Summary

Eurozone

Oil and inflation: between rounds

The decline in oil prices becomes problematic for price stability when it triggers second-round effects, i.e. a lasting change in the expectations and behaviour of economic agents.

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United Kingdom

With love from him to them

Donald Tusk unveiled his proposals for a deal between the UK and the EU. This basis for additional negotiations was relatively well received, but negotiations continue. If an agreement were to be reached at the mid-February EU Summit, a date for the referendum could be announced early in March. June 23rd is a possibility but not a certainty.

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Saudi Arabia

Time to accelerate reforms

The drop in oil prices highlights the crisis of the Saudi rent-economy. Only an acceleration in reforms could limit risks.

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Eco TV WEEK

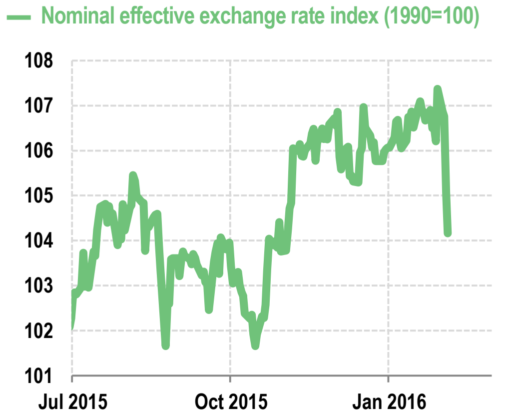
High strung

■ Hesitant oil prices ■ Unnerved equity markets ■ Interest rates plunge, dragging down the dollar

Jittery financial markets did not find any relief this week. Oil prices suddenly dropped after rebounding briefly last week, but then immediately changed directions again. Equity markets lack confidence and corporate spreads are soaring. In the United States, expectations for additional Fed rate increases have evaporated: the yield spread between 3-month and 2-year rates has narrowed to 40 bp from 90 bp at the beginning of the year. There has been a widespread drop-off in bond yields: the yield on 10-year Treasuries slipped below 1.90% this week, the lowest level since April. The latest victim to date is the dollar, which weakened against the euro, passing above USD 1.12 even though it was not so long ago that the dollar seemed to be on an unstoppable run towards parity…

Is the US economy really in such bad shape? True, the manufacturing ISM held below 50 for the fourth consecutive month. But the production and new orders components swung back into positive territory in January. The decline in the non-manufacturing ISM is a more serious concern, although it is still holding at comfortable levels, bolstered by dynamic new orders. Fed members' latest statements do not reveal any major concerns, although they continue to underscore the risks arising from uncertainty about global growth. So are the markets overreacting? If they are, the turnaround could be abrupt. Next Wednesday we should get a preliminary response when Janet Yellen speaks before the House of Representatives.

US DOLLAR PLUNGES



Source: Bank of England

THE WEEK ON THE MARKETS

Week 1-2 16 > 4-2-16

↘	**CAC 40**	4 417	►	**4 229**	**-4.3**	%
↘	**S&P 500**	1 940	►	**1 915**	**-1.3**	%
↗	Volatility (VIX)	20.2	►	21.8	+1.6	%
↘	**Euribor 3M** (%)	-0.16	►	**-0.17**	**-0.4**	bp
↗	Libor $ 3M (%)	0.61	►	0.62	+0.8	bp
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↗	Bund 10y (%)	0.27	►	0.31	+4.4	bp
↘	US Tr. 10y (%)	1.93	►	1.86	-6.6	bp
↗	**Euro vs dollar**	1.08	►	**1.12**	**+3.2**	%
↗	Gold (ounce, $)	1 117	►	1 154	+3.3	%
↗	**Oil (Brent, $)**	34.3	►	**34.9**	**+1.7**	%

Source: Thomson Reuters

Eurozone

Oil and inflation: between rounds

- **The new drop-off in oil prices since fall 2015 should place a significant drag on inflation in 2016. As a result, inflation could be nil this year, as it was last year.**
- **Oil price fluctuations have a rapid and direct impact on inflation via the energy component of the consumer price index.**
- **This direct impact is also accompanied by indirect effects on the prices of goods and services, notably by modifying production costs for companies.**
- **In both cases, these first-round effects have an impact on the general level of prices, but do not have a lasting impact on inflation dynamics.**
- **The decline in oil prices becomes problematic for price stability when it triggers second-round effects, i.e. a lasting change in the expectations and behaviour of economic agents.**

Components of inflation

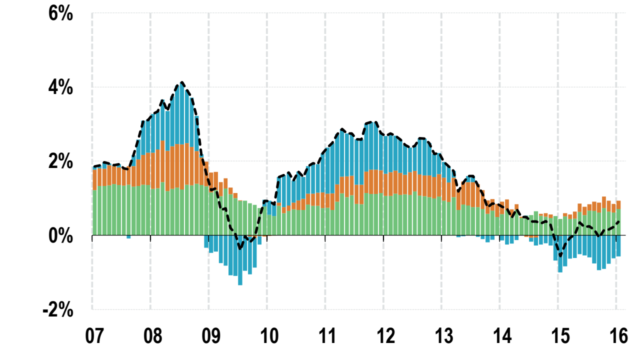

Chart 1 Source: ECB

Although oil prices have picked up over the past few days, they have been fluctuating around a low level of about USD 35 a barrel, far below the prices of fall 2015, and a far cry from the recovery scenario projected at the time. In mid-November, when the ECB made its technical assumptions based on market expectations for oil prices used to prepare its December macroeconomic projections, Brent crude oil prices were expected to average USD 52.2 a barrel in 2016. At the end of January, market expectations had fallen to an average of about USD 38. Without a spectacular rebound in the weeks ahead, the new ECB projections to be presented on 10 March (based on market expectations for oil prices at mid-February) should indicate a net downward revision in the 2016 inflation forecast, which could be slashed to 0% from the December figure of 1.1%.

