their growth forecasts for 2017, insisting on the downside risks more than on the gearing effect of a US fiscal stimulus. Are they being overly cautious after years of systematic downward revisions? It is hard to be so certain given the kaleidoscope of potential risks.

Renewed calm

Donald Trump's election in early November sent a wave of panic through emerging financial markets, and portfolio investment outflows reached about USD 27 billion over the following month according to IIF estimates. Three months later, there are few traces left of the "Trump tantrum". With the notable exception of Mexico and Turkey, the main emerging currencies have been stable or have strengthened. The average risk premium on dollar-denominated sovereign debt returned to pre-election levels, while that of corporate debt has continued to decline without a glitch. Even though US long-term rates have increased by 50 basis points, the cost of corporate financing in dollars has fallen to an all-time low.

At the same time, oil and metal prices have continued to rebound, notably due to the improvement in activity and prices in the industrial and real-estate sectors in China. From a more general perspective, foreign trade has picked up in emerging countries, notably intra-Asian trade. All in all, based on both real and financial indicators, the IIF expects the annualised quarterly growth to accelerate to about 5% in Q4 2016.

Growth forecasts are revised downwards again

Even so, the IMF and the World Bank have revised downwards their 2017 growth forecasts (from the October 2016 outlook for the IMF and the June 2016 outlook for the World Bank).

Although Chinese growth is expected to slow to 6.5% (vs. 6.7% in 2016), the two international institutions still expect average growth to rebound in the emerging countries, as Brazil and Russia both pull out of recession. In contrast, they both expect Mexican growth to slow to less than 2% due to: 1) a persistent financial shock due to the country's exchange rates and interest rates, and 2) a drop-off in exports due to uncertainty over trade relations with its US neighbour. The other big revisions concern 1) India, where the shock of demonetisation will hit growth, a priori temporarily, 2) Turkey, which like Mexico, faces financial tensions, but which are due more to domestic factors than to the Trump effect, and 3) a reassessment of the size of the slowdowns or recessions in the oil-producing countries (Angola, Saudi Arabia, Nigeria).

The World Bank does not take into account any gearing effects due to a US fiscal stimulus, while the IMF gives them cautious consideration. These gearing effects are seen more as upside risks rather than as key assumptions in a baseline scenario.

A kaleidoscope of risks

The two institutions insist, in contrast, on the numerous downside risks: economic risks, including the reduction in potential growth, high corporate debt loads and falling profitability, and the deteriorating quality of bank portfolios; financial risks, including capital outflows and US monetary tightening; and political risks, in the broad sense of the term, including geopolitics, domestic politics and economic policy.

China's financial instability still seems to be the main potential risk factor in our opinion. Non-financial private sector debt (i.e. excluding the central government) reached 210% of GDP in 2016 and will be difficult to scale back. Corporate debt (120% of GDP) is levelling off, but household debt (45% of GDP) and the debt of local governments and their financing vehicles (45% of GDP) continue to rise much faster than GDP. This is also the case for debt originated through the least regulated compartment of shadow banking, which now accounts for 50% of GDP (up from 16% in 2011) according to Moody's estimates. Moreover, there are recurrent squeezes on domestic liquidity, due to capital outflows and panic movements sweeping corporate debt and local government financing instruments. In a nutshell, the potential for a corporate debt crisis continues to rise. Fortunately, unlike in late 2015, the conditions are no longer ripe for a crisis to be triggered: industry is not in deflation any longer, real estate prices have picked up, the exchange rate is more flexible and the Chinese monetary authorities are playing their role as liquidity supplier of last resort.

In terms of political risks, the World Bank economists have tried to evaluate their effects on investment in the emerging and developing countries to explain the latter's weakness since 2010. More precisely, they calculated the impact of two measures of uncertainty on two different examples: economic policy uncertainty in the nearby external environment (the EU for the Eastern European countries) and domestic political risk (in this case Brazil). They show that an increase (or reduction) in political risks can very largely offset the reduction (or increase) in financial market volatility (as measured by VIX), especially if the two sources of political uncertainty are combined.

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Brazil

Patience, recovery is still playing hard to get

The financial markets are "bullish" on the new president's reform programme and seem to be showing patience with a persistently sluggish economy, despite a few positive signals before summer. Certain conditions have nonetheless come together for a gradual upturn in economic growth: a stronger real (BRL), disinflation and monetary policy easing. Yet hopes for a strong, rapid recovery of the Brazilian economy are built on shaky grounds. Budget austerity, unpopular reforms and a deteriorated job market will continue to weigh down consumption in H1 2017.

Bullish markets on the one hand…

After the great sell-off of 2015, Brazil's financial market rebounded strongly in 2016. The launch of impeachment procedures against President Dilma Rousseff in late 2015 helped restore investor confidence, which was further bolstered by the fiscal austerity and structural reforms presented by Michel Temer, interim president since May 2016, and officially inaugurated as president in August. Until Donald Trump's election, external factors were also playing favourably in all of the emerging markets: China was causing fewer concerns, commodity prices rebounded and the normalisation of US monetary policy was postponed.

Despite a few year-end tensions following Donald Trump's election and a new outbreak of domestic political turmoil (corruption scandals), the real (BRL) ended up gaining 22% against the USD in 2016 compared to the previous year. The Ibovespa stock index rose 39% in the local currency, while yields on Treasury bonds and CDS premiums on sovereign bonds denominated in foreign currency shrank by 550 basis points (bp) and 140 bp, respectively.

… a sluggish real economy on the other

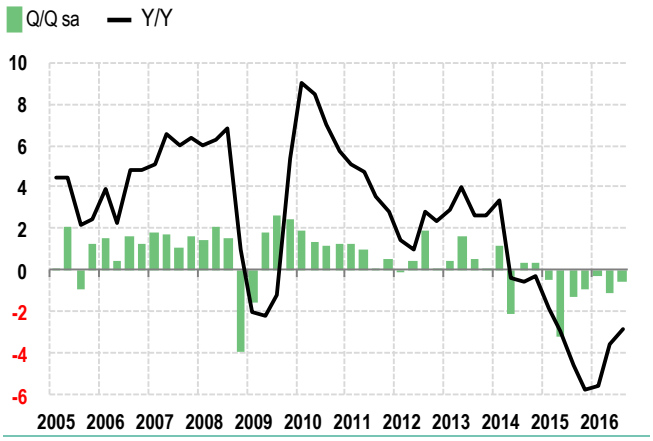
The financial markets are often considered to be the harbingers of cyclical turning points. Yet Brazil's economic recovery is playing hard to get, despite a few encouraging economic signals in Q2 2016 (rebound in investment and industrial output). Economic growth was disappointing in Q3. Seasonally-adjusted (sa) GDP continued to contract by 0.8% q/q, after -0.5% in Q1 and -0.4% in Q2, extending the current recession to seven quarters. Investment contracted again, with GFCF down 3.1% q/q, underscoring the fragility of business confidence and the operational disruptions plaguing sectors like construction, at the heart of Operation "Car Wash" (Lava Jato), and manufacturing, hard hit by sluggish domestic and foreign demand. Since 2013, the investment rate has contracted by nearly 5 points of GDP at constant prices, to barely 18% in 2016. Exports were buoyant earlier in the year, but declined 2.8% q/q in Q3. At the same time, household consumption contracted for the seventh consecutive quarter (-0.6% q/q), which surprised on the upside given the ongoing downturn in the job market (on a seasonally-adjusted basis, the unemployment rate was above 12% in November, with 127,000 net job destructions), the decline in household purchasing power (real wages fell 6.1% year-on-year in October) and sluggish lending (with the exception of credit cards).

1- Forecasts

	2015	2016e	2017e	2018e
Real GDP growth (%)	-3.8	-3.5	1.0	3.0
Inflation (CPI, year average, %)	9.0	8.2	4.5	4.4
Fiscal balance / GDP (%)	-10.3	-9.6	-9.3	-7.4
Gross public debt / GDP (%)	66.2	70.2	76.0	78.7
Current account balance / GDP (%)	-3.3	-1.1	-1.4	-2.1
External debt / GDP (%)	30.5	34.2	29.0	28.1
Forex reserves (USD bn)	349	354	360	365
Forex reserves, in months of imports	20.7	23.9	22.1	19.5
Exchange rate USD/BRL (year end)	3.9	3.3	3.0	3.3

e: BNP Paribas Group Economic Research estimates and forecasts

2- Real GDP growth (%)



Source : IBGE

Fiscal austerity and popular mistrust of reforms…

Welcomed by the markets but much less so by Brazilians, the government's law freezing current public spending in real terms was passed in December before the end of the parliamentary session. The government also presented the first part of its proposed labour law reform package, based on an agreement between employers and unions. It introduces greater job market flexibility (facilitating part-time job contracts and telecommuting, while respecting the legal 44-hour workweek, etc.).

The 2017 legislative agenda is relatively dense and potentially strewn with obstacles. The biggest pitfall could be pension reform. The second pillar of fiscal reform, it will probably need several amendments before winning congressional approval, given the

popular backlash, notably over the proposal to raise the legal retirement age to 65 (from the current average of 54). Plans for concessions and privatisations in the hydrocarbon, mining, water/sanitation and transport sectors should give rise to two bidding cycles this year. As to business sentiment, the World Bank's latest "Doing business" index ranked Brazil 123rd out of 190 countries. This poor showing has led to the elaboration of a series of measures to improve tax efficiency and slash red tape.

A priori, the formalisation of these measures should provide a sufficiently firm base for the consolidation of public finances in the medium term. In the meantime, the most recent figures for November do not reveal any fiscal improvements. The consolidated public sector primary deficit rose to nearly BRL 157 bn over 12 months, i.e. 2.5% of GDP, compared to 1.9% at end-2016. The overall deficit is still higher than 9% of GDP, and public debt has crossed the threshold of 70% of GDP.

… make a substantial easing of monetary policy the main game changer

Disinflation has accelerated in recent months due to the persistently sluggish economic environment, strong appreciation of BRL and the recent decline in food prices. The IPCA general price index was up 6.3% year-on-year in December 2016, compared to 10.7% in the year-earlier period, which is within the fluctuation band of 4.5% +/-2 percentage points tolerated by Brazil's central bank (BCB). Until recently, the BCB was constrained to maintain high interest rates (the Selic was held at 14.25% between July 2015 and September 2016), but initiated a monetary easing cycle in October. After two 25 bp key rate cuts, it surprised market expectations by reducing rates by 75 bp in January. The monetary authorities also announced a series of measures to foster bank lending (simplification of mandatory reserve requirements, improvements in the credit office, stimulation of real-estate loans, and a better framework for using credit cards).

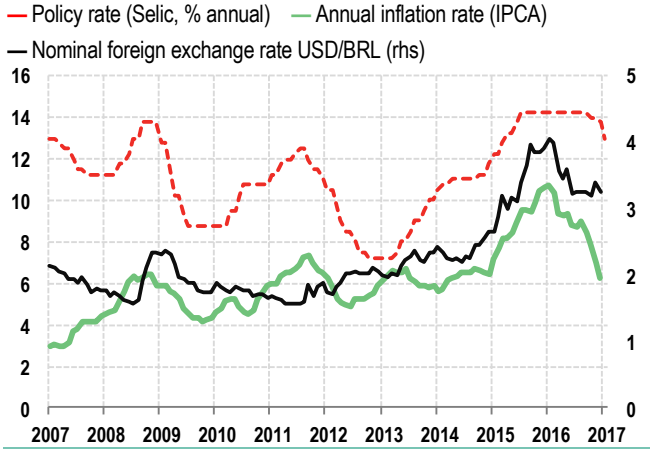
Inflation expectations are now firmly anchored around the 4.5% target in 2017 and 2018. Central bank communications suggest that the reduction in interest rates is far from over, and it could maintain the rapid pace of rates cuts in the months ahead. Indeed, the advancement of fiscal and structural reforms reduces the risk of fiscal dominance. Just a year ago, it was feared that the central bank may have to forego its inflation target to avoid an overly abrupt fiscal adjustment. Since the 11 January monetary policy meeting, the yield on Treasury bonds has fallen again (-30 bp to 10.9% on 5-year instruments), as have risk premiums on sovereign bonds in hard currency.

The upturn in US interest rates and the USD are unlikely to derail the nominal appreciation of BRL. Despite lower domestic interest rates, the good standing of the current account deficit and dynamic capital flows should help maintain the BRL's positive momentum.

… and support factor for a gradual recovery in 2017

In 2016, the carry-over effect from GDP growth was a negative 3.5% in the first three quarters of the year. Based on monthly and leading indicators (industrial output, retail sales, PMI surveys, corporate and household confidence indicators, the job market and lending), we do not foresee a rebound in activity in Q4 2016, nor in the very first months of 2017. Consequently, we have lowered our 2016 and 2017 growth forecasts to -3.7% and 1%, respectively, compared with -3% and 2% previously.

3- Policy rate, FX rate and inflation



Sources : BCB, IBGE

Ongoing monetary easing and a gradual increase in corporate investment spending should buoy the economic recovery, even though confidence indicators are still fragile. Although disinflation and interest rate cuts are expected to boost household purchasing power, poor job market prospects, at least through mid-2017, and households deleveraging could hamper the recovery of private consumption. Consequently, it is only expected to rise moderately this year. Assuming that investment picks up, the acceleration in imports is likely to prevent net exports from making a positive contribution to GDP growth, despite what is expected to be a bumper harvest. The secondary and services sectors are expected to continue struggling this year.

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Russia

Out of recession

The Russian economy is steadily pulling out of recession. In the first 9 months of the year, economic activity contracted by only 0.7% compared to a 3.7% decline in the year-earlier period. In Q3, growth swung slightly back into positive territory. Lower inflationary pressures and higher real wages should steadily lead to an increase in real revenues and an upturn in household consumption in 2017. The government could break with its budget plan and decide to stimulate growth if oil prices were to rise above its assumption. It seems preferable to us for any extra revenues to be allocated to the reserve fund, which is set to dry up sometime in 2017.

Signs of recovery

In Q3 2016, the Russian economy grew 0.1% compared to the previous quarter. Although full-year growth is still expected to be negative in 2016 (-0.5% vs. -3.7% in 2015), Russia seems to have pulled out of recession.

Agriculture (farming, forestry and fishing), mining and real estate were the only sectors to report positive growth in Q3. Business is particularly depressed in hotel services, retailing and construction. In terms of spending, household consumption and corporate investment continued to contract, but at a much milder pace. Net exports are still the only growth engine, and their contribution rose slightly, buoyed by accelerating exports and an ongoing decline in imports (albeit at a milder pace).

Since November, all economic indicators confirm that Russia is exiting recession. Business confidence indexes are unprecedentedly high, while industrial output was up 2.7% year-on-year in November. Even so, the recovery will continue to be subdued because domestic demand is still restrained. Despite higher real wages, households continue to report a general decline in real revenues, triggered by a real decline in social welfare benefits allocated by the government. Companies are also reticent to investment despite: 1) higher earnings growth since July, and 2) production capacity utilisation rates that are at all-time highs. Financing conditions are still not very favourable (lending rates exceeded 12% in late October) even though the central bank cut in its key rates by 100 basis points over the full year, bringing the key policy rate to 10%.

