Global Economic Perspectives
Global Economic Outlook 2017-2018

Economics

Global

Arend Kapteyn
Economist
arend.kapteyn@ubs.com
+44-20-7568 2000

Reinhard Cluse
Economist
reinhard.cluse@ubs.com
+44-20-7568 6722

Rafael De La Fuente
Economist
rafael.delafuente@ubs.com
+1-203-719 7127

Scott Haslem
Economist
scott.haslem@ubs.com
+61-2-9324 3663

Gyorgy Kovacs
Economist
gyorgy.kovacs@ubs.com
+44-20-7568 7563

Drew T. Matus
Economist
drew.matus@ubs.com
+1-212-713-4448

Tao Wang
Economist
wang.tao@ubs.com
+852-2971 7525

Duncan Wooldridge
Economist
duncan.wooldridge@ubs.com
+852-2971 6046

Continuity or Discontinuity?

Our baseline is for nominal global growth to increase for the first time in seven years…

Baselines never materialize because they are modal rather than probabilistic, and so don't incorporate the inevitable tail risk events. But our baseline is for nominal global growth to increase for the first time in seven years (real growth up from 3.1% to 3.5%), driven by above-consensus growth in the US, a recovery in oil-sector-related investment, and several large emerging markets emerging from recession. This is not a story of great optimism – mostly a modest improvement in investment, which has been contributing only a third as much to GDP growth relative to its pre-GFC contribution. And the rebound in EM is extremely narrow. Brazil, Russia and Argentina explain almost the entire EM growth improvement and Brazil's contribution to the increase in global growth is almost as large as the US, despite having a GDP weight that is only one-sixth the size.

…but unusual levels of uncertainty about policies and outcomes

The outlook is unusually uncertain given political developments in the US and Europe, the degree to which 'monetary space' to be accommodative gets reduced by (projected) higher inflation and growth, and the market's reaction to likely tapering by the ECB and BoJ.

What could go right? US fiscal/tax, Banks, China and Europe

- A large fiscal spending/tax package in the US that is not neutralized by disruptive trade policy could lift global growth (Trump's pre-election plans suggest 20bp extra US growth annually, with some upside if the composition of the package changes to income groups with higher fiscal multipliers, and downside if it runs into implementation constraints).

- Banks have cut 40-50% of GDP out of their balance sheets and that process appears to be nearing completion (see the section "is the end of the debt super-cycle approaching?"). It's possible that helps further unclog the credit channel.

- We have embedded policy-induced slowing in the property sector in China into our baseline, and political uncertainty-induced slowing into our Eurozone baseline. We could be wrong on both.

What could go wrong? Oil, end of QE, protectionism

- The market is priced for an extrapolation of the 'low for longer' environment with zero monetary policy normalization (on average) in 2017. We show that a two-standard-deviation shock in oil prices to the upside would lead to a very significant overshooting of central bank inflation targets (in DM) and induce a 2013-like sell-off in fixed income, equity and EMFX markets.

- Although G3 central bank balance sheets aren't projected to decline in aggregate until 2020 (the Fed should start to passively roll off in 2018), the net additional injection of liquidity coming from QE programs should peak next month (December 2016) and then progressively decline. It is unclear how the market will adjust to the simultaneous reduction in liquidity support and a potentially large increase in US debt issuance.

- Creeping protectionism has so far explained only 7% of the global trade slowdown. But there is potential for more overt trade disputes and a dismantling of free trade agreements.

Contents

Arend Kapteyn
Economist
arend.kapteyn@ubs.com
+44-20-7568-2000

Pierre Lafourcade
Economist
pierre.lafourcade@ubs.com
+1-203-719-8921

Sophie Constable
Analyst
sophie.constable@ubs.com
+44-20-7568-3105

Arend Kapteyn
Economist
arend.kapteyn@ubs.com
+44-20-7568-2000

Pierre Lafourcade
Economist
pierre.lafourcade@ubs.com
+1-203-719-8921

Sophie Constable
Analyst
sophie.constable@ubs.com
+44-20-7568-3105

Global

UBS Research THESIS MAP **2017-18 Global Economic Outlook**

PIVOTAL QUESTIONS

Q: Are we approaching the end of the debt super-cycle?
The banking systems in the US, UK and Eurozone have now cut their collective balance sheets by 40-50% of GDP since the GFC and the pace of deleveraging is declining rapidly. If balance sheets stabilize there is upside risk to credit growth.