Direct impact of oil price fluctuations on inflation

Crude oil price fluctuations have a rapid, direct impact on inflation through the prices of energy products, which account for about 10% of the consumer price index. This component is comprised mainly of liquid fuel for transport and home heating[1]. Its price depends on crude oil prices, refining and distribution margins, as well as taxes (excise duty, VAT).

Two factors are particularly important. First, there is the preponderant weight of taxes, which account for a little more than half of the pump prices for petrol and diesel. They are largely independent of crude oil prices. The excise duty is a fixed amount per unit in volume. VAT applies to the pre-tax price of petrol plus the excise tax: in other words, part of the tax base is fixed. Second, although refining margins can vary widely, distribution margins are relatively constant, which suggest that they are fixed in absolute value terms and not as a percentage of oil prices.

The fact that fixed costs account for such a big share of pump prices results in a major characteristic: the elasticity of energy prices to oil prices increases as a function of the level of oil prices. In other words, the higher the price of oil, the higher the effects of its fluctuation on the CPI energy. The deflationary impact of a 50% decline in oil prices is not as strong when oil is trading at EUR 50 than when it is trading at EUR 100. In the first case, the share of fixed costs is comparatively higher, and the drop in crude oil prices has less of an effect on end pump prices.

In an August 2010 article[2], the European Central Bank (ECB) estimated the elasticity of consumer prices for energy relative to crude oil prices. Elasticity was estimated at 42% when Brent crude oil was trading at EUR 100, but "only" 26% when oil was trading at EUR 40. Based on these estimates, the decline in Brent crude oil prices – which dropped from EUR 43 in mid-November to EUR 30 in late January – should result in a 0.78 point decline in energy price inflation (10%*30%*26%).

Indirect first-round effects

In addition to these rapid, direct effects (between 3 and 5 weeks), there are also more diffuse, indirect effects arising from changes in production costs for companies and how they are passed on to the sales prices of goods and services. These indirect effects apply to core inflation, i.e. excluding energy and food products. Naturally, the biggest impact is on energy-intensive products, such as transport services and pharmaceutical products. Yet with imports making up

[1] Natural gas, electricity, heat energy and solid fuels are also part of the energy component of the harmonised consumer price index.

[2] https://www.ecb.europa.eu/pub/pdf/other/art1_mb201008en_pp75-92en.pdf

such a big proportion of production costs and end consumption in the eurozone, inflation of relatively low energy-intensive products can also be affected when oil price fluctuations change the sales prices of goods and services in countries exporting to the eurozone.

The size of indirect effects depends crucially on corporate behaviour with regard to margins. In this perspective, two factors must be taken into consideration. First, as the degree of competition increases, there is a stronger tendency to carry over lower oil prices to consumer prices. Second, for a given degree of competition, the cyclical position of the economy is key: during periods of sluggish demand, lower production costs are more likely to be carried over to sales prices. The ECB estimates the elasticity of core inflation to oil price at 20%[3]. In this case, the 30% decline in Brent crude oil prices between mid-November and late January would place downward pressure on core inflation of 0.6 points.

Yet several other factors must also be taken into account. First, the ECB went on to say that the full impact of these indirect effects is felt after three years. Second, its elasticity estimate was based on the assumption that crude oil prices were trading at USD 60-80. Like direct effects, however, these indirect effects tend not to be as strong when prices are low. Lastly, production costs depend on numerous factors, and as far as imports are concerned, they crucially depend on past fluctuations in the euro's effective exchange rate. Although the effective exchange rate has appreciated by about 5% since mid-November, it has declined sharply over the past year. Recent inflation trends for industrial goods and services suggest that the sluggishness of core inflation is due more to Europe's depressed economic situation rather than to external factors (see chart 2).

Indirect second-round effects

In principle, first-round effects – whether direct or indirect – have an impact on the general level of prices but do not have a lasting impact on inflation dynamics. Even if they don't rebound, oil prices will sooner or later stop dragging down inflation.

Consequently, the decline in inflation attributed to lower oil prices is not, in itself, a big cause for concern for the ECB as its mandate is focused on medium-term inflation prospects. From this perspective, by boosting household purchasing power and consumer spending, the decline in oil prices is a positive development.

The decline in oil prices becomes problematic for price stability when it triggers second-round effects, i.e. a lasting change in the expectations and behaviour of economic agents. Lower inflation expectations strain wage formation which in turn pulls down expectations, creating a vicious circle that could lead to deflation.

In a speech before European parliament members this week[4], Mario Draghi stated that "while the most recent wave of disinflation is mainly due to the renewed sharp fall in oil prices, weaker than anticipated growth in wages together with declining inflation expectations call for careful analysis of the channels by which surprises to realised inflation may influence future price and wage-setting in our economy". This analysis will be published in March, 10th when the ECB presents its new macroeconomic outlook.