In H1 2017, the monetary authorities are expected to ease monetary policy further, at a time when inflationary pressures have declined sharply, facilitated notably by the rouble's appreciation. Price inflation was only 6.2% y/y in November, compared to nearly 16% in the year-earlier period.

Privatisation proceeds preserve reserve fund

The Russian government's fiscal deficit is expected to approach 3.7% of GDP in 2016, up 1.3 points compared to 2015. Public finances have deteriorated mainly due to the decline in revenues from oil and natural gas activities (-19%), which was only partially offset by higher taxes and the proceeds from the privatisation of Alrosa, Bashneft and Rosneft (which totalled USD 17.4 bn, the equivalent of 1.3% of GDP). For full-year 2016, government revenues (including privatisation proceeds) are estimated at only 16.1% of GDP, 0.7 point less than in 2015.

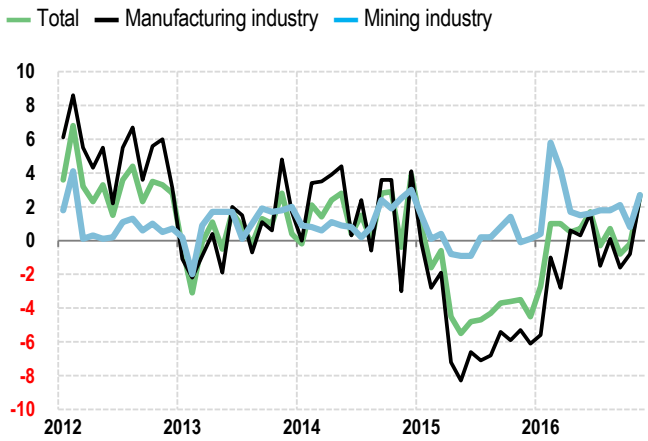
1- Forecasts

	2015	2016e	2017e	2018e
Real GDP growth (%)	-3.7	-0.5	1.0	2.5
Inflation (CPI, year average, %)	15.6	7.0	4.6	4.2
Federal Gov. balance / GDP (%)	-2.4	-3.7	-2.9	-1.8
Public debt / GDP (%)	13.6	14.3	15.6	15.2
Current account balance / GDP (%)	5.2	2.5	2.7	3.2
External debt / GDP (%)	38.9	38.1	32.2	30.6
International reserves (USD bn)	368	380	401	438
International reserves, in months of imports	11.9	13.3	12.9	12.9
Exchange rate RUB/USD (year end)	72.5	60.3	67.5	68.3

e: BNP Paribas Group Economic Research estimates and forecasts

2- Industrial output

Year-on-Year, %



Source: Rosstat

At the same time, despite cutbacks in military spending, government expenses increased 1.2% due to higher pension costs. The government failed to meet its target of reducing all spending by 10%. According to the Finance Ministry, government spending would be equivalent to 19.8% of GDP in 2016, 0.5 point of GDP more than in 2015.

We estimate that nearly 86% of the government's fiscal deficit was financed through withdrawals from the reserve fund, estimated at only USD 18 bn at year-end 2016. The disposal of state-owned shares in Rosneft considerably reduced the drain on the reserve fund.

In its 2017 budget plan, however, the government does not expect the reserve fund to suffice to cover the deficit, which means it will have to dip into the national wealth fund[1]. Even if the government manages to reach its target of lowering spending by 1 point of GDP, the deficit would still swell to 3.2% of GDP, or about USD 41 bn. However, these budget forecasts are based on extremely conservative assumptions (average Brent crude oil price of USD 40 per barrel; GDP growth of 0.6%), which could provide the government with greater flexibility. Officially, the government claims that if oil prices exceed USD 40 a barrel, the additional revenues would be used to reduce the deficit and to "preserve" the reserve fund as long as possible. It seems more probable, however, that any extra funds would be used to increase spending and stimulate growth.

By 2019, the Finance Ministry aims to reduce the budget deficit to 1.2% of GDP by reducing spending by 1% a year on average, and by increasing revenues by 11% over 3 years. In this manner, all of the deficits in 2017-2019 would be financed mainly via liquid assets held in the national wealth fund. Yet if this were the case, the government would not have the least manoeuvring room beyond 2019.

In an ideal world, the government would adopt a supplementary fiscal bill that would use any surplus oil revenues (notably if oil prices exceed USD 40 a barrel) to boost the reserve fund, as was the case before 2008. Yet despite numerous discussions within the government, no "new" fiscal rules have yet to be adopted.

Capital outflows continued to decline in 2016

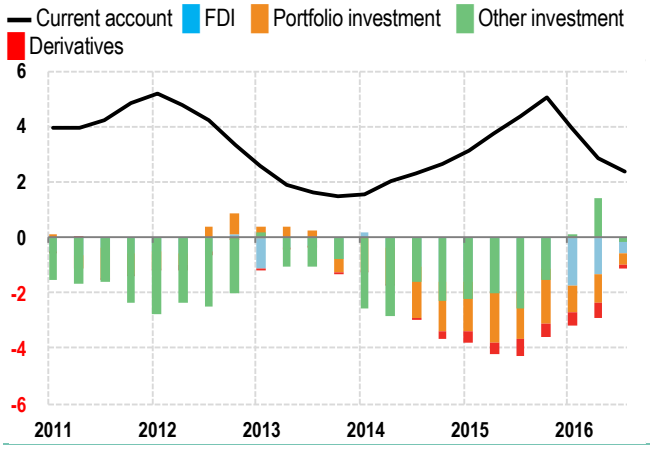
In the first 11 months of 2016, the current account surplus narrowed to the equivalent of only 1.9% of GDP, compared to 5.2% of GDP in 2015. The decline in the current account surplus mainly reflects the reduction in the trade surplus. In Q3, exports continued to contract in value terms (due to the decline in commodity prices), while imports of goods picked up for the first time since 2013, reflecting a slight upturn in activity, notably in the market for machinery and capital goods. According to the Russian central bank's outlook, the current account surplus should continue to contract throughout 2017-2019 due to accelerating imports and the ongoing moderation of export growth. Yet with the net outflow of private capital in decline (to only USD 16.1 bn in the first 11 months of 2016, compared to more than USD 54 bn in 2015), the central bank should be able to continue rebuilding its foreign reserves. External debt payments are estimated at USD 80 bn for the year 2017, compared to USD 106 bn in 2016. As to the banks, they will have to reimburse about USD 21 bn, compared to nearly USD 28 bn in 2016.

Banking sector: asset quality continues to erode

The banking sector is still in a fragile situation due to the deterioration in the quality of assets. Even so, liquidity has increased and profitability has picked up slightly.

In the first 10 months of the year, bank lending was up only 2.6% year-on-year, whereas deposits rose more than 14%. Under these conditions, liquidity pressures have eased significantly. The loan-to-deposit ratio slipped to 94% at the end of October, down from 105% two years earlier. Moreover, monetary easing and the inflow of deposits helped reduce the deposit remuneration rate, boosting net interest margins to more than 4% for the banking sector as a whole (compared to 3% in the year-earlier period).

3- Balance of payments (4-quarter moving average, % GDP)



Source: Central Bank of Russia

Yet at the end of October, the doubtful debt ratio had increased to 9.1% (provisions covered 92% of non-performing loans), 3 points more than two years previously, and 15% of loans had been restructured with a low provision coverage.

The rouble's appreciation and higher interest margins should help reduce the pressure on the banking sector as a whole, despite the ongoing deterioration in the quality of assets in 2017. Yet the banking sector has sufficient financing capacity to face up to rising credit risks. The capital adequacy ratio was 12.4% at the end of June, and state-owned banks are still benefiting from government support.

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[1] According to the Finance Ministry, 15% of the national wealth fund -- more than USD 10 bn -- will be tapped to partially finance the 2017 deficit. The government does not foresee any major privatisations in 2017.

India

The shock of demonetisation: temporary but severe

In the first half of fiscal year 2016/2017, India's GDP growth reached 7.2%, buoyed by the dynamic pace of household consumption in a disinflationary environment. In H2, in contrast, growth is expected to slow significantly due to the shock created by demonetisation. The liquidity shortage triggered a sharp drop in automobile sales, and PMI indexes have plunged to May 2013 levels. This shock should nonetheless be short lived. Activity is expected to rebound in FY 2017/2018, facilitated by the consolidation of corporate balance sheets, even though the troubles of state-owned banks could restrict loan distribution.

Demonetisation triggers growth shock

Indian GDP growth hit 7.2% in the first half of fiscal year 2016/2017 (ending 31 March 2017). Household consumption and public spending were particularly buoyant, while investment continued to contract for the third consecutive quarter.

Yet H2 growth should slow down sharply due to the liquidity squeeze triggered by demonetisation.

On 8 November, the Indian government decided to withdraw all of the INR 500 and INR 1000 banknotes from circulation by 31 December (85% of the banknotes in circulation). The government claimed this measure would curtail the shadow economy, corruption and money laundering. It is hard to say whether the operation will be successful in the medium term. In the short term, however, demonetisation has triggered a sharp economic slowdown, because 78% of payments are made in cash. At the end of December, 48% of the deposited banknotes still had not been replaced. The first economic indicators for November and December show a sharp drop in automobile sales and a downturn in household and corporate confidence indexes.

Yet the economic impact of demonetisation is unlikely to last beyond March 2017. The consolidation of corporate balance sheets and the easing of lending conditions should help foster a rebound in investments during FY 2017/2018, even though the troubles of state-owned banks could restrict loan distribution.

Monetary conditions are still not very favourable

Even though key monetary policy rates have been cut by 175 basis points (bp) since end-2014, lending rates are still particularly high. The average lending rate was 10.4% at the end of September, only 100 bp less than two years earlier. Yet after the demonetisation of the old banknotes and the concomitant increase in deposits, bank liquidity has improved significantly. The loan-to-deposit ratio fell to 69% at the end of the year. Under these conditions, and with the government calling for action, some banks eased their lending conditions. The State Bank of India lowered its benchmark lending rate by 90 bp in early January.

Consolidation of corporate balance sheets

Indian companies continued to pursue deleveraging process in Q3 2016 and on the whole, they have managed to consolidate their balance sheets.

1- Forecasts

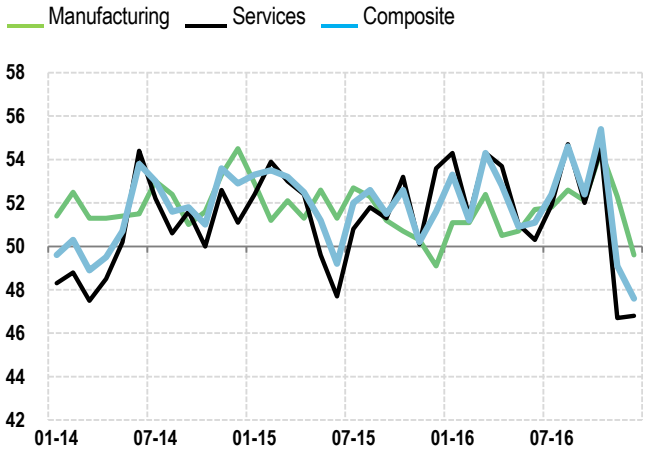
	2015	2016e	2017e	2018e
Real GDP growth(1) (%)	7.2	7.6	6.2	8.4
Real GDP growth(2) (%)	7.2	7.0	7.3	8.0
Inflation (2) (CPI, year average, %)	4.9	5.0	5.7	4.9
Central Gov. Balance(1) / GDP (%)	-4.1	-3.9	-3.5	-3.5
Central Gov. Debt(1)/ GDP (%)	46.4	47.6	47.4	46.2
Current account balance(1) / GDP (%)	-1.3	-1.1	-0.8	-1.6
External debt(1)/ GDP (%)	23.0	23.2	21.2	20.4
Forex reserves(1) (USD bn)	322	336	337	369
Forex reserves(1), in months of imports	6.7	7.8	7.7	7.9
Exchange rate INR/USD (year end)	66.2	67.8	69.0	72.0

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

(2): Calendar year

e: BNP Paribas Group Economic Research estimates and forecasts

2- PMI indices



Source: Macrobond

The central bank esteems that heavily indebted and very heavily indebted companies[1] now account for only 30.5% of private non-financial companies in September 2016, 25 points less than in 2015.

Moreover, only 14.1% of companies had an interest burden to profit ratio of more than 1 (nearly 2 points less than the previous year).

On the whole, corporate profitability has picked up. The net profit of private companies increased by more than 16% year-on-year in Q3

[1] To be considered heavily indebted or very heavily indebted, companies must have debt-to-equity ratios of more than 2 and 3, respectively.

2016, even though spending increased for the first time in more than two years. Over the same period, profit margins have also picked up.

Yet financial situations still vary widely depending on the business sector. The most fragile companies are those in iron and steel, as well as those in energy and construction. Gearing is high and earnings barely suffice to cover interest burden. Even so, textile companies have reported a net improvement in their balance sheets.

Banking sector: loan quality continues to deteriorate

The quality of bank assets continued to deteriorate in 2016. At the end of September, the doubtful loan ratio hit 9.3%, and the share of risky loans rose to 12.3% of total loans outstanding, 1 point more than the previous year. Although state-owned banks have seen their balance sheets deteriorate ceaselessly over the past four years, those of private banks have remained relatively stable. At the end of September, 15.8% of the loans granted by state-owned banks were considered to be risky, compared to only 4.6% for private banks.

Risky loans continue to be concentrated in the industrial sectors, particularly in metal, construction, infrastructure, textiles and food. According to the central bank, nearly 43% of the loans outstanding in the iron and steel sector are risky.

The quality of bank assets is likely to continue deteriorating over the next twelve months. Although the overall corporate situation is improving, it remains fragile in the most highly exposed sectors. Moreover, demonetisation will strain the economic recovery.

To address the increase in non-performing loans, state-owned banks have increased their provisions by more than 53% over the past 12 months. Yet the central bank estimates that provisions are still too small to cover any expected losses, because they cover only 41.5% of non-performing loans.

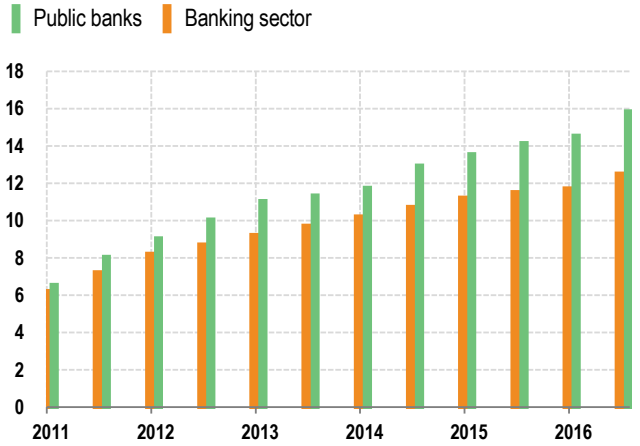
In its latest report on financial stability, the central bank estimated that for the banking sector as a whole, in case of a standard macroeconomic shock, only six banks (including five state-owned banks) would face bigger losses than their capital.