Q: What are the biggest upside/downside risks to the outlook?
- A large fiscal spending/tax package in the US that is not neutralized by disruptive trade policy could lift global growth.
- There is also upside risk if we are wrong on the expected policy-induced slowdown in the property sector in China, and the political uncertainty-induced slowdown in Europe.
- A two-standard-deviation move in oil to the upside (close to the two-standard-deviation move in early '16 to the downside) would be a stagflationary shock that in first instance would lead to a dramatic repricing of expected monetary policy (headline inflation in Europe and the US would exceed 4% and would spill over into core) and expose the build-up of duration in the system.
- In terms of independent growth shocks, EM is most sensitive to China and DM to the US.

Q: How much more government and central bank stimulus will be injected into the world economy in 2017?
12-month rolling central bank liquidity support should peak at a post-crisis high in December 2016 and then start to gradually decline. The ECB and BoJ may both taper their asset purchases during 2017 and (with the exception of the US) governments appear incapable of adding fiscal stimulus.

UBS VIEW

Nominal global growth should improve for the first time in seven years, helped by a mechanical post-recession rebound of investment in emerging economies, above consensus growth in the US, higher energy prices and some recovery in related investment. The overall direction of travel looks ok, but the magnitude of improvement is generally uninspiring. There is more than the usual uncertainty coming from politics in Europe and the US, uncertainty over the impact of reduced central bank liquidity support, and whether FX feedback loops will continue to contain economic divergence.

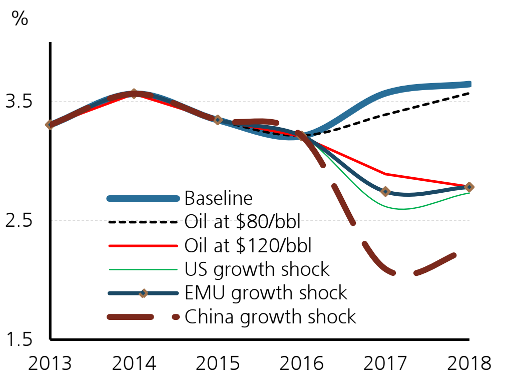
EVIDENCE

Investment is contributing two-thirds less to global growth than it did pre pre-crisis, and that weakness explains most of the slowdown in trade as well as deliberate attempts by central banks to stay behind the curve (if you applied their pre-GFC responsiveness to inflation and output gap improvements, policy rates should be 100bp higher). But 73% of countries are still running output gaps.

WHAT'S PRICED IN?

An extrapolation of the current 'low for longer' environment with zero monetary policy normalization by end-2017 (on average).

Figure 1: Growth Scenarios Global



Source: Haver, UBS

Figure 2: First-Order Financial Market Impact

Growth shocks	US10y	Bund	EUR/$	SPX (%)	USDEM (%)
-2% US Shock	1.0	-0.3	1.16	-40.0	5.0
2% EMU shock	1.3	-0.6	1	-25.0	10.0
4% China growth	1.3	-0.3	1.05	-25.0	15.0
Oil shocks					
Oil at 80	2.4	1.1	1.2	-5.0	0.0
Oil at 120	3.1	2.0	1.3	-40.0	17.0
Baseline 2017	**2.1**	**0.5**	**1.15**		