Core inflation

— Services; — Industrial goods excluding energy, %

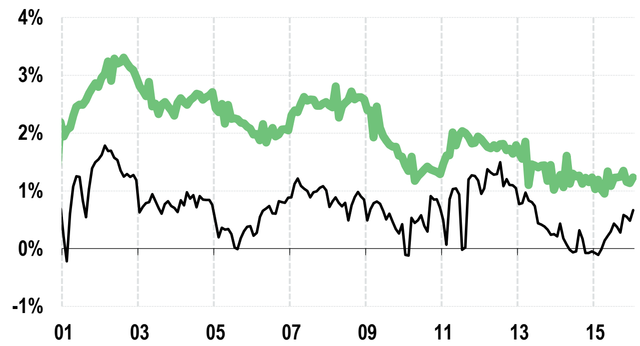

Chart 2 Source: Eurostat

Whether or not second-round effects materialise depends on the conditions under which the shock occurs. The ECB points out two key factors: the economy's cyclical position and the central bank's credibility. Clearly, a deflationary shock would not have the same impact on medium-term price dynamics if inflation was closer to 2% and expectations were well anchored, than in the current situation, with inflation nearing 0% and expectations in decline. Moreover, at a time when the ECB has not met its inflation target for nearly three years, it also faces the challenge of maintaining credibility.

In a very insightful speech made in April 2014, Mr. Draghi carefully spelled out the ECB's reaction function. In particular, he stated that faced with a decline in medium-term inflation expectations resulting from a *substantial* supply-side shock at a time of low inflation, the appropriate response would be for the ECB to strengthen its quantitative easing programme. Now that Mr. Draghi has raised the possibility of a further easing of monetary policy in March, the opportunity seems ripe for increasing QE. It would allow the Eurozone to fully benefit from falling oil prices and their positive effects on medium-term inflation.

[3] https://www.ecb.europa.eu/pub/pdf/other/mb201412_focus03.en.pdf

[4] https://www.ecb.europa.eu/press/key/date/2016/html/sp160201_1.en.html

United Kingdom

With love from him to them

- **The European Council President unveiled his proposals for a deal between the UK and the EU. This is the basis for additional negotiations, and was relatively well received.**
- **The four areas in which the UK was demanding improvements are covered. Proposals in terms of economic governance, competitiveness, and sovereignty look close to the best deal the UK can get.**
- **The main focus in the British press is immigration, and more precisely the question of benefits received by the newly arrived in the UK. The proposed "emergency-brake" disappoints some expectations. It could, however, be efficient in lowering the pressure the UK experiences due to massive inflows of migrants.**
- **Negotiations continue. Were the mid-February EU Summit to end up with a deal, a date for the referendum could be announced early in March. June 23rd is a possibility but not a certainty as local elections will be held on May 5th in Northern Ireland, Scotland, and Wales, which could postpone the remain-or-leave vote until September.**

This week proved key in the process towards the British in-or-out referendum, as the proposals from Donald Tusk (see Box next page), the European Council President, were unveiled. Those proposals are more a basis for further work than a ready-to-sign text. As stressed by Foreign Secretary Philip Hammond, this is a step in the negotiation of Britain's EU membership, and the proposals still have to be negotiated before being agreed on by heads of State. As noted by Mr. Tusk, it is "too early to say what will be the assessment of the rest of the member States". In short if an agreement at the EU Summit of February 18th and 19th is possible, it is definitely not a done deal. Mr. Tusk's proposals have been relatively welcomed. For instance, European Commission President Jean-Claude Juncker characterized them as fair, as he considers that the concerns of Prime Minister David Cameron have been addressed while respecting the treaties. On the British negotiators' side (Mr. Cameron, George Osborne, the Chancellor of the Exchequer, and Mr. Hammond), they were also rather well received.

There were four main demands from the UK: 1/ Immigration, 2/ Economic governance, 3/ Competitiveness and, 4/ Sovereignty. On the first point, Mr. Tusk's proposes an "emergency brake" on in-work benefits for up to four years in the event a particular member State is under immigration pressure, a procedure that would have to be approved by the EU Council. Note this has been regarded as not meeting the UK demands, but the text from Mr. Tusk also details all the limitation to the free movement of persons that already exist in the European treaties, reminding us all that there already are large rooms for maneuver for member States. On the second point, Mr. Tusk reassures EMU-out member States that they will not have to comply with eurozone rules and that their taxpayers' money will never be used to support the eurozone. The third point always was

Undecided

Poll results from different institutes, % of respondents

— Remain a member of the EU ; — Leave the EU ; --- Don't know

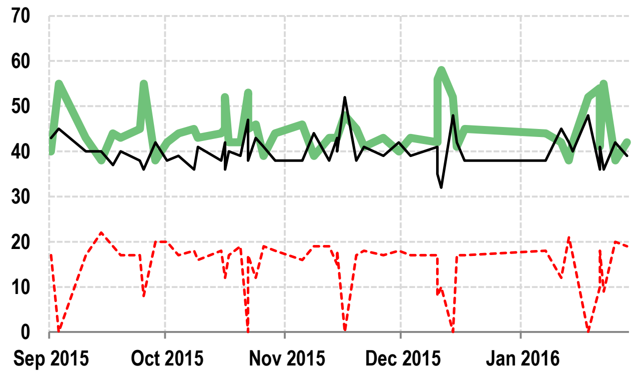

Chart 1

Sources: BMG Research, ComRes, Greenberg Quinlan Rosner Research, ICM, Ipsos MORI, ORB, Panelbase, Survation, YouGov

the easy point as the EU Commission is already actively working on a number of projects aiming at increasing competitiveness: the capital markets union, the simplification of regulation. As for the final point, Mr. Tusk is quite in line with the British demands in proposing a "red-card" system that would allow a group of national parliaments to veto a piece of EU legislation, while committing strongly to the principal of subsidiarity.