Bank profitability is still low and has eroded sharply over the past twelve months. On the whole, ROA reached 0.4% and ROE, 5%, in September 2016, compared to 0.7% and 8.5%, respectively, in September 2015. Although the state-owned banks report negative ROA and ROE, the private and non-resident banks are generating very satisfying returns.

In the medium term, Indian banks will face a significant increase in their equity capital needs in order to comply with new international regulatory standards by March 2019.

At the end of June 2016, the solvency ratio was 13% and the Tier 1 capital ratio was only 10.6%, but the situation differed widely between banks. On the whole, state-owned banks have capital adequacy ratios of about 11%, while private banks have ratios of between 13% and 15%. At the end of June 2016, 10 out of 27 state-owned banks had capital adequacy ratios below the minimum requirement to comply with the Basel III from March 2019 (11.5%). Yet the capital adequacy ratios of all the systemic banks were higher than the minimum requirement.

3- Stressed assets (% of loans)



Source: Reserve Bank of India

To meet regulatory requirements, Fitch estimates that the banking sector as a whole would need an equity injection of USD 90 bn (about 4% of GDP), with state-owned banks alone accounting for 83%. The IMF estimates their need for equity capital at 1.8% of GDP, or 3% of GDP if their balance sheets were to deteriorate further. Although the government supports its banks, it does not intend to inject more than INR 700 bn (the equivalent of USD 10.4 bn, or 0.5% of GDP). Since fiscal year 2015/2016, it has already injected nearly INR 500 bn (0.4% of GDP) [2] and an additional INR 100 bn will be injected in both 2017/2018 and 2018/2019. So far, given the deterioration in the balance sheets of the state-owned banks, it is hard to imagine how they can manage to raise capital on the markets equivalent to about 3% of GDP. The government may well have to provide even more support for the state-owned banks. This risks undermining the consolidation of public finances.

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[2] Recapitalisation of the banking sector could exceed the amount in the government's 2016/17 budget forecast. At the end of December, INR 229 bn had already been injected out of a total budget of INR 250 bn.

China

Stability, a complicated goal

There is no doubt about the authorities' determination to maintain "stability" through the 19th Party Congress in fall 2017. Yet short-term growth prospects present high downside risks, such as the possibility of a downturn in the real estate market and mounting trade tensions with the United States. Capital account dynamics could also become a source of instability. Growing pressures on the yuan and capital outflows have grown in recent months and are expected to persist in the short term. As a result, foreign reserves should decline further and yuan depreciation should continue. To limit these trends, the authorities will not hesitate to introduce more capital control measures.

Priority on stability

The economic growth slowdown has been checked since Q2 2016 thanks to the authorities' expansionist policy. Real GDP growth stood at 6.7% in 2016 and is projected to slow down moderately in 2017 (*table 1*). The structural factors of the weakening in export and manufacturing investment growth persist (especially the slowdown in Asian and international trade transactions, the loss of industrial competitiveness and the reduction in surplus production capacity). However, services and private consumption are struggling to pick up the slack, held back by slower wage growth and insufficient progress in structural reform. To offset the impact of these trends, the authorities should maintain an expansionist policy in the short term. Stability will be their top priority until the 19th Congress of the Communist Party in fall 2017, which is expected to see the replacement of a large number of Central Committee members as well as five of the seven members of the Politburo Standing Committee (President Xi Jinping and Prime Minister Li Keqiang should be the only ones to conserve their positions for another five years). Consequently, China is only expected to pursue structural reforms in 2017 when they do not threaten the country's stability, while economic policy will focus on measures that stimulate domestic demand in the short term.

The authorities do not have much manoeuvring room. In particular, monetary policy will remain very cautious due to the high credit risks looming over the financial sector and the risk of capital outflows. Moreover, though still moderate, consumer price inflation has begun to rise again in recent months (2.2% y/y in Q4 2016). Property policy (i.e. the prudential rules applied to property purchases, sales and loans) is expected to be adjusted in order to support activity while at the same time containing the risk of asset bubble, and should prove increasingly "city-specific". As a matter of fact, the upturn in the real estate market in 2016 has been characterised by divergences between big cities on the one hand, where signs of overheating have already emerged, forcing the local authorities to tighten prudential rules and, on the other hand, small and mid-sized cities, where price increases have remained more subdued. As a consequence, should additional stimulus prove necessary to boost growth, fiscal policy (public investment, fiscal measures) is likely to be the preferred option, as it was in 2016. The authorities set their 2017 targets during the annual Economic Conference last December. In brief, monetary policy should be "cautious and neutral" and fiscal policy should remain "proactive", to promote "stability" and "continue the restructuring of the economy".

There is no doubt about the authorities' determination to meet their targets, although it will be hard to maintain a steady course. Major downside risks loom over short-term growth prospects. On the domestic front, high financial risks permanently threaten to cause disruptions in the supply of credit to the economy. Moreover, a new downturn in the real estate market is possible in 2017 in case property policy tightening measures are extended much further. On the international front, the introduction of protectionist measures and mounting tensions with the United States could handicap China's foreign trade at a time whereas the global environment is still not very growth supportive. Lastly, China's capital account balance could also be a source of instability.

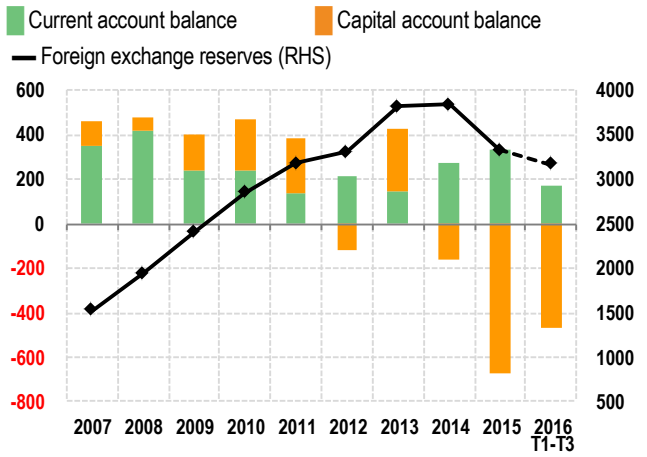
1- Forecasts

	2015	2016e	2017e	2018e
Real GDP growth (%)	6.9	6.7	6.2	6.4
Inflation (CPI, year average, %)	1.4	2.0	2.3	2.5
Official budget balance / GDP (%)	-2.4	-3.0	-3.3	-3.5
Central Gov. debt / GDP (%)	15.6	16.0	18.7	20.9
Current account balance / GDP (%)	3.1	2.2	1.7	1.5
External debt in FC / GDP (%)	5.6	4.5	4.0	3.8
Forex reserves (USD bn)	3 330	3 011	2 692	2 819
Forex reserves, in months of imports	19.5	18.1	15.5	15.5
Exchange rate CNY/USD (year end)	6.49	6.94	7.40	7.02

e: BNP Paribas Group Economic Research estimates and forecasts

2- Deterioration in balance-of-payments dynamics

USD billion



Sources: SAFE, IMF

The threat of capital outflows

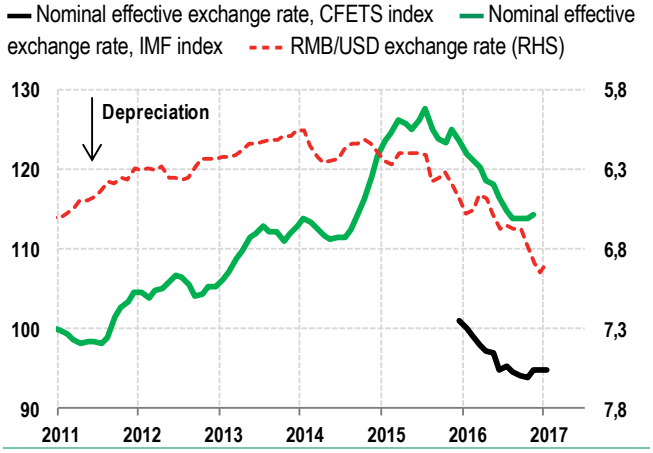
Over the past three years, net capital inflows by non-residents have declined while net capital outflows by residents have increased rapidly, due to lower economic growth prospects and changing expectations over the evolution of the yuan in a context capital account opening, exchange rate policy reform and global expansion of Chinese firms. The capital account balance, which has been negative every year since 2014, should represent close to about 6% of GDP in 2016. The current account surplus is estimated at less than 3% of GDP. Due to these external account movements, foreign exchange reserves have dropped by 25% since the mid-2014 peak and hit the symbolic threshold of USD 3000 bn at end-2016. Over the same period, the renminbi (RMB) depreciated by 12% against the dollar (*charts 1 and 2*).

Net capital outflows intensified again in the last months of 2016. After the election of President Trump and the hike in the Fed's key rate in December, the general appreciation of the USD has exerted downward pressure on the RMB/USD exchange rate. In the meantime, People's Bank of China (PBOC) has increasingly made reference to the RMB's exchange rate against a basket of currencies (of its main trading partners) in the management of its fx policy. With US interest rates expected to rise in 2017, depreciation pressures on the yuan and capital outflows are expected to continue. Possible trade tensions with the United States would only add to pressures on China's external accounts.

As in 2016, capital outflows are expected to have a restrictive impact on domestic monetary conditions as well as amplify: 1) the decline in foreign reserves, 2) the RMB's depreciation against the USD, and 3) the risk of additional capital control measures. Having made stability a priority, the authorities are bound to remain active in forex markets (both onshore and offshore) to contain the RMB's depreciation against the USD. It seems highly probable that they would prefer to impose new capital controls rather than let the RMB and/or foreign reserves decline too fast. Even though the stock of foreign reserves is still extremely comfortable, the pace of change is an additional source of concern for investors.

Beijing has gradually reinforced its capital control measures since mid-2015, and even more strongly in recent weeks. The measures cover an increasingly broad range of transactions and counterparties. SAFE (*State Administration of Foreign Exchange*) has significantly tightened its "scrutiny" of resident investments abroad as well as forex purchases by individuals. It has also temporarily banned the acquisition of non-industrial foreign assets, and certain programs aiming to liberalise Chinese investment flows in foreign equity markets have been suspended. Moreover, in recent days, controls on banks' overseas transfers of RMBs (which are then converted in offshore markets) have been strongly tightened. All these measures cast a shadow on the internationalisation of the RMB and the capital account opening process. Going forward, capital account liberalization may continue, but it will be cautious and done in a very asymmetrical manner, with the authorities possibly lifting further controls on non-resident capital inflows (with an uncertain impact on investment flows) while maintaining or reintroducing controls on capital outflows.

2- Exchange rate policy



Sources: SAFE, IMF

Our baseline scenario for 2017 calls for a decline in foreign reserves and a depreciation in the RMB against the USD relatively similar to those observed in 2016 (*table 1*). Moreover, the authorities may continue to adjust gradually their exchange rate policy regime. The most recent reform has been aimed at reducing the reference to the RMB/USD bilateral exchange rate and increasing that to the effective exchange rate. The CFETS (China Foreign Exchange Trade System)'s average exchange rate was introduced in November 2015, with a benchmark basket of currencies initially comprised of 13 currencies. The basket was then broadened on January 1st, 2017 to include the 24 currencies of China's main trading partners.

After CFETS was introduced in late 2015, the RMB entered a period of depreciation in effective terms, which partially offset the strong appreciation of the previous four years. With the general strengthening in the US dollar since mid-2016, PBOC has appeared to target two goals: firstly limit the depreciation of the RMB against the USD and, secondly, stabilize the CFETS (*chart 2*). Meeting these targets can be hard and require a significant use of foreign exchange reserves; this was the case in Q4 2016 when capital outflows and depreciation pressures on the RMB intensified.

Moreover, PBOC also needs to counter RMB depreciation *expectations* (which can fuel more capital flight, which in turn can trigger self-sustaining bouts of stress). As a matter of fact, persisting doubts of local and international investors about the objectives of Beijing's exchange rate policy only add to the downward pressure on the RMB. Therefore, the authorities will need to shore up the credibility of their policy, notably via better communication, if they want to anchor investors' expectations around the RMB's effective exchange rate and less on the bilateral USD/RMB exchange rate.

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Vietnam

The transformation continues

Economic growth held above 6% in 2016, bolstered by export manufacturing and sectors focused on domestic demand, such as construction and services. In the short term, the country is expected to continue to expand its export base thanks to foreign investment, while private consumption growth should accelerate thanks to a better performance of the agricultural sector. Therefore, economic growth prospects are still looking strong. The risk of increased protectionism is a big cloud on the horizon. Moreover, in 2017, the authorities will certainly have to tighten monetary policy and increase fiscal consolidation efforts in order to contain the risks of macroeconomic instability.

Dynamic economic growth

Real GDP growth stood at 6.2% in 2016, a solid performance even though it was not quite as strong as in 2015. The manufacturing sector was still the main growth engine. It increased by 11.9% in real terms over the full year (compared to 10.6% in 2015), driven by foreign direct investment (FDI) and export sales. Net FDI inflows exceeded USD 8 billion in the first 3 quarters of 2016 (vs. USD 10 billion in 2015), which allowed the Vietnamese industry to continue expanding and diversifying its export base (chart 1). In the last months of 2016, exports benefited from the upturn in the electronics cycle, despite the failure of the latest smartphone model of the Korean manufacturer Samsung (one of Vietnam's largest investors). Export growth accelerated from 5% year-on-year in Q2 2016 to 14.8% in Q4, easily surpassing the average performance for the rest of Asia.

The year was much tougher for commodity-dependent sectors. The mining sector contracted 4% in 2016 after briefly rebounding in 2015. Growth in the primary sector slowed to 1.4%, mainly due to drought and salinity intrusion problems. The poor performance of the agricultural sector eroded household purchasing power and strained private consumption, due to the negative effects on both farmers' revenues and inflation. Inflation in food and consumer prices has in fact accelerated in recent months.

As a result, growth in retail sales slowed slightly in H2 2016 (to 6% y/y in real terms in Q4 2016, vs 7.7% in Q2). Yet growth in domestic demand-oriented sectors has remained solid, with construction up 10% in full-year 2016, electricity up 11.6%, and services up 7%. Under this environment (buoyant FDI, rebound in construction and the real estate market), investment also rose at a dynamic pace, estimated at 10% in 2016 (compared to 9.4% in 2015).