Source: Haver, UBS

Key Economic Indicators

	Real GDP			CPI (% year average)			Current account (% GDP)			Fiscal balance (% GDP)		
	16F	17F	18F	16F	17F	18F	16F	17F	18F	16F	17F	18F
US	**1.5**	**2.4**	**2.5**	**1.3**	**2.3**	**2.3**	**-2.6**	**-2.6**	**-2.4**	**-3.2**	**-3.1**	**-2.6**
Japan	**0.5**	**0.8**	**0.9**	**-0.3**	**0.5**	**0.6**	**3.6**	**3.4**	**3.2**	**-5.4**	**-5.5**	**-4.1**
Canada	**1.1**	**2.3**	**2.7**	**1.5**	**1.8**	**2.0**	**-4.4**	**-2.7**	**-2.9**	**-1.6**	**-2.0**	**-1.9**
UK	**2.0**	**1.0**	**0.7**	**0.7**	**2.8**	**2.8**	**-5.4**	**-4.5**	**-3.9**	**-3.6**	**-2.9**	**-2.1**
Switzerland	**1.5**	**1.3**	**1.6**	**-0.4**	**0.4**	**0.9**	**9.2**	**9.0**	**8.9**	**0.2**	**0.2**	**0.0**
Eurozone	**1.6**	**1.3**	**1.2**	**0.2**	**1.4**	**1.8**	**3.2**	**3.0**	**2.8**	**-2.0**	**-1.7**	**-1.5**
Germany	1.8	1.3	1.3	0.4	1.3	1.8	8.9	8.4	8.2	0.2	0.1	0.2
France	1.3	1.3	1.4	0.3	1.4	1.6	-0.6	-0.4	-0.6	-3.4	-3.1	-2.7
Italy	0.7	0.8	0.8	-0.1	1.1	1.8	2.0	1.8	1.7	-2.4	-2.2	-1.3
Spain	3.2	2.3	1.9	-0.4	1.6	1.7	1.5	1.3	1.1	-4.6	-3.2	-3.0
Greece	0.0	2.0	2.6	0.2	0.6	1.0	1.9	1.8	1.4	-3.4	-2.7	-1.7
Emerging EMEA	**1.1**	**2.1**	**2.4**	**5.7**	**4.6**	**4.5**	**0.0**	**0.2**	**0.0**	**-3.0**	**-2.1**	**-1.3**
Turkey	3.2	3.0	3.1	7.8	7.0	6.5	-4.9	-5.8	-6.2	-1.8	-1.6	-1.5
South Africa	0.6	1.2	1.6	6.3	5.7	5.6	-4.0	-3.6	-3.6	-3.4	-3.2	-2.8
Kazakhstan	0.3	1.5	2.4	14.7	7.3	7.0	-3.4	-1.5	0.1	-5.9	-2.6	-1.3
Czech	2.7	2.9	2.7	0.5	2.1	2.3	1.7	1.4	1.2	0.0	-0.5	-0.5
Hungary	2.0	2.7	2.7	0.4	2.2	2.7	4.7	4.6	3.6	-1.6	-2.5	-2.5
Poland	3.1	3.3	3.3	-0.7	1.6	2.2	-0.7	-1.1	-1.3	-2.8	-2.8	-2.6
Russia	-0.6	1.3	1.7	7.1	5.0	4.2	2.5	3.0	2.5	-3.7	-2.5	-1.6
UAE	2.6	2.9	3.0	1.4	1.2	4.4	3.4	4.6	5.0	-3.6	-0.2	2.4
Asia (ex Japan, inc. Aus & NZ)	**6.0**	**5.8**	**5.8**	**2.5**	**2.7**	**2.7**	**2.3**	**1.7**	**1.5**	**-3.3**	**-3.3**	**-3.3**