From now, more talks will ensue between British negotiators, the other twenty-seven member States and EU authorities. Mr. Cameron is scheduled to visit Warsaw and Hamburg in the coming days and speak at the European Parliament on February 16th. Meetings of technicians will take place in Brussels in the run-up to the EU Summit. If there is an agreement then, Mr. Cameron would officially endorse it in the House of Commons and a piece of legislation would be put in place, probably in early March, to allow the referendum. Then, with the government having a clear message, the Ministers would be allowed to campaign either for the remain-vote or the leave-vote. Indeed, in early January, Mr. Cameron had announced the members of his cabinet would be free to campaign for either side, as soon as a deal would have been passed. In the meantime, they were asked not to voice their preference and follow the "collective cabinet responsibility". Cracks are already appearing, on both sides. For instance, and a bit surprisingly, Theresa May, the home secretary, previously seen as a possible leader for the campaign to leave, qualified Mr. Tusk's proposals as "very interesting".

The date of June 23rd is often cited as the one Mr. Cameron prefers. Still, the vote could well be postponed after the summer holiday. This is indeed the request that was made this week by First Ministers in Northern Ireland, Scotland, and Wales. As elections will be held there on May 5th, they argue that a referendum campaign running at the same time "risks confusing issues at a moment when clarity is required".

Box: Donald Tusk's proposals for a new settlement for the United Kingdom within the European Union

The letter Mr. Tusk wrote is accompanied with a draft decision. Proposals are quite detailed even if the actual agreement might be very different. We provide here a sum-up.

1/ Economic Governance. The so-called economic governance question is related to the relationship between countries that have adopted the euro as their currency and the countries that opted-out. The concerns of the UK were the recognition that the country would never join the euro, the willingness to be guaranteed that its tax-payers would never have to contribute to a support to the eurozone, would be free to choose whether to adopt or not eurozone changes and would be sheltered from the possible adverse consequences of such changes.

Excerpt from the proposals. "Accordingly, for as long as the said derogations are not abrogated or the said protocols have not ceased to apply following notification or request from the relevant Member State, not all Member States have the euro as their currency". "Emergency and crisis measures addressed to safeguarding the financial stability of the euro area will not entail budgetary responsibility for Member States whose currency is not the euro, or, as the case may be, for those not participating in the banking union.". "Measures, the purpose of which is to further deepen the economic and monetary union, will be voluntary for Member States whose currency is not the euro and will be open to their participation wherever feasible". "It is acknowledged that Member States not participating in the further deepening of the economic and monetary union will not create obstacles to but facilitate such further deepening while this process will, conversely, respect the rights and competences of the non-participating Member States."

2/ Competitiveness. This was always the easy part within Mr. Cameron's requests. At the time he became the President of the European Commission, Jean-Claude Juncker's agenda was to deepen the single market and expand it into the services industry and digital economy, an agenda supported by member States.

Excerpt from the proposals. "The EU must increase efforts towards enhancing competitiveness, along the lines set out in the Declaration of the European Council on competitiveness." "EU institutions and the Member States will make all efforts to strengthen the internal market and to adapt it to keep pace with the changing environment. At the same time, [they…] will take concrete steps towards better regulation." "lowering administrative burdens and compliance costs on economic operators, especially small and medium enterprises, and repealing unnecessary legislation." "And the European Union will pursue an active and ambitious policy of trade."

3/ Sovereignty. The UK was asking not to be committed to an "ever-closer" union, a greater role for national Parliaments, a stronger commitment of the EU to the subsidiarity principle and the recognition that national security was a national responsibility.

Excerpt from the proposals. "References [to] an ever closer union […] are not an equivalent to the objective of political integration." "It is recognized that the UK, in the light of the specific situation it has under the Treaties, is not committed to further political integration into the European Union." The purpose of the principle of subsidiarity is to ensure that decisions are taken as closely as possible to the citizen. […] Reasoned opinions issued by national Parliaments […] on the application of the principles of subsidiarity and proportionality are to be duly taken into account of by all institutions involved in the decision-making process of the Union. Appropriate arrangements will be made to ensure this." "Where reasoned opinions on the non-compliance of a draft Union legislative act with the principle of subsidiarity represent more than 55 % of the votes allocated to the national Parliaments, the Council Presidency will [review the act]" and "unless the draft is amended to accommodate the concerns expressed in the reasoned opinions" "the representatives of the Member States acting in their capacity as members of the Council will discontinue the consideration of the draft legislative act in question." "Article 4(2) of the Treaty on European Union confirms that national security remains the sole responsibility of each Member State. This does not constitute a derogation from Union law and should therefore not be interpreted restrictively. In exercising their powers, the Union institutions will fully respect the national security responsibility of the Member States."

4/ Immigration. The original demands from Mr. Cameron were for non-British residing in the UK for less than four years not to be eligible to in-work and housing benefits, a ban on child benefit for UK resident with children living abroad.

Excerpt from the proposals. "It is legitimate to […] to provide […] for measures avoiding or limiting flows of workers of such a scale that they have negative effects both for the Member States of origin and for the Member States of destination." "The measures […] should take into account that Member States have the right to define the fundamental principles of their social security systems and enjoy a broad margin of discretion to define and implement their social and employment policy, including setting the conditions for access to welfare benefits." "The Commission will submit proposals for amending existing EU secondary legislation as follows: (a) a proposal to […] give Member States, with regard to the exportation of child benefits to a Member State other than that where the worker resides, an option to index such benefits to the standard of living in the Member State where the child resides; (b) a proposal […] which will provide for an alert and safeguard mechanism that responds to situations of inflow of workers from other Member States of an exceptional magnitude over an extended period of time."