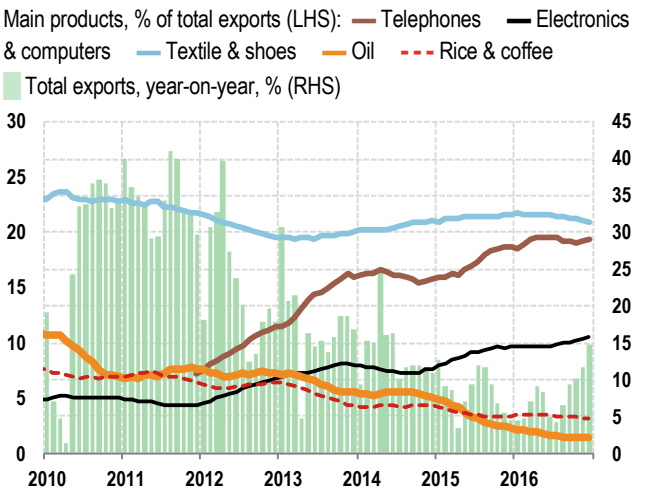
In 2017, economic growth prospects are looking strong, with ongoing support from the expansion of export manufacturing and its gearing effect on the rest of the economy. Export performance is expected to remain robust. Asian corporates should remain attracted by Vietnam's solid comparative advantages (wages, skilled labour force, ongoing process of opening to foreign capital and geographic location) and continue to increase their FDIs in the months ahead, not only in the electronics industry, but also in lower value-added sectors such as textile. Moreover, private consumption growth is expected to pick up, thanks notably to the rebound in revenues in the agricultural sector, which is beginning to benefit from better weather conditions and higher commodity prices.

1- Forecasts

	2015	2016e	2017e	2018e
Real GDP growth (%)	6.7	6.2	6.5	7.0
Inflation (CPI, year average, %)	0.6	1.9	5.0	3.5
Budget balance / GDP (%), IMF def.	-5.9	-5.6	-4.9	-4.4
General government debt / GDP (%), IMF def.	62.2	63.7	65.1	64.6
Current account balance / GDP (%)	0.5	4.0	3.0	1.5
External debt / GDP (%)	38.8	38.0	39.0	38.0
Forex reserves (USD bn)	28.3	38.0	42.3	46.9
Forex reserves, in months of imports	2.0	2.6	2.7	2.8
Exchange rate VND/USD (year end)	22 456	22 756	23 300	24 200

e: BNP Paribas Group Economic Research estimates and forecasts

2- Exports: solid performance, increasing value-added



Sources: General Statistics Office of Vietnam, CEIC, BNP Paribas

Nonetheless, downside risks on growth are significant. Prospects for exports, FDI and real GDP growth are darkened by the rising risks of protectionism and trade tensions between Asia and the United States. The Trans-Pacific Partnership (TPP) has also been called into question, and Vietnam was seen as one of the largest beneficiaries of this free trade agreement. Moreover, monetary and fiscal policies could turn less growth-supporting in the months ahead.

Economic policy challenges

On the whole, the authorities maintained an expansionist economic policy in 2016 despite the dynamic momentum of domestic demand growth and rising inflation. The central bank held its key refinancing rate at 6.5% (unchanged since March 2014), banking sector liquidity continued to improve and domestic credit grew at a vigorous pace. Its acceleration, which was rapid in 2014-2015, was nonetheless checked in 2016; in real terms, growth in bank credit to the private sector slipped to 17% year-on-year in September 2016, from 18.2% in 2015 (and 12% in 2014)

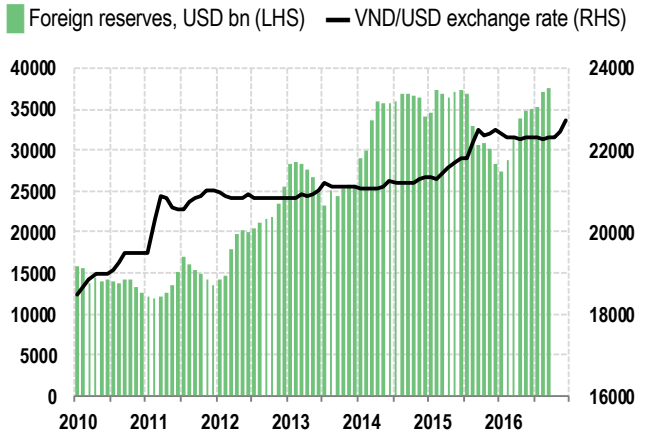
The authorities could want to maintain a pro-cyclical policy stance given the external risk factors overshadowing growth prospects. Yet the domestic risks threatening macroeconomic stability cannot be neglected either; as a result, the authorities are likely to adopt a cautious approach and could tighten economic policy in 2017. First, the government should reduce its fiscal deficits since its debt is approaching the ceiling of 65% of GDP defined by the National Assembly. Second, the central bank must be careful: i) to limit the acceleration in bank credit as the banking system is still extremely fragile due to high credit risks and insufficient capital adequacy ratios, and ii) to fight inflationary pressures – all the more so as inflation should increase in the very short term due to the expected rise in certain administered prices (education and healthcare costs). Higher inflation could undermine Vietnamese confidence in their currency, and encourage the transfer of VND-denominated savings into gold or dollars. This would aggravate downward pressure on the dong (VND), which is likely to intensify anyway in the months ahead based on our scenario of an appreciation of the dollar and depreciation of the renminbi. VND has already shed 2% against the USD in the last two months of 2016, after remaining virtually flat since June[1] (*chart 2*).

External account dynamics are thus likely to be less favourable in 2017 than in 2016, with a reduction in the current account surplus and an increase in capital outflows (notably by residents). The "basic balance" (current account balance + net FDI) is largely positive, which limits the country's need for external financing. Yet we cannot rule out the possibility of bouts of strong pressure on foreign reserves and on the dong. In this case, the central bank might resort to a sudden tightening of monetary policy, since it lacks a foreign reserve cushion to buffer against shocks while its exchange rate policy flexibility is limited. The authorities are indeed likely to continue to give preference to a moderate depreciation of the dong, given its potential impact on both inflation and on public debt dynamics.

Fiscal consolidation is crucial

The government has reported fiscal deficits of between 5.5% and 7.5% of GDP since 2012. This poor performance is mainly due to lower fiscal revenues (corporate tax cuts, declining oil revenue, etc.), while fiscal spending has remained close to 29-30% of GDP. Wide deficits have been the main factor behind the increase in public debt, which now exceeds 60% of GDP and should approach 65% in 2017.

3- Foreign reserves and the exchange rate



Sources: IMF, SBV

The debt servicing burden is also getting heavier as its profile has changed, with a decline in the share of concessional debt held by official creditors (which still account for more than 80% of foreign-currency debt) and an increase in the share of VND-denominated debt financed in the local markets (57% of total debt in 2015, up from 52% in 2014). This trend reduces the sovereign's vulnerability to currency risk (which nonetheless remains high), but gradually increases the average interest rate paid on the debt.

Public debt is fast approaching the debt ceiling set by the National Assembly for 2016-2020. The government seems to be determined to intensify its fiscal consolidation efforts in order to trim the deficit to about 3% of GDP by 2020. In addition to higher tax revenues and spending cuts, the government also plans to limit the amount of guarantees granted to public institutions and to step up the partial or total privatisation of state-owned enterprises. It is very uncertain whether the authorities have the capacity to reach these targets, but it is crucial that they improve fiscal discipline and step up public-sector reforms in order to reassure private creditors, contain the rise in debt refinancing costs, and improve the sustainability of public finances.

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[1] *Vietnam uses a "managed float" exchange rate regime in which the dong fluctuates around a benchmark rate. Since 1 January 2016, this benchmark has been based on a basket of the eight currencies of its main trading partners, including the United States and China.*

South Korea

Political crisis is not the whole story

After months of political crisis, the Korean parliament voted to impeach President Park in early December. Pending validation by the Constitutional Court, which would allow new elections to be held, the Prime Minister has been named as interim President. Political uncertainty in the coming months will hold back growth, but a greater contribution to the slowdown expected in 2017 will come from the limited support from economic policy and the lack of vigour in the export sector. There are considerable challenges ahead for the medium term, but the good health of external accounts and public finances and the solidity of the banking sector should help South Korea to make reforms without increasing structural vulnerabilities.

A lively six months

South Korean economic growth slowed in the second half of last year. The support provided by the authorities in the summer[1] helped limit the slowdown, with real GDP growth of 2.6% y/y in Q3 from 3.2% in Q2. It seems likely that the slowdown was amplified in the final quarter: the construction sector showed signs of weakening, while the restructuring of the shipbuilding sector and the high level of household debt have slowed growth in domestic demand. Meanwhile, exports remain very weak, hit by the discontinuation of the production and export of Samsung's Galaxy Note 7. Lastly, the coming to a head of the political crisis and its impact on the *chaebol* conglomerates has hit domestic demand hard.

At the beginning of December, parliament voted to impeach President Park, who had been elected in 2012, bringing to an end several months of public demonstrations calling for her to stand down. On top of the political scandal, she has been blamed for the perceived failure of the "economic innovation plan", and poor handling of the various crises that have faced the government since she came to power (notably the sinking of MV Sewol in 2014 and the coronavirus epidemic in 2015). The large majority in favour of impeachment (234 of 300 votes) illustrated the strength of feeling against her, including in her own Saenuri Party. This party has 126 of the National Assembly's seats, against 174 opposition members, including 122 from the centre-left Minjoo Party of Korea.

The Constitutional Court has up to six months (i.e. until mid-June at the latest) to validate the impeachment. If the vote is validated, the President will be officially impeached and new elections will be organised in the 60 days following the ruling. In the highly unlikely looking alternative outcome, the President would remain in post until the end of her mandate in February 2018. In the interim, the President has been suspended from her duties and the Prime Minister, Hwang Kyo-ahn, who has never been elected, has been appointed as a caretaker president.

Limited support from economic policy

It is highly unlikely that the interim government will introduce new economic stimulus measures between now and the new elections. Although insufficient to support growth, the targets set in the 2017 budget law, which plans to spend 70% of the total budget in the first half of the year, are nevertheless likely to be met.

Over the longer term, the much-needed structural reforms could also be difficult for the new government to introduce. There is no clear majority in the National Assembly, creating potential stumbling blocks for any future reform programme, irrespective of which party wins the presidential election.

A new, one-off stimulus package after the elections (as has been seen every year for the past five years) cannot be ruled out, but, as with previous versions, its scope is likely to be modest. In the short term, the room for manoeuvre yet remains comfortable: the deficit (excluding the social security fund) is likely to have been stable at around 2.4% of GDP in 2016 and government debt remains below 40% of GDP.

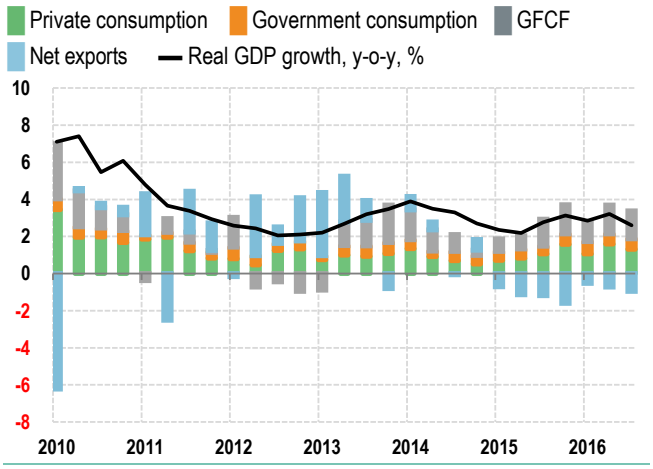
1- Forecasts

	2015	2016e	2017e	2018e
Real GDP growth (%)	2.6	2.7	2.8	3.3
Inflation (CPI, year average, %)	0.7	0.9	1.5	2.0
Gen. Gov. balance / GDP (%)	-2.1	-2.3	-2.4	-2.5
Gen. Gov. debt / GDP (%)	36.0	37.5	37.5	38.5
Current account balance / GDP (%)	7.8	7.0	6.1	6.5
External debt / GDP (%)	31.4	32.6	34.0	35.0
Forex reserves (USD bn)	358	364	368	370
Forex reserves, in months of imports	6.6	7.1	7.5	7.5
Exchange rate KRW/USD (year end)	1 200	1 200	1 250	1 250

e: BNP Paribas Group Economic Research estimates and forecasts

2- Real GDP growth

Real GDP growth (%) and contribution (p.p.), y/y.



Source: National Accounts

[1]The Central Bank cut its policy rate by 25 basis points to 1.25% and a stimulus package worth 0.6% of GDP was introduced by the government.

Over and above short-term political blockages, the small scale of the measures adopted since the early 2000s is above all a reflection of the commitment to rigorous management of fiscal policy in a bid to tackle the impacts of an ageing population on public finances. This commitment was renewed in the presentation of the medium-term plan (2016-2020) last September, with the two main targets being "preparing for demographic changes and the country's industrial restructuring". This plan aims to reduce the deficit to 1% of GDP (excluding the social security fund) and keep government debt below 40% of GDP.

Monetary policy is circumscribed by the high level of household debt (around 80% of GDP in Q3) and its rapid rise (nearly 8 percentage points over the past two years), even though this does not pose a systemic threat in the short term. The improvement in the structure of the debt that has been taking place over the past decade has accelerated since 2015 and the introduction of a debt restructuring plan: in particular, the share of fixed-rate debt was increased to nearly 40% of the total in Q3 2016 (from less than 25% in 2014), but households remain vulnerable to an increase in interest rates.

In its latest press release, the Central Bank indicated that it wants to maintain an accommodating monetary policy whilst also continuing the efforts of recent years to improve financial stability. Its policy interest rate has been unchanged at the record low level of 1.25% since last June.

Exports unlikely to help out

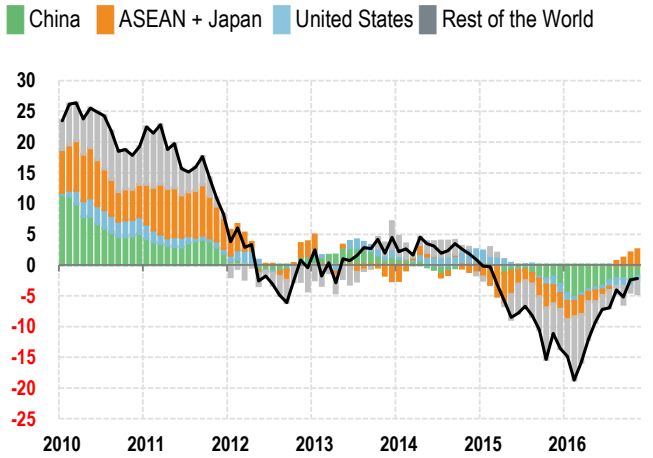
Overall, we expect real GDP growth of 2.8% in 2017 (from 2.7% in 2016). The cause of this mild recovery will be weak domestic demand, which will be only partly offset by an upturn in exports. The recovery should then remain modest, to 3.3% in 2018, lower than the average recorded in 2011-2014 (at 3% per year, when real GDP growth averaged 5% per year in 2000-2010).