Australia	2.9	3.0	2.8	1.2	1.8	2.1	-3.0	-2.1	-1.8	-2.4	-2.2	-1.4
New Zealand	3.3	2.6	2.4	0.5	1.6	1.9	-2.7	-3.1	-3.0	-2.1	1.5	1.8
Hong Kong	1.1	1.3	1.4	2.2	1.8	1.8	2.8	1.4	1.3	0.5	-0.3	-0.9
Singapore	1.1	1.4	2.0	-0.6	0.7	1.1	26.4	30.6	32.1	-1.1	-1.0	-1.0
Korea	2.8	2.6	2.5	0.9	1.8	1.7	7.0	6.1	5.5	-2.0	-2.0	-1.9
Taiwan	1.6	1.0	1.8	1.2	1.5	1.1	14.4	12.8	12.0	-0.2	-0.3	-0.4
Malaysia	3.8	3.4	3.7	2.1	2.7	2.8	0.9	1.3	1.6	-3.5	-3.0	-3.0
Thailand	3.1	2.5	3.1	0.2	1.4	1.7	10.5	8.1	7.1	-2.8	-3.0	-2.5
Indonesia	5.0	4.8	5.2	3.5	4.5	5.1	-2.1	-2.8	-3.0	-2.8	-2.8	-2.3
Philippines	6.6	5.6	6.0	1.7	2.9	3.2	0.8	0.3	-1.3	-2.6	-3.0	-2.9
India	7.4	7.6	7.8	4.8	4.5	4.9	-0.6	-1.1	-1.7	-3.5	-3.0	-3.5
China	6.7	6.4	6.0	1.9	2.1	1.8	1.9	1.3	1.2	-4.0	-4.0	-4.0
Latin America*	**-1.0**	**1.6**	**2.3**	**8.9**	**6.8**	**5.6**	**-2.5**	**-2.4**	**-2.6**	**-7.6**	**-7.5**	**-6.3**
Argentina	-1.8	3.0	3.0	32.6	26.9	17.1	-2.1	-3.0	-3.2	-7.2	-6.9	-6.0
Mexico	2.2	1.7	2.0	2.8	4.0	4.0	-2.6	-3.3	-3.6	-2.9	-2.5	-2.0
Brazil	-3.6	1.3	2.6	8.8	4.8	4.6	-1.3	-1.4	-2.1	-9.1	-9.5	-8.7
Venezuela	-10.0	-5.0	-3.0	450.4	1,460	2,600	-7.0	-1.6	1.0	-25.0	-25.0	-22.0
Chile	1.8	2.2	2.6	3.8	2.2	2.9	-2.0	-2.2	-1.8	-2.1	-1.8	-1.7
Colombia	2.2	2.4	3.2	6.4	5.0	3.8	-4.8	-4.4	-4.2	-4.1	-3.4	-3.0
Peru	3.8	4.4	4.3	3.3	2.8	2.6	-3.7	-3.2	-3.0	-3.0	-2.3	-2.3
G7	**1.4**	**1.8**	**1.9**	**0.8**	**1.8**	**2.0**	**-0.5**	**-0.5**	**-0.4**	**-2.6**	**-2.6**	**-2.1**
Advanced economies	**1.6**	**1.8**	**1.9**	**0.7**	**1.8**	**1.9**	**0.3**	**0.3**	**0.3**	**-2.5**	**-2.4**	**-2.0**
Emerging & Developing Economies	**4.4**	**4.9**	**5.1**	**4.2**	**3.8**	**3.5**	**0.5**	**0.1**	**-0.1**	**-4.4**	**-4.2**	**-3.9**
World*	**3.1**	**3.5**	**3.6**	**2.6**	**2.9**	**2.8**	**0.3**	**0.2**	**0.1**	**-3.5**	**-3.3**	**-2.9**