The latest is the so-called "emergency brake". The process would see first the member State notify the Commission and the Council it requires the brake; after the Commission having examined the request, the Council would authorize the member States to restrict access to in-work benefits for up to four years from the commencement of employment; the Council decision would have a limited duration, and apply to newly arrived EU workers.

Saudi Arabia

Time to accelerate reforms

- **Having run a record deficit in 2015, the Saudi government has announced a series of measures aimed at adjusting public finances to a period of low oil prices.**
- **There is limited room for manoeuvre and the public finances are likely to continue to worsen over the medium term.**
- **The deterioration in the net public and external assets remains sustainable, even with low oil prices.**
- **The pace of structural reforms aimed at diversifying the economy and creating jobs for Saudi nationals has to accelerate in order to contain rising socio-political risk.**

The sharp fall in oil prices and the increase in geopolitical tensions in the region have raised a number of questions over the prospects for the Saudi economy. Economic growth is sluggish and the fiscal situation continues to deteriorate.

Limited fiscal flexibility

In 2015, official estimates show that the government ran a record deficit of 15% of GDP. On top of this, one could include "non-budgetary" project financing which is estimated at around 5% of GDP. Even if one takes into account the exceptional nature of some expenditure (the coronation of the new King added spending equivalent to 4% of GDP) a deficit on this scale would seem hard to sustain.

The 2016 budget is based on a Brent Crude price of around USD42/b and includes spending cuts of around 14% relative to 2015. The government estimates that this will bring the budget deficit for 2016 down to 13% of GDP. The Minister of Finance has announced savings across all departments of government and the introduction of new sources of revenue. Despite the stated desire for action, the room for manoeuvre is limited and too sharp a fiscal contraction would quickly come into conflict with the goals of growth and job creation. As a result it is likely that Saudi fiscal deficit will remain under pressure over the medium term, unless oil prices bounce back.

On the expenditure side, a first source of savings will come in the reduction in subsidies for energy products. These are estimated to cost some 10% of GDP, and the authorities have announced a doubling of petrol prices. Further ahead, all fuel, water and electricity prices are likely to be affected by cuts to subsidies over the next few years. In the short term, the reduction in energy subsidies is likely to produce cost savings for the government equivalent to around 1.2% of GDP. In addition, the government has indicated that it plans to cut expenditure at the Ministry of Education (by 11.7%) and in the health and social welfare sector (by 35%). This looks like a hard task, given sustained demographic pressures and the urgent need to adjust the current education system to the realities of the labour market. Military and security expenditure are included in the budget for the first time. They are equivalent to 25% of total government spending. Given the geopolitical tensions in the region and the structural rise in military spending (averaging 19% per year since 2001), further upward pressure on spending in this area is likely.

For revenues – 90% of which come from oil revenues – the introduction of taxes and duties is in the very early stages in a country which currently levies neither VAT nor income tax. Total tax revenue was just 1.4% of GDP in 2014. The introduction of a Value Added Tax, at a 5% rate, has been announced. According to the IMF, this tax is unlikely to raise more than 1.5% of GDP over a full year.

Economic growth and fiscal expenditures

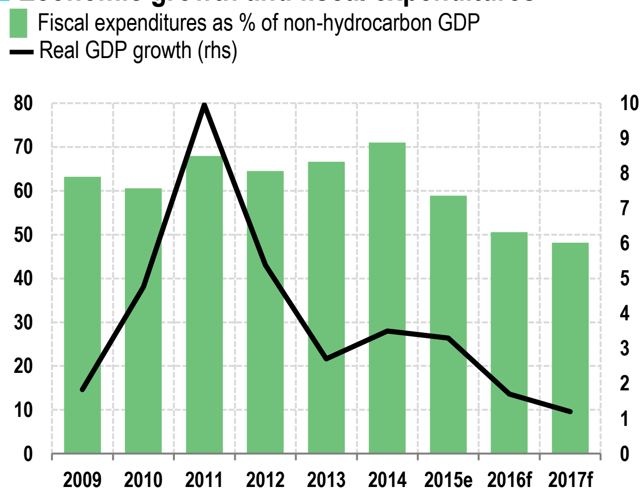

Chart 1 Sources: MoF, BNP Paribas

Government debt and assets

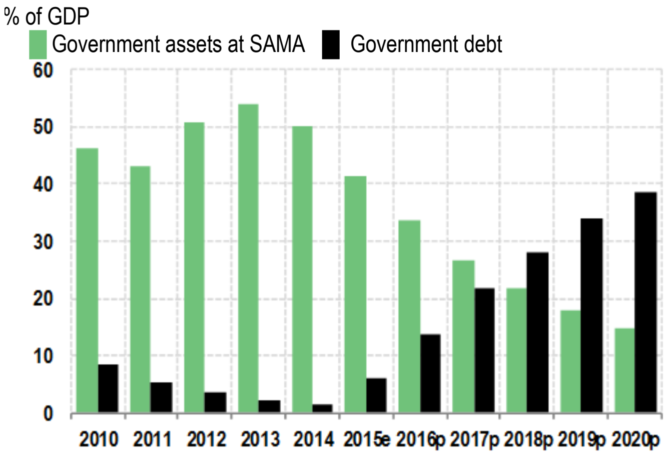

Chart 2 Sources: SAMA, BNP Paribas

Fiscal prospects are uncertain but sustainable over the medium term

The outlook in the oil market is very uncertain and a prolonged period of low prices (below the Saudi government's assumptions) can not be ruled out. The policy of winning market share, conducted primarily by Saudi Arabia, has not been crowned with success for the time being. US production has fallen from its mid-2015 peak, but remains high. The fall in production could gather pace in 2016. However, although certain US oil companies are currently experiencing severe financial difficulties, productivity gains in the sector have been substantial and have significantly reduced the industry's breakeven point. Moreover, the specific technical nature of shale oil, and the presence of more responsive private companies, means that the ability of US companies to bounce back is much greater than for other producer nations. In the USA, the leadtime between a final investment decision and the beginning of production is less than one year, compared to around four years for most countries in the Middle East. In addition, the return of Iranian oil to a weak global market could serve to keep oil prices low.