The prospects for the export sector are indeed not very encouraging. Structural weaknesses remain: South Korea is highly integrated, both with global value chains and with the regional economy, and is thus particularly exposed to: i) a slowdown in China; ii) the stagnation of global trade; and iii) a decline in the gains from extending production chains. Secondly, the rise in protectionism seen in the last two years could hit Korean exports, particularly if there is a radical change in trade policy in the US, which represents 14% of total exports. This situation could be further complicated if the US seeks to renegotiate or cancel its free trade deal with South Korea. This would be particularly hard on the automotive industry, which accounts for more than one-third of Korea's total exports to the USA. Moreover, given the scale of exports to China which are then re-exported, South Korea could be indirectly hit if Chinese exports are affected by significant restrictive measures.

In short, short-term economic prospects are not particularly favourable: domestic demand will continue to be undermined by the political crisis and the restructuring of the shipbuilding sector, and will lack clear public sector support, whilst exports will lack vigour.

3- Exports by destination

Exports growth (%) and contribution by destination (p.p.), y/y



Source: Central Bank

The banking sector remains solid

Over the medium term, there are numerous challenges, but South Korea enjoys major structural strengths: public finances are robust, external accounts are solid, and the high level of household debt and restructuring of the shipbuilding sector have not affected the solidity of its banking sector. Against a background of relatively slow economic growth, banks' asset quality could see a temporary deterioration, most notably in the most vulnerable sectors like shipbuilding (although shipbuilding accounts for only 2.5% of total loans). Non-performing loan ratios have already risen slightly over the past six months, but remain at very low levels (less than 2%, but 12% in the shipping/shipbuilding sector). Moreover, the macroprudential measures put in place by the Central Bank will help maintain stable financing and liquidity conditions. In addition, banks have enough short-term liquidity (both in local and foreign currencies), which would help them absorb the shock if sources of financing temporarily dry up.

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Indonesia

Smooth acceleration

After a tough year in 2015, Indonesia's macroeconomic situation picked up in 2016. Economic growth accelerated slightly, driven by a hefty increase in public spending in the first half of 2016. Moreover, public finances improved, external vulnerability declined and corporates consolidated their balance sheets. At the same time, reforms were stepped up and the business environment improved. Even though credit risk continued to rise despite the rebound in commodity prices, the banking sector has large capital buffers to handle the situation.

Economic activity accelerated in 2016

In the first 9 months of 2016, economic growth accelerated slightly to 5.2% from 4.8% in 2015. Although this is still far below the average medium-run growth rate, the acceleration reflects the economy's strong resilience to the external environment.

In the first part of 2016, a big increase in domestic demand was the main growth engine, while exports contracted. There was a very big acceleration in government spending, notably in infrastructure investment, but this movement was cut short in Q3 for budget constraints. At the same time, household consumption continued going strong, bolstered by fewer inflationary pressures. In contrast, net exports made another negative contribution to growth as exports contracted at a faster pace than imports.

In the first 9 months of the year, the biggest acceleration was in construction and manufacturing. In the mining sector, activity is expected to rebound in Q4 2016, and even more so in H1 2017, buoyed by higher commodity prices (notably coal, rubber and palm oil) and by the easing of the export ban unprocessed ores, such as nickel, as of 1 January 2017.

The growth forecast for 2017 and 2018 is relatively upbeat. Economic activity should get a boost from a rebound in exports, but also from an upturn in public and private investment as investors take advantage of more accommodating monetary conditions.

Public finances consolidate slightly

In 2015, Indonesia's public finances were undermined by the drop in international commodity prices.

In the first 11 months of 2016, central government revenues increased by 3.9% - despite the ongoing decline in oil revenue - after contracting by 3.2% the previous year. Thanks to the tax amnesty on capital stashed abroad (voted in July 2016) government revenue increased by 0.6 point of GDP. Yet Indonesia's tax base is still one of the lowest in Asia. In 2016, government revenue accounted for only 12.5% of GDP, compared to a range of 16% to more than 21% of GDP for all the other ASEAN-5 countries.

Over the same 11-month period, government spending was cut to only 15.1% of GDP, well below the Minister of Finance's target in its draft budget plan. After significantly increasing spending in H1 2016, the government had to slash spending as of July to face up to lower tax revenues and to maintain the fiscal deficit below the legal threshold of 3% of GDP. Government actions are still restricted due to the high share of rigid expenditure, which still accounted for 31% of total spending in 2016, despite cutbacks in subsidies over the past two years.

In full-year 2016, we expect the deficit for the central government to narrow slightly to 2.5% of GDP, despite an increase in regional transfers.

In 2017, the finance ministry expects all of its fiscal revenues to increase by nearly 0.3 point of GDP to 12.8% of GDP, while spending is to increase by about 0.1 point of GDP to 15.2% of GDP. This budget seems fairly realistic: by reducing the deficit to 2.4% of GDP, it would continue to consolidate public finances.

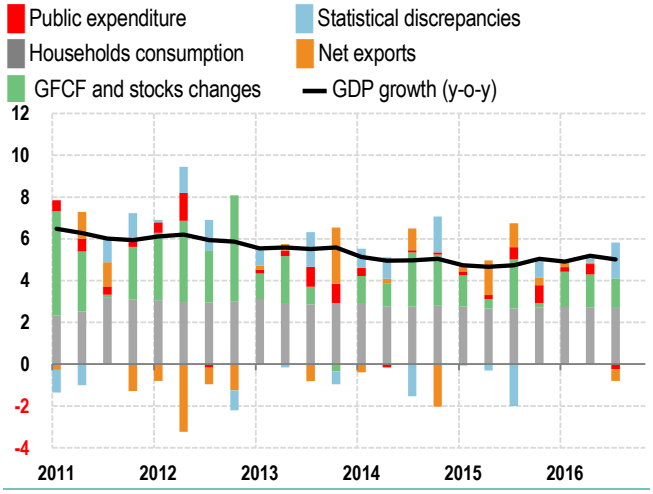
1- Forecasts

	2015	2016e	2017e	2018e
Real GDP growth (%)	4.8	4.9	5.0	5.5
Inflation (CPI, year average, %)	6.4	3.5	3.5	4.3
General gov. budget balance / GDP (%)	-2.7	-2.8	-3.0	-2.8
General government debt / GDP (%)	26.8	28.9	30.6	31.5
Current account balance / GDP (%)	-2.1	-2.0	-2.5	-2.8
External debt / GDP (%)	36.0	35.0	34.8	34.6
Forex reserves (USD bn)	100.6	106.0	113.6	119.0
Forex reserves, in months of imports	6.3	7.2	7.4	7.4
Exchange rate IDR/USD (year end)	13 788	13 436	13 800	14 500

e: BNP Paribas Group Economic Research estimates and forecasts

2- GDP

GDP growth (year-on-year) and contribution to growth (percentage points)



Source: Central bank

A stronger external position

In 2015, Indonesia's balance of payments deteriorated due to the drop in international commodity prices and large capital outflows.

In 2016, the external position has strengthened. In the first 11 months of the year, the balance of payments swung into a surplus of 1.1% of GDP from a deficit of 0.9% of GDP in the year-earlier period. This consolidation can be attributed to a big increase in the trade surplus (driven by a decline in imports) and a large rise in net capital inflows. In the first three quarters, the current account deficit was moderate at 2% of GDP, despite sharply higher interest charges. The capital and financial account surplus amounted to 3.1% of GDP, two points more than in 2015. An improved business climate, the implementation of reforms and the upturn in economic activity created a favourable environment for foreign direct investment and portfolio investment, each of which increased by nearly 0.5 point of GDP in 2016. At the end of September, direct investment in the country completely covered the current account deficit.

The balance of payments surplus resulted in a USD 11 billion increase in foreign reserves in the first 11-months of the year, the equivalent of 1.4 times the country's short-term financing needs.

Yet like all net capital importing countries, Indonesia is still vulnerable to capital flight. At the end of September, it had a net external position of USD 340 billion, the equivalent of 37.5% of GDP. This position is particularly exposed to the international economic and financial environment given the fact that the country's net portfolio investments outstanding account for two thirds of this figure (25.1% of GDP in September, 6 points higher than the previous year).

Consolidation of corporate balance sheets

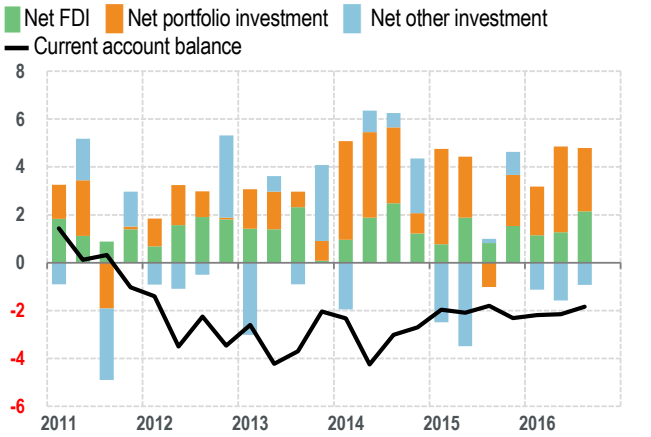
In the period 2011-14, the Indonesian non-financial corporations' debt increased at an average annual rate of nearly 30%. It hit 28.6% of GDP in Q1 2014, nearly 10 points more than in 2011. The most heavily indebted companies were concentrated in the commodity sector: they were particularly hard hit by the global economic slowdown and the decline in commodity prices. Since then, they have had to consolidate their finances. Since mid-2014, the non-financial corporations' debt has slowed to only 0.5% year-on-year in Q3 2016. The debt to GDP ratio fell to 28.4% at end-September, from 31% just a year earlier.

The central bank's latest survey results confirm that corporate balance sheets have improved over the past year. More than 37% of companies esteem that they are in a good financial position, 8 points more than in the year-earlier period. Only 3.3% consider that their situation has gotten worse in Q4 2016, compared to more than 8% in the year-earlier period.

In 2016, several factors facilitated the consolidation of corporate balance sheets, including the rebound in non-farm commodity prices, the stabilisation of the rupiah against the dollar after four successive years of decline, and the easing of lending conditions.

3- Balance of payments

% of annualised GDP



Source: Central bank

A resilient banking sector

Over the past 12 months, interest rates on corporate loans have declined by 100 basis points (bp). Banks passed on only part of the central bank's monetary easing (-275 bp). The lack of monetary policy transmission shows that Indonesian banks are determined to consolidate their balance sheets to face up to the increase in credit risks.

In 2014, the quality of bank assets began to deteriorate at the same time as the erosion of corporate balance sheets. At end-November 2016, non-performing loans accounted for 3.2% of total loans outstanding, 2 points more than two years earlier. This slight increase in credit risk is nonetheless under perfect control, and the banks have large buffers to handle it. Moreover, since 2015, they have managed to consolidate their financial positions. At year-end November, commercial banks had a solvency ratio of 23% and a Tier 1 ratio of 21.3%. Moreover, profitability has improved due to higher interest margins.

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Turkey

Circumspection

"Revision" is the key word: of the national accounts, of the constitution and of diplomatic policy. The first one suggests that Turkey was a tiger economy without knowing it in 2012-2015, whereas all indicators were previously pointing to a slowdown in growth made worse by the deteriorating political situation. However, the rewriting of Turkey's economic narrative does not remove the external vulnerability and the limited credibility of monetary policy. There are plans to revise the constitution in order to strengthen the president's powers, and Turkey has overhauled its geostrategic vision. Political and security concerns are likely to continue dragging down confidence among economic agents and investors, as well as the Turkish lira and economic activity, in 2017.

Major upward adjustments to the national accounts

In December, Turkstat, the National Statistics Institute, published national accounts for the third quarter, accompanied by a revised methodology and revised historical GDP figures, resulting in some good news and bad news. The bad news was the extent of the economic decline following the attempted coup on 15 July. According to the new published data, real GDP fell 1.8% year-on-year in Q3; the failure to publish figures adjusted for seasonal variations and changes in the number of working days means that sequential analysis is not relevant. The upward revision of Q3 2015 GDP growth also raised the base for comparison, leading to a larger year-on-year drop. Most of the reduction in economic activity was caused by a slump in consumer spending (-3.2% year-on-year). The tourist season was disastrous, with summer revenues down 40%. The unemployment rate rose to 11.8% seasonally-adjusted. Investment stagnated (-0.6%), whereas public-sector consumption rose sharply (+23.8%), as expected given the government's expansionary fiscal policy. Exports (-7%) suffered from weak external demand. On the supply side, only the real-estate and construction sectors continued to show growth.

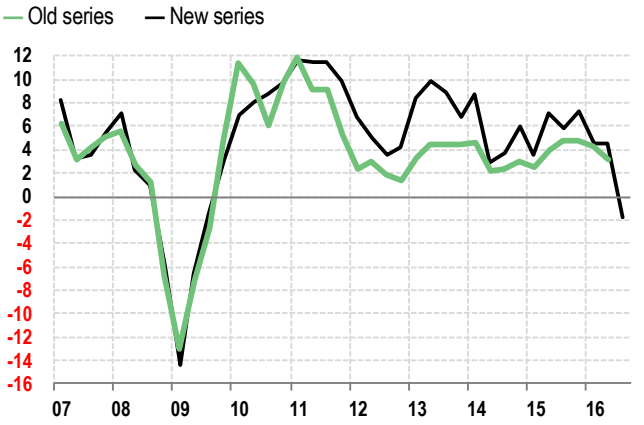
The biggest surprise – and a pleasant although rather puzzling one – was the extent of the upward revision of past economic growth figures from 2011 onwards, following the adoption of European standards (ESA 2010) that comply with international standards (SNA 2008). According to the new figures, real GDP grew at a CAGR of 6.1% between 2012 and 2015, as opposed to only 3.3% under the old standards. Real GDP was revised upward by almost 11% and nominal GDP by 19%. As a result, the breakdown between real and nominal GDP is not an issue. Most GDP components were upgraded. However, consumer spending, which has been the main growth driver since 2013, has been revised lower from mid-2015 onward, suggesting that consumer confidence has become less resilient given the difficult socio-political and geopolitical context. The largest revision concerns investment. Some expenditure such as R&D has been reclassified as investment. Most importantly, despite the lack of detail about gross fixed capital formation (public or private sector; expenditure on machinery/equipment or construction), Turkstat states that the old figures significantly understated the construction boom. This puts a new complexion on Turkish investment, one that is more consistent with the growth in lending to companies seen in the last few years. Even factoring in companies' working capital requirements and the scale of the debt they had to refinance, the old figures showed a lack of correlation between investment and lending that was hard to explain.

1- Forecasts

	2015	2016e	2017e	2018e
Real GDP growth (%)	6.1	2.1	2.5	3.5
Inflation (CPI, year average, %)	7.7	7.8	9.7	8.0
Budget balance / GDP (%)	-1.0	-1.1	-2.9	-1.8
Public debt / GDP (%)	29.0	29.1	30.4	30.8
Current account balance / GDP (%)	-3.7	-3.9	-3.8	-3.6
External debt / GDP (%)	46.8	48.9	58.3	57.3
Forex reserves (USD bn)	95.7	92.0	88.0	90.0
Forex reserves, in months of imports	5.2	5.8	5.2	4.8
Exchange rate USD/TRY (year end)	2.9	3.5	4.1	4.3

e: BNP Paribas Group Economic Research estimates and forecasts

2- Real GDP growth, % y/y



Sources: Turkstat, Bloomberg

A rewriting of macroeconomic narrative, although the country's weaknesses still exist

The new methodology seems to be more robust (chained volume series that remove the effect of price changes, more data from observed sources instead of surveys, reclassification of certain criteria) and the new statistics are meant to reflect the economic reality more accurately: 74% of the gap between the old and new data series is apparently due to measurement errors. However, the new figures mean that the previous analysis of Turkey's economic slowdown since 2012 and lack of productivity growth – following a good decade (average growth of 5%) punctuated by two years of overinvestment (2010-2011) in response to the recessionary impact of the global crisis – is now null. The low domestic savings rate –

singled out as the Turkish economy's Achilles heel and the cause of its dependence on foreign savings – turns out to be a myth. The investment rate has been revised upward by 5 points to 28% and Turkey's external deficit has been revised down by 1 point of GDP because of upgraded GDP figures. Those changes have pushed up the domestic savings rate by more than 6 points. At around 21% of GDP, it is now in line with the average seen in developed countries, higher than figures in Central and Eastern Europe and Latin America, but well below Asian levels. Overall, therefore, the Turks are substantially richer and less spendthrift than previously thought, while ratios regarding the public finances have also improved from relatively good levels.

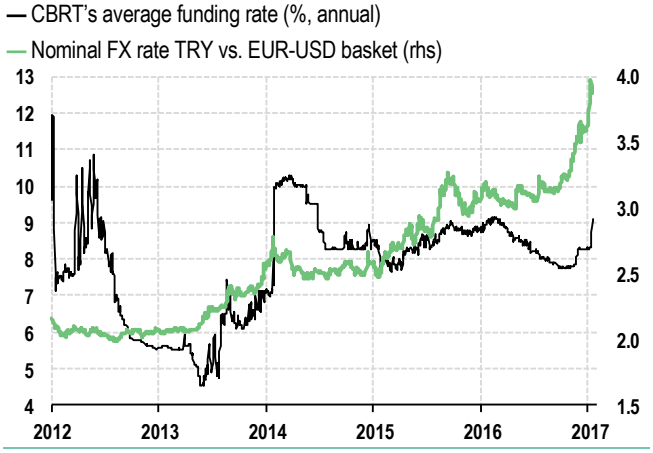
However, Turkey's external position remains vulnerable. Nominal GDP in US-dollar terms has been trimmed by the sharp decline in the Turkish lira, which has fallen 50% against the euro-dollar basket since May 2013. The country's external borrowing requirements remain substantial at almost USD 200 bn in 2016, equal to almost 25% of estimated GDP, because of a current-account deficit of around USD 35 bn and external debt repayments of around USD 135 bn. USD 200 bn is also the amount of foreign-currency debt owed by Turkish non-financial companies, most of which is onshore (i.e. owed to local banks) and involves medium- to long-term maturities. Set against those foreign liabilities, FX reserves declined slightly year-on-year at USD 92 bn in December 2016. They provide a relatively thin safety cushion, especially since "free" FX reserves (i.e. excluding commercial bank deposits at the central bank) only amount to USD 37 bn. Since peaking in May 2013, when the Fed announced its tapering plan and Turkey's social unrest began, local-currency assets (bonds and stocks) held by non-residents have fallen from USD 152 bn to USD 61 bn, due to around USD 9 bn of net portfolio investment outflows but more importantly because of currency and valuation effects.

...notably given deteriorating political and security situation

Terror attacks by IS and the PKK are becoming more common, especially since Turkey started its military involvement in Syria in August, and a state of emergency was reimposed in July. The crackdown on institutions and businesses has widened beyond Gulenist circles and is continuing, making social divisions worse. On 22 January, the Turkish parliament adopted a plan to revise the constitution, introducing a strong executive presidency (removing the position of prime minister and replacing it with that of a president who is the head of the government and the majority party; giving the president more powers over the judiciary, etc.). A referendum should take place in the next three months. That could be followed by early parliamentary elections in order to make the reform applicable immediately instead of in 2019, and to replace existing MPs, some of whom are suspected to be Gulenists. In addition to the difficult domestic and regional context, diplomatic relations with the USA and EU have become strained again and Turkey has moved closer to Russia, while Donald Trump's election victory has had a negative impact on all emerging markets.

The lira has fallen sharply, dropping 35% against the dollar since July 2016, including 32% since Moody's cut Turkey's sovereign credit rating to junk in late September (a move that Fitch followed on 27 January), 23% since the US election in November and 10%

3- Interest rates and foreign exchange rates



Sources: CBRT, Datastream, BNP Paribas

since the start of 2017. The authorities are nervous, and President Erdogan has suggested to holders of foreign-currency assets that they convert them into lira to show patriotism. Although some public- and private-sector companies have apparently complied with that request, the conversion of bank deposits into euros and dollars has accelerated, clearly showing the concerns of savers. There have been rumours that capital controls will be introduced. However, the government has quickly denied them, conscious of the devastating impact that constraints on capital outflows will have on capital inflows, which are crucial if the balance of payments is to remain sustainable. Higher taxes on foreign-currency deposits, which would not constitute capital controls, would in theory have little effect on the behaviour of savers, who are looking more for safety than high returns. A simple ban on foreign-currency deposits cannot be ruled out.

In its 2017 monetary and exchange-rate policy programme, the central bank (CRBT) reiterated its "official" target of price stability within a floating exchange-rate system. Nevertheless, shock therapy such as the sharp hike in interest rates carried out in January 2014 does not appear to be on the cards. Political pressure and the flagging economy mean that monetary policy remains rather loose. The limited action taken in November (symbolic increase in the one-week repo rate and overnight lending rate) was not enough to stem the rapid decline in the lira or the major inflationary pressure also resulting from higher oil prices and increases in wages and certain taxes. Since 16 January, the CBRT has focused on its "late liquidity window", the interest rate of which was hiked by 100 bp to 11% at the latest monetary policy committee on 24 January. The one-week repo rate was unchanged (8%) and the o/n lending rate was hiked by 75 bp to 9.25%.

Our baseline scenario does not include stagflation. However, the high level of political and security risk is likely to remain a drag on the lira, confidence among economic agents and foreign investors, and therefore economic activity.

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Hungary

Tax policy to boost growth

Economic growth slows down. Consumption growth accelerates, boosted by job creations and wage growth. Investment collapses, reacting to the slowdown in EU funds' absorption in 2016, but should recover in 2017. Inflation is back in positive territory, but does not justify a tightening in monetary policy. With the cut in corporate income tax and the reduction in social contributions, the government intends supporting activity as well as boosting the country's attractiveness for investors. The intensity of the crowding out effect is weakening, paving the way for a recovery in banks' lending to the private sector.

Growth slows in a context of EU funding "normalization"

The Hungarian economy has recovered its way to sustained growth since 2013. Growth accelerated strongly in 2014-2015, expanding at rates above 3% before slowing to 1.5% over the first three quarters of 2016. While private consumption (60% of total GDP) has been accelerating gradually since 2013, reaching 4% y-o-y in Q1-Q3 2016, investment (20% of GDP) has been extremely volatile. Double-digit growth in 2013-2014 was followed by near-zero growth in 2015 and a double-digit contraction in Q1-Q3 2016

This volatility was due to the contraction in EU budget transfers. The bulk of the funds allocated in the 2007-2013 fiscal envelop was disbursed in 2014-2015 (the deadline for the disbursement was set at end-2015). These funds were added to the "regular" disbursement decided within the 2014-2020 envelop. In 2016, the situation was back to "normal" with only the 2014-2020 envelop available; hence funding may have contracted strongly compared with the peak reached in 2014-2015, triggering the investment downturn. Disbursements of EU funds are likely to remain the key factor explaining short- and medium-term economic growth. The authorities' efforts to accelerate the disbursement of EU funds aim to smooth out the inflows: if realized, it may allow reducing investment and growth volatility.

The labor market performed quite well, with the decline in the unemployment rate to 5% in August 2016 (from 10% in 2013) and the increase in the rate of activity. However, such a rapid recovery in employment is triggering labor shortages, in particular for high-quality jobs. Wages picked up quickly (+6% y-o-y over the 9M-2016), stimulating consumption, but confirming potential tensions on the labor market.

Real estate prices recovered from the drop of 2008-2014, reflecting returning demand for homes. The increase in the delivery of building permits and the measures of support for modest families wishing to acquire their residences (Family Housing Allowance) should lead to acceleration in home construction activity in the short term.

Inflation is back

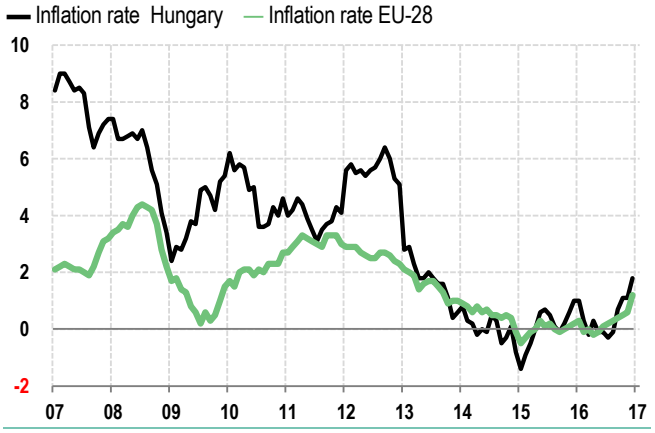
Inflation returned to positive territory in September 2016 after four consecutive months of negative readings. The harmonized indices of consumer prices (HICP) reached 0.46% y-o-y on average in 2016, accelerating to 1.8% at the end of the year. This is in line with the trend for the acceleration in inflation observed in the EU (Chart 1).

1- Forecasts

	2015	2016e	2017e	2018e
Real GDP growth (%)	3.1	1.4	1.6	2.0
Inflation (HCPI, year average, %)	0.1	0.5	2.1	2.5
Gen. Gov. balance / GDP (%)	-1.6	-2.1	-2.6	-2.6
Gen. Gov. debt / GDP (%)	74.7	74.3	74.9	74.1
Current account balance / GDP (%)	4.4	6.0	3.8	3.2
External debt / GDP (%)	106.0	93.3	90.9	81.6
Forex reserves (USD bn)	33	25	28	30
Forex reserves, in months of imports	3.9	3.0	3.2	3.2
Exchange rate EUR:PLN (year end)	316.00	309.07	312.00	320.00

e: BNP Paribas Group Economic Research estimates and forecasts

2- Inflation picks up in line with the EU trend



Source: Eurostat

The return of inflation should end the period of policy rate cuts (at 0.9% since May 2016). But, as inflation remains below the 3% target of the National Bank (MNB), it is too early for rate hikes. Moreover, economic growth and employment are high on the MNB's list of priorities. Therefore, the bank may tolerate a much higher inflation rate if it helps to further stimulate job creation.

External accounts remain in very good shape

The current account has been enjoying sustained surpluses since 2011. Capital account surpluses (mainly from the EU budget) are added to the current account surpluses.

This allowed a net repayment of USD 8 bn in external debt obligations by the state and the private sector. After peaking at 1.5xGDP in Q1-2010, the overall foreign debt reached 1xGDP in mid-2016.

As a result of this active external deleveraging and the accumulation of foreign assets by banks, foreign reserves declined from USD 33 bn end-2015 to USD 25 bn end-2016. For the moment, the level of reserves remains adequate at about 3 months of imports.

In 2017, we expect the current account surplus to narrow under the pressure from expanding domestic demand and the recovery in energy and commodity prices. In order to maintain external liquidity, the pace of foreign debt deleveraging will have to be slowed. The government even envisages returning to foreign bond markets with the EUR 1 bn Eurobond issuance.

Fiscal policy keeps accomodative

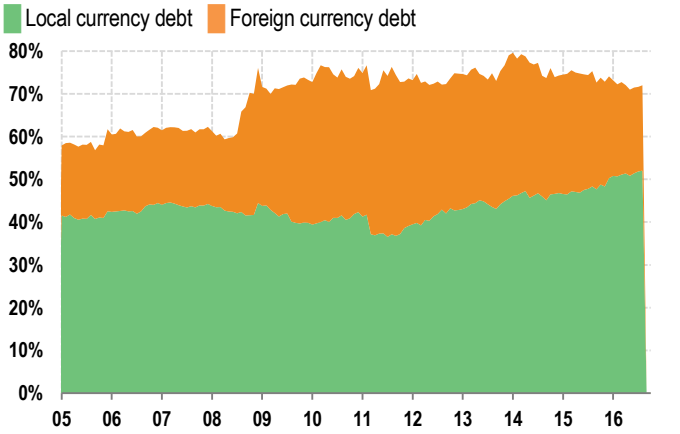
Fiscal performance was quite good in 2016. Taking into account the sharp acceleration in spending in December, the cash deficit attained 2.4% of GDP for the full year. The entire year's fiscal outcome measured using the ESA methodology will stay comfortably below the 3% threshold.

The fiscal plan for 2017 targets a deficit of 2.4% of GDP as well. The authorities intend to pursue growth-supporting policies in 2017 ahead of the 2018 election. The most important fiscal initiative will be the cut in the corporate income tax (CIT) to 9%, which would be the lowest level in the EU. In the meantime, the 23% increase in the minimum wage will oblige companies to "share" some of the gains from the cut in the CIT with the employees. In order to avoid a switch to the use of undeclared work, the government intends to cut payroll taxes by 5%. The VAT rates on several primary foodstuffs will also be reduced from 27% to 5%.

On the expenditure side, an increase in spending on health and education is planned. Wages of teachers will increase in September 2017, followed by those of medical personnel (doctors and nurses). The subsidies for families will reach a record of 4.7% of GDP via the increase in tax breaks for families with two or more children. The measure targets encouraging birth in a country where the birth rate (1.35 children per woman) remains among the lowest in the region.

With 2018 elections on the horizon, it is likely that the government will again resort to last-minute spending at the end of 2017. Thus, the 2017 ESA deficit could eventually turn out to be above the government target of 2.4% but should remain below the 3% EU threshold.