Against this sluggish climate for oil, and assuming that Brent Crude remains below USD60/b over the medium term, we estimate that the Saudi budget will remain in deficit for the next five years. From an estimated 15% in 2015, the budget deficit is likely to be gradually reduced to 7% of GDP by 2020. Over this time scale, the financing of the deficit is unlikely to create difficulties. In 2015, three-quarters of the deficit was financed by withdrawals of government reserves from the central bank (SAMA), with the remaining quarter financed by debt issued on the local market. At the end of December 2015, government deposits with SAMA totalled USD280 billion, a fall of USD97 billion over one year, whilst the equivalent of USD22 billion in debt was issued. At end-2015, total government debt was estimated at 6% of GDP, and government deposits with SAMA stood at around 40% of GDP.

Our projections show that, assuming a steady reduction in the share of the deficit funded by asset withdrawals (1/3 from 2017), government debt could rise to around 39% of GDP by 2020, with deposits falling to 15% of GDP. Thus although there would be an undeniable deterioration of the public finances over five years, we are still some way from an alarming situation. Even under these circumstances, the Saudi government would still be able to borrow on the capital markets on favourable terms. In addition, public assets other than those deposited with SAMA are substantial. Government holdings in listed Saudi companies are valued at some USD200 billion (or around 30% of 2015 GDP), whilst those in unlisted companies, which could be privatised, are also thought to be significant.

Saudi Arabia's external position does not seem too likely to pose a threat between now and 2020, but there will be a significant deterioration. Assuming that the current account returns to surplus by 2019, total currency reserves (including the share held by the government) will be USD240 billion in 2020, the equivalent of 15 months of imports.

Structural changes are needed

Medium term prospects remain dominated by the twin problems of diversifying the economy and creating jobs for Saudi nationals. The scale of the task is immense, and the challenges numerous: most notably, developing the non-hydrocarbon private sector, encouraging the national population to join the private sector and improving labour productivity.

The recent announcement of the privatisation of part of national oil company Aramco could be interpreted as a desire to speed the pace of economic liberalisation and improvement of the transparency of economic structures. However, structural economic reform in Saudi Arabia is a slow process and recent developments argue for a degree of caution. Saudi Arabia remains relatively unattractive for foreign investors, and FDI has been less than 2% of GDP on average since 2011. As for employment, the arrival on the labour market of an additional 6 million people by 2030 will require the accelerated massive creation of jobs in the private sector. However, constraints in this area remain substantial. A study by McKinsey during the recent period of high oil prices (2003-2013) showed that 1.7 million jobs were created for Saudi nationals, including 1 million in the public sector. The proportion of Saudi nationals working in the public sector remained constant at 70%. In addition, the average salary in the public sector is 70% higher than the private sector average. This represents a significant constraint on the development of employment of Saudi nationals in the private sector. The current programme of nationalisation of employment has generated positive results but could soon reach certain limits (some economic sectors remain relatively unattractive for Saudi nationals) and cannot be considered as a positive factor towards job creation in the private sector.

Although we believe that macro-financial risks are manageable over the medium term, and despite the bullish statements of the authorities, we believe that current economic conditions bring risks and require an acceleration in the reform process.

Markets overview

The essentials

Week 1-2 16 > 4-2-16

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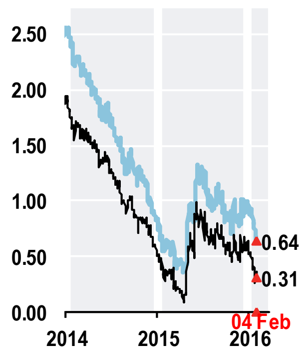
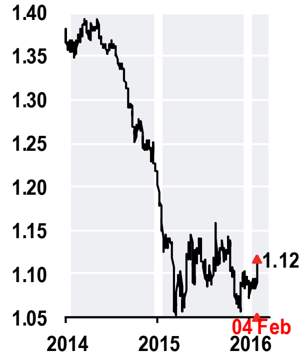
↗ **Oil (Brent, $)**	34.3	▸	**34.9**	**+1.7**	%

10 y **bond yield, OAT vs Bund**



Euro-dollar



CAC 40

Money & Bond Markets

Interest Rates		highest' 16		lowest' 16	
€ ECB	**0.05**	0.05	at 01/01	0.05	at 01/01
Eonia	**-0.23**	-0.13	at 01/01	-0.25	at 06/01
Euribor 3M	**-0.17**	-0.13	at 01/01	-0.17	at 04/02
Euribor 12M	**0.00**	0.06	at 01/01	0.00	at 04/02
$ FED	**0.50**	0.50	at 01/01	0.50	at 01/01
Libor 3M	**0.62**	0.62	at 19/01	0.61	at 04/01
Libor 12M	**1.13**	1.18	at 01/01	1.13	at 03/02
£ BoE	**0.50**	0.50	at 01/01	0.50	at 01/01
Libor 3M	**0.59**	0.59	at 22/01	0.59	at 12/01
Libor 12M	**1.00**	1.07	at 01/01	1.00	at 01/02