3- Government debt in national and foreign currency
In % of GDP



Sources: Hungary's Ministry of Finance, BNP Paribas

Debt dynamics: crowding-out effect to ease

Central government debt attained 72% of GDP in November 2016, compared with the peak of 80% reached in 2014. Debt remains however substantially above the cap of 60% GDP set by the Treaty of Maastricht. The interest rate on Treasury bills was close to zero end-December 2016. The low interest rate environment has enabled the government to attract HUF funding at very favorable conditions, thus allowing a reduction in currency risk and debt servicing costs at the same time.

The "Self-Financing Program", which gives national savings priority over foreign funding in financing public deficits allowed reducing the share of foreign-currency debt in the total to 25% in November 2016 (declining from the peak of 41% mid-2014).

The situation in the banking sector points to the beginning of a recovery in lending to the private sector. The intensity of the crowding-out effect, which emerged as a side effect of the "Self-Financing Program" is easing. The quality of the loan portfolio improved: the NPL ratio went below 10% mid-2016 (declining from the peak of 17% mid-2013). Credit institutions restored profitability, with the return on equity ratio reaching 19% in Q2-2016 (it was at 4.5% mid-2015). Therefore, the era of distress in the banking sector seems to be behind us. The coming quarters will show whether the sector has strengthened enough to become a genuine growth driver, without central bank support.

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Egypt

Continued reform momentum key to recovery

Egypt's economic slump could bottom out in 2016/2017. Ongoing fiscal reforms, a floating currency, massive external support and favourable energy prospects could lead to a reduction in the fiscal and current account deficits. Yet any improvements will be slow in the making, and vulnerable to external economic and political factors. Above all, high inflation introduces the risk of social discontent in the short term. The return to strong, sustainable growth will depend on the authorities' capacity to restore confidence of local and non-resident investors.

Foreign-currency liquidity improves significantly

Since November 2016, the decision to float the Egyptian pound (EGP) and the financial assistance agreement reached with the IMF have significantly changed the country's short-term economic prospects. The pound depreciated by more than 40%, and part of the foreign-currency liquidity returned to the banking system, thanks to significantly higher interest rates (the Central Bank of Egypt raised its key rate by 300 bp). About USD 4 billion returned to the official banking system and more than USD 1.3 billion entered the country as portfolio investment. Official capital flows are expected to exceed USD 10 billion in 2016/2017. In addition to an IMF loan of USD 2.8 billion (out of a total of USD 12 billion over three years), there was USD 1.5 billion in loans from the World Bank and African Development Bank, about USD 3 billion in GCC government deposits, and about USD 2.6 billion in a currency swap agreement with China. A reverse repo financing agreement was also reached with a consortium of international banks that provided an additional USD 2 billion in fresh capital. At the end of December 2016, the central bank's foreign reserves amounted to USD 24.5 billion, up from USD 19 billion at the end of October. Although the level of foreign-currency liquidity is not comfortable yet, it is nonetheless acceptable. We expect CBE foreign reserves to reach USD 28 billion at end 2016/2017, which is equivalent to 4.8 months of imports of goods and services, compared to less than 3 months in 2015/2016.

Higher inflation and sluggish growth in the short term

The pound's sharp depreciation has direct consequences on domestic prices, given the massive imports of numerous consumer goods. Since November, the increase in food prices (40% of the price index) has been the main driver of inflation. Headline inflation is expected to double this year to an average annual rate of more than 20%. Although we expect inflation to drop to about 14% on average in 2017/2018, certain factors could help hold it above our forecast.

In large parts of the private sector, wages are expected to rise 15-20%. At a time when household purchasing power is falling sharply, wages will remain under strong upward pressure, which could contribute to inflationary pressures. Another inflationary factor is the mild increase in international oil prices expected as of 2017. Although it is hard to estimate, inflation might also be due in part to money supply growth. The monetisation of the fiscal deficit has been clearly declining over the past year, but it could re-emerge if fiscal results are not as strong as expected. In the short term, support from international donor funds should reduce this risk.

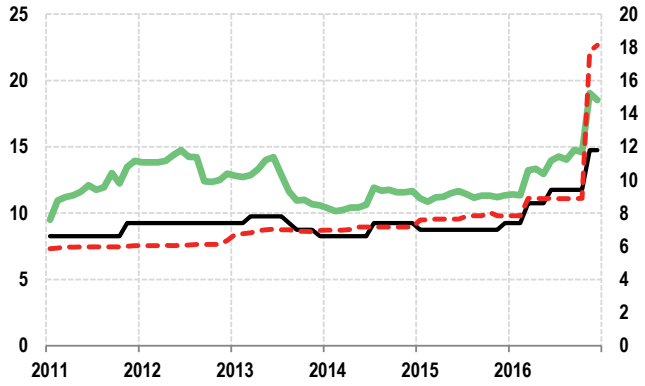
1- Forecasts

	2015	2016e	2017e	2018e
Real GDP growth (%)	4.1	4.3	3.8	4.5
Inflation (CPI, year average, %)	11.5	10.2	20.2	14.5
Gen. Gov. balance / GDP (%)	-11.4	-12.2	-10.0	-8.2
Gen. Gov. debt / GDP (%)	90.0	94.0	93.0	87.0
Current account balance / GDP (%)	-3.8	-5.6	-4.5	-4.7
External debt / GDP (%)	17.0	18.0	32.0	31.0
Forex reserves (USD bn)	20	18	28	30
Forex reserves, in months of imports	3.1	2.9	4.8	4.9
Exchange rate EGP/USD (year end)	7.4	8.2	14.6	16.5

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

e: BNP Paribas Group Economic Research estimates and forecasts

2- Exchange rates and interest rates



Sources: CBE, Macrobond

Economic growth was buoyant in 2015/2016 (estimated at 4.3%) thanks to private consumption (80% of GDP) and investment in real estate, energy and infrastructure. GDP growth is unlikely to be as strong this year (estimated at 3.8%) due to the sharp decline in household purchasing power. Moreover, even though imports were restricted in the first half of the year, the net contribution of exports to growth is unlikely to improve significantly due to higher natural gas imports and the limited short-term impact of the pound's depreciation on non-oil exports. In the real estate sector, growth will not be as strong this year due to higher construction costs and the decline in disposable income, which could have a negative impact on investment.

Towards a reduction in the current account deficit

Egypt's three traditional sources of external income are currently under pressure. The energy external balance continues to deteriorate due to the growing use of relatively high-priced natural gas imports. The energy deficit is expected to swell to a record high of USD 4.6 billion in 2017/2018. With the start-up of production at the Zohr gas field, the country should become self-sufficient in natural gas by 2019. However, with natural gas imports accounting for only 30% of hydrocarbon imports (excluding crude oil), we expect an energy deficit of at least USD 1 billion to persist in the medium term (2019/2020). It is worth recalling that in 2009/2010, Egypt reported an energy surplus of more than USD 5 billion.

Tourism activity is weak. Since 2013, tourist numbers and revenues have been slashed by more than half. The situation could improve in the short term as some countries lift travel restrictions. Rising arrivals from China and the pound's depreciation should also support this trend. Yet the security situation is still tight, and business in this sector is bound to pick up very slowly.

Suez Canal revenue has stagnated even though capacity was recently doubled. This is mainly due to the sharp slowdown in global trade in 2016 (+1.9% vs. 2.7% in 2015 according to the IMF). In 2017, canal revenues should pick up again in keeping with world trade (estimated at +3.9%), even though most of the recovery will occur in Asia.

As to the non-hydrocarbon trade balance, prospects are uncertain, at least in the short term. A non-negligible share of imports (notably foodstuffs) is hard to compress, even though they cost more in the local currency. As to exports, higher import costs could discourage exporters from reducing export prices in order to preserve a certain level of margins.

All in all, the current account balance could narrow, although it is likely to hold above USD 12 billion through 2017/2018. Private capital flows and the support of bilateral and multilateral donor funds will limit the downward pressure on the pound. According to our estimates, support from official donor funds and sovereign issues on international markets should cover about two thirds of the current account deficit in the medium term. Whether foreign reserves hold at an acceptable level will depend on the country's capacity to maintain attractive conditions for investors (interest rate level and exchange rate expectations).

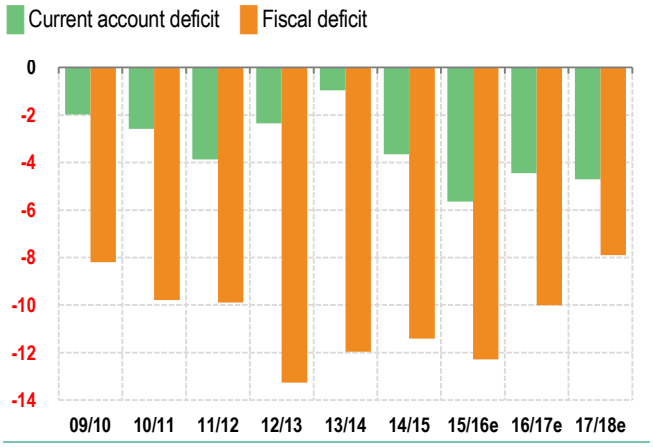
Public finances under pressure

The IMF loan agreement enabled the government to continue pursuing the fiscal reform policy launched in 2014. The two main measures are VAT reform, including a higher VAT rate, and cutbacks in energy subsidies (electricity and gasoline). According to the IMF, all these fiscal measures (including increases in certain social welfare expenditures) should bring in additional net revenue of 2.9% of GDP.

Given the size of the country's deficits (which averaged 11.8% of GDP over the past five years) and the rigidity of certain expenses, reducing the fiscal deficit will be a slow process. Interest charges on the public debt and wages account for 49% and 43% of total fiscal revenues, respectively. Maintaining high interest rates and meeting social demands during a period of high inflation will make it hard to control these two expenditures. Despite the implementation of reforms, the primary fiscal balance should remain slightly negative in the medium term (less than 1% of GDP as of 2017/2018).

3- Fiscal and current account deficits

% of GDP



Sources: Ministry of finance, CBE, BNP Paribas

Under this environment, public debt should narrow, but will remain at high levels. Estimated at 94% of GDP in 2015/2016, public debt could be trimmed to 87% in 2017/2018. At the same time, the share of external debt will double to about 20% of total public debt.

Several factors will undoubtedly have a positive macroeconomic impact, including the floating pound, improvements in foreign currency liquidity, the accelerated pace of fiscal reforms, and the start-up of production at the Zohr gas field. Yet the public and external accounts will continue to show deficits in the medium term, and the authorities will have to deal with growing social pressures at a time of high inflation. Only the return to strong growth (notably via job-rich investments in non-energy sectors) will enable the Egyptian economy to pull out of a 5-year slump.

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Senegal

Improvements must still be confirmed

Economic growth is picking up, buoyed by favourable tailwinds and the start-up of an ambitious infrastructure programme. The consolidation of public finances continues to progress, and public debt should begin to decline as of 2017. Yet there is little manoeuvring room. Fiscal discipline cannot be eased given the high level of public debt. Alongside financial constraints, the authorities will have to engage in a vast reform programme to set economic growth on a more solid path. As a member of the West African Economic and Monetary Union (WAEMU), Senegal can nonetheless count on the stabilising mechanisms of the CFA franc zone, whose sustainability is not threatened yet despite persistent vulnerabilities.

Growth: renewed optimism

Is the Senegalese economy finally turning the page after a long period of sluggishness? This is what the strong growth figures of the past two years seem to be saying. According to the estimates of the National Agency of Statistics and Demography (ANSD), real GDP rose 6% in the first 9 months of 2016, after a strong 6.5% in 2015. This is a significant rebound compared to the period 2006-2014, when growth averaged only 3.4% a year. It is also double the Sub-Saharan average, excluding South Africa.

The economy was lifted by several buoyant tailwinds, beginning with the drop-off in oil prices, which reduced the total import bill by nearly 3 points of GDP between 2014 and 2016. With inflation virtually nil over the past two years, lower energy prices were also a supportive factor for household consumption. On top of this are favourable weather conditions for agriculture and the first effects of the Plan for Emerging Senegal (PSE), although it is hard to quantify the impact at this point. Launched in 2014, PSE is an ambitious USD 19 billion infrastructure programme, 40% financed by international donor. Numerous infrastructure projects have been identified, notably in energy, whose dysfunctions have long placed a damper on growth.

Under this environment, the perception of the country's prospects has improved considerably. The IMF is now forecasting growth of close to 7% in 2017. The risk premium on Senegalese government bonds in foreign currency is now among the lowest in Sub-Saharan Africa. And there is more good news: major offshore hydrocarbon fields have been discovered, which should stimulate foreign investment, even though any commercial exploitation of these resources is unlikely to start up before 2021.

Fiscal consolidation: maintain the cap

The consolidation of public finances is another source of satisfaction. The fiscal deficit has been cut from 6.7% of GDP in 2011 to 4.3% in 2016, thanks to major efforts to streamline current expenditure. At the same time, the government has preserved its investment capacity. Capital expenditure continued to rise by 10% a year over the period 2012-2016, and now accounts for more than 40% of the budget, up from 36% in 2011. The authorities' ambitious but apparently credible deficit reduction target is to bring it in line with the standard for the West African Economic and Monetary Union (WAEMU) of 3% of GDP by 2018.

Yet the authorities have little manoeuvring room. On the revenue side, expected improvements in tax collection should be taken with caution, especially in a country where taxes already account for 20% of GDP. Admittedly, this is low compared to international standards, but well above the WAEMU's norm of 17%. On the spending side, pressures are still high given the government's ambitious public investment plans. Legislative elections in 2017 and presidential elections in 2019 also do not augur well for moderation in the growth of expenditures.

Moreover, since the massive debt forgiveness granted by bi-multilateral donors in 2006, public debt has increased rapidly. Expressed as a percentage of GDP, public debt was estimated at 59.2% at year-end 2016, vs 21.8% ten years earlier. At the same time, the dynamics was accompanied by greater recourse on non-concessional financial sources, notably in the domestic/ regional debt market. Domestic borrowing accounts for more than 40% of the increase in public debt since 2011. Like the other Sub-Saharan

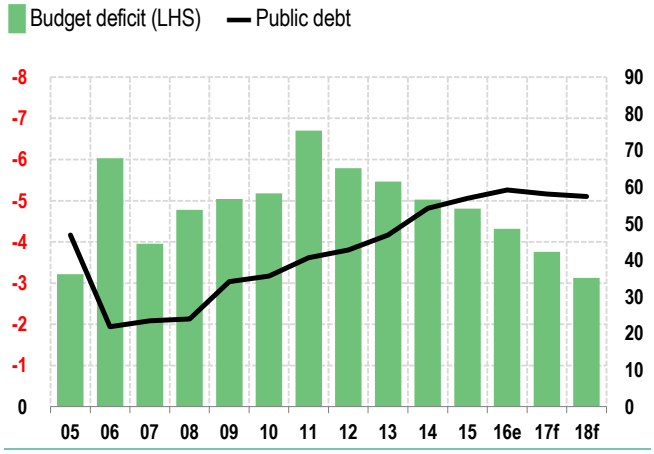
1- Forecasts

	2015	2016e	2017e	2018e
Real GDP growth (%)	6.5	6.0	6.0	6.2
Inflation (CPI, year average, %)	0.1	0.8	1.7	1.8
Budget balance / GDP (%)	-4.8	-4.3	-3.8	-3.1
Central. Gov. debt / GDP (%)	56.9	59.2	58.1	57.4
Current account balance / GDP (%)	-7.8	-7.0	-7.4	-7.7
External public debt / GDP (%)	41.1	39.9	39.8	38.9
Forex reserves (USD bn)	2.1	2.1	2.2	2.2
Forex reserves, in months of imports	4.1	4.0	3.8	3.6
Exchange rate CFAF/USD (year end)	603	622	665	610

e: BNP Paribas Group Economic Research estimates and forecasts

2- Fiscal and debt indicators

% of GDP



Sources: Ministry of Finances , IMF, BNP Paribas

African countries, Senegal has also benefited from abundant global liquidity to issue euro-bonds on three different occasions since 2009. Although the diversification of financial resources is a positive change in itself, notably in terms of liquidity, this implies a higher cost.