At 4-2-16

Yield (%)		highest' 16		lowest' 16	
€ AVG 5-7y	**0.29**	0.49	at 12/01	0.25	at 01/02
Bund 2y	**-0.47**	-0.34	at 01/01	-0.49	at 03/02
Bund 10y	**0.31**	0.63	at 01/01	0.27	at 29/01
OAT 10y	**0.64**	0.98	at 01/01	0.61	at 03/02
Corp. BBB	**2.32**	2.50	at 20/01	2.22	at 06/01
$ Treas. 2y	**0.72**	1.06	at 01/01	0.72	at 04/02
Treas. 10y	**1.86**	2.27	at 01/01	1.86	at 02/02
Corp. BBB	**4.40**	4.47	at 21/01	4.30	at 06/01
£ Treas. 2y	**0.37**	0.65	at 01/01	0.35	at 29/01
Treas. 10y	**1.57**	1.96	at 01/01	1.52	at 03/02

At 4-2-16

10y bond yield & spreads

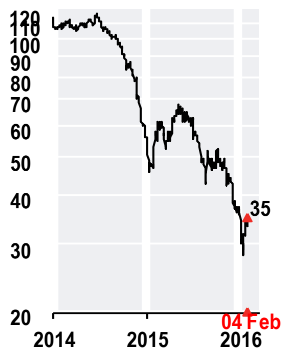
9.67%	Greece	935 pb
2.81%	Portugal	250 pb
1.75%	Spain	143 pb
1.52%	Italy	121 pb
0.77%	Belgium	45 pb
0.71%	Ireland	39 pb
0.64%	France	33 pb
0.58%	Austria	27 pb
0.48%	Finland	17 pb
0.44%	Netherland	13 pb
0.31%	Germany	

Commodities

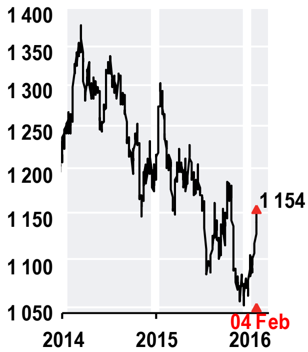
Spot price in dollars		lowest' 16			2016(€)
Oil, Brent	**35**	28	at	20/01	**-5.0%**
Gold (ounce)	**1 154**	1 062	at	01/01	**+5.6%**
Metals, LMEX	**2 220**	2 049	at	12/01	**-2.0%**
Copper (ton)	**4 692**	4 328	at	15/01	**-3.0%**
CRB Foods	**341**	329	at	11/01	**-1.1%**
wheat (ton)	**176**	146	at	04/01	**+11.1%**
Corn (ton)	**143**	135	at	11/01	**+0.6%**

At 4-2-16 *Variations*

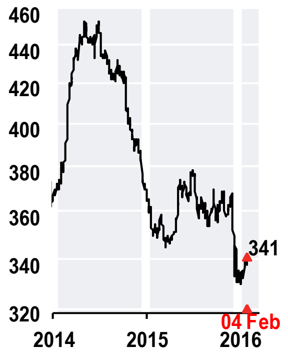
Oil (Brent, $)



Gold (Ounce, $)



CRB Foods



Exchange Rates

1€ =		highest' 16			lowest' 16			2016
USD	**1.12**	1.12	at	04/02	1.07	at	05/01	**+2.8%**
GBP	**0.77**	0.77	at	19/01	0.73	at	05/01	+3.9%
CHF	**1.11**	1.11	at	04/02	1.08	at	06/01	+2.5%
JPY	**130.84**	131.84	at	01/02	126.68	at	20/01	+0.1%
AUD	**1.55**	1.59	at	20/01	1.49	at	01/01	+3.5%
CNY	**7.35**	7.35	at	04/02	6.99	at	05/01	+4.2%
BRL	**4.33**	4.50	at	21/01	4.30	at	01/01	+0.8%
RUB	**85.28**	91.18	at	21/01	78.65	at	05/01	+7.5%
INR	**75.57**	75.57	at	04/02	71.42	at	05/01	+5.2%

At 4-2-16 *Variations*

Equity indices

Yield (%)		highest' 16		lowest' 16		2016	2016(€)
€ AVG 5-7y	**0.29**	0.49	at 12/01	0.25	at 01/02	+1.1%	**+1.1%**
Bund 2y	**-0.47**	-0.34	at 01/01	-0.49	at 03/02	+0.2%	**+0.2%**
Bund 10y	**0.31**	0.63	at 01/01	0.27	at 29/01	+3.7%	**+3.7%**
OAT 10y	**0.64**	0.98	at 01/01	0.61	at 03/02	+3.3%	**+3.3%**
Corp. BBB	**2.32**	2.50	at 20/01	2.22	at 06/01	-0.2%	**-0.2%**
$ Treas. 2y	**0.72**	1.06	at 01/01	0.72	at 04/02	+0.7%	**-2.0%**
Treas. 10y	**1.86**	2.27	at 01/01	1.86	at 02/02	+3.8%	**+1.0%**
Corp. BBB	**4.40**	4.47	at 21/01	4.30	at 06/01	+0.1%	**-2.7%**
£ Treas. 2y	**0.37**	0.65	at 01/01	0.35	at 29/01	+0.5%	**-3.3%**
Treas. 10y	**1.57**	1.96	at 01/01	1.52	at 03/02	+3.6%	**-0.3%**

At 4-2-16

* Indices MCSI

Economic forecasts

En %	GDP Growth 2015 e	GDP Growth 2016 e	GDP Growth 2017 e	Inflation 2015 e	Inflation 2016 e	Inflation 2017 e	Curr. account / GDP 2015 e	Curr. account / GDP 2016 e	Curr. account / GDP 2017 e	Fiscal balances / GDP 2015 e	Fiscal balances / GDP 2016 e	Fiscal balances / GDP 2017 e
United States	**2.3**	**1.7**	**1.9**	**0.1**	**1.4**	**2.3**	**-2.6**	**-2.8**	**-3.2**	**-2.5**	**-2.4**	**-2.5**
Japan	0.6	0.7	0.4	0.8	0.5	1.9	3.2	2.9	2.8	-4.4	-3.9	-3.2
United Kingdom	2.7	1.8	1.9	0.0	0.9	2.1	-4.8	-4.3	-3.4	-4.0	-2.9	-2.2
Euro Area	**1.5**	**1.6**	**1.8**	**0.0**	**0.5**	**1.5**	**3.1**	**2.8**	**2.6**	**-2.0**	**-1.8**	**-1.3**
Germany	1.5	1.6	2.0	0.1	0.6	1.7	8.1	8.3	8.4	0.9	0.5	0.7
France	1.1	1.4	1.6	0.1	0.6	1.3	0.1	-0.3	-0.9	-3.8	-3.4	-3.0
Italy	0.7	1.3	1.2	0.1	0.4	1.3	1.9	1.7	1.6	-2.6	-2.5	-1.6
Spain	3.1	2.2	2.7	-0.6	0.0	1.2	0.6	0.3	0.4	-4.6	-3.7	-2.3
Netherlands	1.8	1.8	1.9	0.3	1.0	1.3	10.7	9.9	9.3	-2.1	-1.8	-1.6
Belgium	1.2	1.3	1.5	0.6	1.5	1.5	0.4	0.6	0.0	-3.0	-2.7	-2.3
Portugal	1.5	1.5	1.4	0.6	1.0	1.2	1.3	1.5	1.8	-3.0	-2.3	-1.9
Emerging	**3.7**	**3.8**	**4.5**									
China	6.9	6.3	6.1	1.4	1.8	2.0	3.5	3.5	3.3	-2.5	-3.1	-3.0
India	7.3	7.3	8.0	4.9	5.9	5.4	-1.3	-0.8	-0.9	-4.1	-3.9	-3.5
Brazil	-3.8	-4.0	0.0	9.0	9.0	7.0	-3.4	-2.3	-3.0	-12.0	-10.9	-9.8
Russia	-3.8	-2.0	0.5	15.6	8.5	7.0	5.5	1.5	3.5	-5.0	-4.3	-3.0
World	**2.9**	**3.1**	**3.5**									

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

Financial forecasts

Interest rates		2015				2016						
End period		Q1	Q2	Q3	Q4	Q1e	Q2e	Q3e	Q4e	**2015**	**2016e**	**2017e**
US	Fed Funds	0.25	0.25	0.25	0.5	0.50-0.75	0.75-1.00	1.00-1.25	1.00-1.25	0.01	1.00-1.25	2.00-2.25
	3-month Libor $	0.27	0.28	0.33	0.61	0.88	1.13	1.25	1.38	0.61	1.38	2.25
	10-year T-notes	1.93	2.35	2.03	2.27	2.55	2.75	2.75	2.75	2.27	2.75	2.75
EMU	Refinancing rate	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05	0.05
	3-month Euribor	0.02	-0.01	-0.04	-0.13	-0.20	-0.20	-0.20	-0.20	-0.13	-0.20	-0.20
	10-year Bund	0.18	0.77	0.59	0.63	0.40	0.45	0.50	0.70	0.63	0.70	1.20
	10-year OAT	0.42	1.20	0.90	0.98	0.65	0.70	0.75	1.00	0.98	1.00	1.45
	10-year BTP	1.29	2.31	1.73	1.60	1.20	1.25	1.35	1.60	1.60	1.60	2.30
UK	Base rate	0.50	0.50	0.50	0.50	0.50	0.75	1.00	1.25	0.50	1.25	2.00
	3-month Libor £	0.57	0.58	0.58	0.59	0.75	1.00	1.25	1.50	0.59	1.50	2.25
	10-year Gilt	1.58	2.03	1.77	1.96	2.10	2.20	2.25	2.30	1.96	2.30	2.50
Japan	Overnight call rate	0.02	0.01	0.01	0.04	0.10	0.10	0.10	0.10	0.04	0.10	0.10
	3-month JPY Libor	0.17	0.17	0.17	0.17	0.17	0.17	0.17	0.17	0.17	0.17	0.20
	10-year JGB	0.40	0.44	0.35	0.25	0.50	0.60	0.65	0.70	0.25	0.70	0.90

Exchange rates		2015				2016						
End period		Q1	Q2	Q3	Q4	Q1e	Q2e	Q3e	Q4e	**2015**	**2016e**	**2017e**
USD	EUR / USD	1.07	1.11	1.12	1.09	1.04	1.02	1.00	1.02	1.09	1.02	1.10
	USD / JPY	120	122	120	120	128	130	134	134	120	134	135
EUR	EUR / GBP	0.72	0.71	0.74	0.74	0.69	0.69	0.67	0.67	0.74	0.67	0.73
	EUR / CHF	1.04	1.04	1.09	1.09	1.12	1.14	1.14	1.16	1.09	1.16	0.01
	EUR/JPY	129	136	134	131	133	133	134	137	131	137	149

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

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Internet : www.bnpparibas.com - www.economic-research.bnpparibas.com

Publisher: Jean Lemierre
Editor : William De Vijlder