At this point, the situation is still manageable. Though rising, interest charges still account for just under 10% of government revenues. Moreover, Senegal benefits from institutional stability – which is relatively rare for the region – ensuring that it will continue to receive lasting support from the international community. Yet the country still needs to reduce its debt to rebuild some manoeuvring room in case of a shock. We expect this to happen as of 2017, assuming the fiscal consolidation programme continues to progress well.

Medium-term outlook: obstacles must be cleared

Despite upbeat prospects, there is still reason to doubt the economy's capacity to sustain the growth rates of the past two years. In the past, Senegal has already experienced periods of strong growth followed by sharp slowdowns due to domestic or exogenous shocks (bad harvests, rapid rebound in oil prices). Yet without speaking about potential shocks, the economy still faces major constraints in the medium to long term.

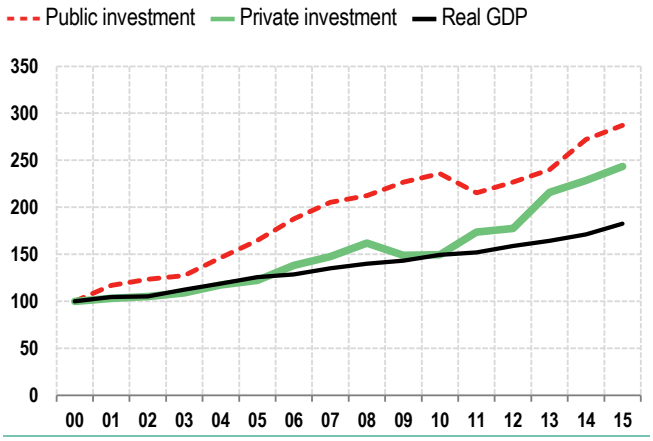
The structural impact of the PSE might not be as strong as expected. On the one hand, the economy suffers from a lack of infrastructure. On the other, an acceleration in public investment is far from being a sufficient condition for setting growth on a solid path. This is one conclusion that can be drawn from the past fifteen years, when public investment has increased 2 points faster, on average, than private investment. Moreover, fiscal discipline cannot be eased given the already high level of public debt. At the same time, the business climate needs to be improved. The challenges are enormous. Despite notable progress over the past three years, Senegal still ranks 147th in the latest World Bank "Doing Business" ranking of 190 countries. In addition, the economy suffers from a weak competitiveness of exports, which though relatively diversified, still cannot count as a powerful growth engine. The same can be said for the country's attractiveness. Although foreign direct investment inflows rose from 2.1% of GDP in 2013 to 2.5% in 2014-15, they are still two times less than the average for the oil importing countries of Sub-Saharan Africa.

The CFA franc zone: sustainable, but vulnerabilities remain

One characteristic of Senegal is its membership in the West African Economic and Monetary Union (WAEMU), whose mechanisms are based on the full convertibility of the CFA franc guaranteed by the French Treasury at a fixed rate against the euro. In counterpart, FX reserves are pooled at the regional central bank, the BCEAO, of which at least 50% are deposited on an account at the Banque de France. Although the monetary flexibility of member states is necessarily limited, the gains in terms of macroeconomic stability are significant. Inflation in the sub-region is structurally low, and the risk of a balance of payments crisis is de *facto* greatly reduced. In the light of the monetary turmoil recently experienced by several African economies, and not only the oil producers (Ghana, Zambia), it is an undeniable supportive factor. Furthermore, there are no

3- Public investment drives growth

Index:, 2000 =100



Sources: Ministry of Finances , BNP Paribas

tangible signs of currency overvaluation according to the IMF. Lastly, the peg is technically sustainable despite the erosion of FX reserves.

Even so, the fall in oil imports (all WAEMU's countries are net oil importers) did not ease the pressures on the external accounts. Public investment in infrastructure has continued to fuel a robust growth of imports, keeping the region's current account deficit at a high 6% of GDP since 2015. Moreover, forecasts call for similar if not slightly higher deficits in the future. In the meantime, external liquidity is still comfortable, but eroding. At end-October 2016, the BCEAO's gross foreign assets covered 76% of short-term liabilities down from 82% at year-end 2015 and a peak of 120% in the mid-2000s. There is still room before reaching the statutory limit of 20%. However, without a sustained development of export, a consolidation in public finances could be necessary in the medium-term to maintain the sustainability of the peg.

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Angola

No bright skies on the horizon

In Angola, adjusting to the "new normal" for oil prices has been particularly painful due to the economy's lack of diversification. Growth has slowed sharply at a time of currency rationing and drastic cutbacks in public spending. The current upturn in the oil market should have a favourable impact, albeit without triggering a real easing of external or fiscal constraints. This environment raises the question of the sustainability of public and external debt, notably in the medium term.

In Angola, the adjustment to the new balance prevailing in the oil market has been particularly painful due to the lack of economic diversification. In 2013, when Angolan crude oil prices still surpassed USD 100 a barrel, the oil sector was the source of 98% of export revenues, nearly 75% of fiscal receipts, and more than 40% of the economy's entire value added.

Adjusting to the "new normal" for oil prices

The sharp drop in oil prices starting in mid-2014 triggered a significant tightening of fiscal and external constraints, requiring macroeconomic policies to be adjusted rapidly. According to our estimates, government primary expenditures were slashed by more than 40% in real terms (deflated by the consumer price index) in 2015 and by another 20% in 2016. More importantly, the National Bank of Angola (BNA) has devalued the kwanza's official exchange rate by almost 70% against the dollar since September 2014 (from AOA 97.8 to AOA 165.9 to the dollar), while strictly rationing foreign currency supply to preserve foreign exchange reserves. A priority list[1] was established to regulate access to foreign currency at the official exchange rate, and a special tax was levied on capital outflows associated with technical assistance and service contracts. At the same time, LUIBOR, BNA's benchmark rate, was raised by 725 basis points (from 8.75% to 16%) to contain the inflationary pressures resulting from the kwanza's depreciation and foreign currency rationing.

Contractionary effects

In an economy highly dependent on imports and public demand, these measures had a negative impact on both activity and price momentum. Inflation soared to 42% year-on-year in December 2016, and growth slowed markedly. After exceeding 10% a year on average during the period 2003-2013, real GDP growth barely hit 3% in 2015 according to preliminary data published by the finance ministry. This mild growth was largely fuelled by the oil sector, which reported its best performance in volume terms (+6.3%) since 2008, despite falling prices. Technical and operational problems were not as frequent as usual, which enabled production to pick up (from 1.65 m barrels a day to 1.76 m barrels a day according to official data).

Yet this support factor vanished in 2016. According to official statistics, oil production declined by 3.3% in 2016 due to maintenance problems and the postponement of certain investment projects. Secondary sources point to a slightly less negative trend, but nonetheless suggest a decline in Angolan crude oil production in 2016 (-1.2% according to OPEC data). Meanwhile, agricultural production kept on suffering from bad weather conditions, and the situation in the other sectors of the economy doesn't seem to have improved either. After reporting their worst performances in a decade in 2015, the construction, manufacturing and services sectors continued to be hit by budget cuts and currency shortages. According to Fitch, the agents had to wait on average 4 to 8 months for obtaining dollars at the official exchange rate last October. This has driven part of demand onto the black market, where the kwanza is still trading at a rate three to four times higher than the official exchange rate, illustrating the persistently sharp imbalance between supply and demand. The recent loss of correspondent banking relationships also seems to have aggravated the difficulties for

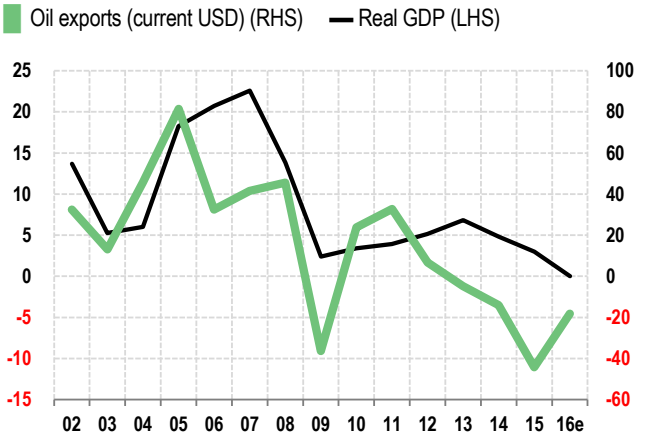
1- Forecasts

	2015	2016e	2017e	2018e
Real GDP growth (%)	3.0	0.0	1.6	2.3
Inflation (CPI, year average, %)	10.3	32.4	30.0	30.0
Cent. Gov. balance / GDP (%)	-3.3	-5.5	-5.7	-3.5
Cent. Gov. debt / GDP (%)	64.2	77.4	65.9	52.8
Current account balance / GDP (%)	-10.0	-12.0	-8.5	-5.8
External debt / GDP (%)	32.8	41.6	38.4	32.1
Forex reserves (USD bn)	24	20	18	14
Forex reserves, in months of imports	7.5	7.0	6.0	5.5
Exchange rate USD/AOA (year end)	135	166	166	166

e: estimates and forecasts BNP Paribas Group Economic Research

2- A marked slowdown in real GDP growth

Annual percentage change



Sources: Ministry of Finances, BNP Paribas, BNA

[1] Priority is given to food imports, medical imports, and imports for development projects and the oil sector.

accessing dollars and made cross-border payments even more complex.[2] In such an environment, real GDP growth might have slowed further, and we expect the economy to have stagnated in 2016.

Still tight external and fiscal constraints in the short term

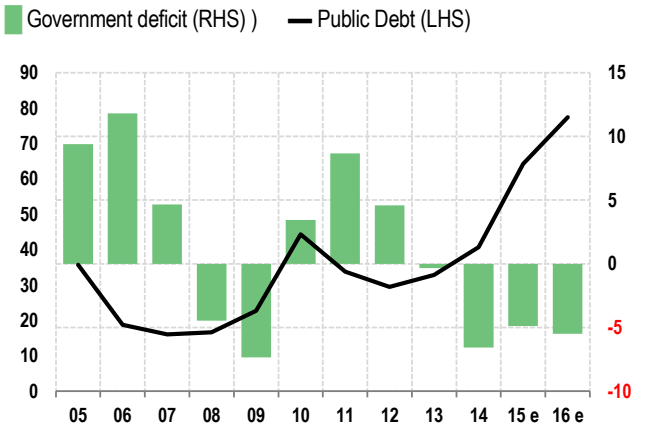
In the short term, any acceleration in real GDP growth requires a substantial easing of fiscal and external constraints. As encouraging as they may sound, recent oil market trends are unfortunately unlikely to be strong enough to restore a significant room for manoeuvre. According to our central scenario assumptions, oil prices are expected to stay far below the 2013 and 2014 averages over the next two years (USD 58 per barrel on average in 2017 and USD 63 per barrel on average in 2018 for the Brent, to be compared to USD 99 per barrel on average in 2014). For Angola, this means a shortfall of export revenues of more than USD 36 billion (1.6 times the amount of foreign reserves) compared to 2014, *ceteris paribus*. The situation is slightly better in terms of fiscal revenues, because the depreciation of the exchange rate automatically increases the kwanza value of oil-related taxes, which are generally denominated in dollars. Yet assuming the authorities forego this leverage in 2017-2018, to avoid adding to what is already a very high inflation, fiscal revenues from the oil sector would fall short of the 2014 level by nearly 1.8 points of GDP.

Worrisome debt dynamics

In an environment of still lower oil prices, the sustainability of public and external debt over the medium term remains an issue. Fiscal metrics have deteriorated sharply over the past three years. Despite drastic spending cutbacks, the government failed to bring the fiscal deficit below 5% of GDP in 2016, and the public debt virtually doubled between 2013 and 2015. According to the IMF, it even surpassed the threshold of 70% of GDP in 2016. Granted, high inflation and very negative real interest rates should help contain the increase in the debt/GDP ratio. The government's foreign assets (USD 4.5 billion in the sovereign wealth fund and USD 9.5 billion in deposits in the local banking system) should cover about 80% of debt servicing in 2017. Looking beyond the short term, however, there are numerous sources of fragility. The share of foreign-currency denominated public debt (about half of public debt) is in particular concerning, even though fiscal receipts are also for a part dollar denominated. The government might even have to favour increasingly external over domestic financing, as it can hardly continue to raise funds at such negative real rates on the domestic market without destabilising further a banking sector that is already fragile and highly exposed to public debt.

Moreover, public entities are probably the Angolan counterparties that can the most easily raise external financing to cover the current account deficit, which reached 10% of GDP in 2015 and 12% in 2016, according to our estimates. Indeed, the current level of oil prices might reduce the appetite of oil companies for Angolan reserves, whose operating costs are high. Foreign capital inflows

3- A pronounced deterioration in fiscal metrics
% of GDP



Sources: IMF, BNP Paribas

into other sectors of the economy are also likely to remain subdued in the current environment due to: i/ weak growth prospects, ii/ numerous shortcomings in the banking and financial regulation relative to international standards, iii/ uncertain access conditions to foreign currency, and iv/ a difficult business climate.

External account sustainability and public account sustainability are therefore closely related. The break-off of negotiations with the IMF in mid-2016 has reduced the authorities' access to emergency funding, but other multilateral and, above all, bilateral financing lines (China) are likely to keep on materializing. If this is not the case, or if oil prices were to stop increasing, foreign reserves (USD 22 billion) and assets held by the government (for a cumulative total of USD 14 billion, see above) would probably be exhausted before 2020.

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[2] For more on this subject, see IMF Staff Discussion, Note SDN 16/06 "*The Withdrawal of Correspondent Banking Relationships: A case for Policy Action*", June 2016 and Bloomberg "*Angola's Access to Dollars Dries up as Foreign Banks Halt Supply*", 15 Dec 2016.

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