Source: UBS * CPI excludes Venezuela

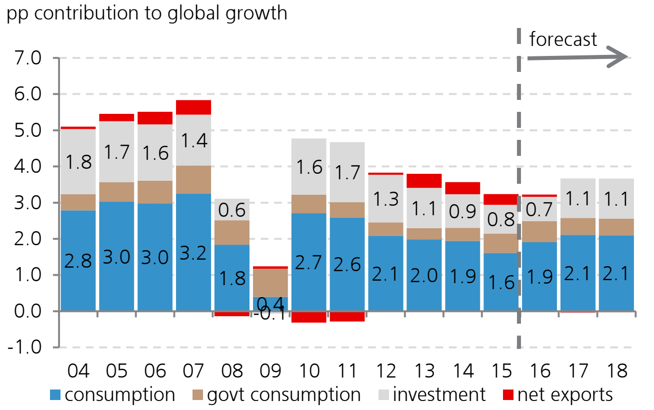
Global Outlook: continuity or discontinuity?

Baseline hockey-stick forecasts

Nominal growth to improve for first time in seven years

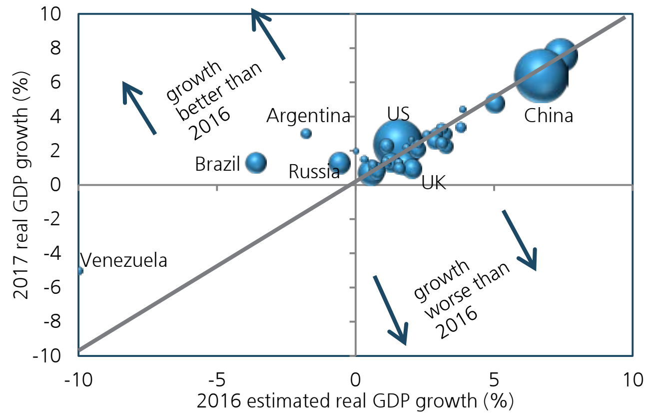
We expect global real GDP growth to increase from 3.1% to 3.5% – 20bp more acceleration than the IMF's forecasts but roughly in line with consensus. That improvement is largely coming from a recovery in a number of relatively large economies that should rebound from recessions this year: Russia (weighed down by low oil), Brazil (political corruption scandal), Argentina (regime change). Most importantly, however, we also expect the US to grow nearly 1pp faster than this year (from 1.5% in 2016 to 2.4% in 2017) which puts us roughly in the 80-85th highest percentile among analysts on Bloomberg (20bp above Blue Chip consensus in '17 and 50bp in '18). Half of that US acceleration is due to diminishing inventory drag and half due to higher investment – we'll come back to that in a second. Global nominal growth – and by extension we hope revenues/profitability – we project will improve for the first time in seven years in local-currency terms.[1]

Figure 2: Pick-up in 2017 growth mostly driven by modest recovery of investment from low levels



Source: UBS Estimates

Figure 3: The main growth acceleration is in EM (Brazil, Russia, Argentina rebound from contractions) and the US



Source: UBS Estimates (Bubble size reflects PPP weight)

More expansionary US fiscal policy could boost growth by 20bp

But let's start by addressing the elephant in the room. The US election outcome was a major surprise and there is substantial uncertainty on the future course of policies, the make-up of the administration, possible changes in leadership at the Fed (Yellen's term ends Feb 2018), trade policy (NAFTA in doubt; trade restrictions for China) and fiscal policies (potentially adding 20% of GDP to government debt over the next 10 years as explained here: [What does the election mean for the US economy?]). The uncertainty created by the US election is qualitatively different from that created by the UK referendum: the UK referendum was a vote on a single proposal, which would then dictate a specific future course of action

[1] In USD terms we project global nominal growth to improve a full 300bp to 4.8% next year, which would be a 10½ pp swing vs 2015 (which itself was a 20-year low). However, whether that materializes hinges more on our G10 FX forecasts being correct than the underlying growth/inflation dynamics. In local-currency terms, the acceleration is 70bp to 6.4% global nominal growth, which is roughly in line with the historical average and around 2013/2014 levels. A bit under two-thirds of the improvement comes from better real GDP growth (the rest is inflation). And some countries (e.g. 200bp nominal acceleration in the US) show a more impressive increase.

(withdrawal from the EU). The US election, like most elections, is more complex and open-ended. Yes, there is new leadership with some strong views, but there is also a legislative process that will affect what exactly, and how quickly, changes get implemented. The point is: there is a fog of uncertainty, and it affects everything: growth, inflation, the Fed's reaction, the USD and global rates.

For now, and until we get more clarity, we assume that from a global perspective upside risks to growth from fiscal policy (21bp per year using low Congressional Budget Office (CBO) fiscal multipliers applied to the specific components of Trump's pre-election proposals) offset downside risks from increased protectionism.

2017: 10y Treasury at 2.25%, EUR/USD at 1.13, oil at $60/bbl

Our strategy colleagues are similarly wary of extrapolating near-term uncertainty to big 2017 moves in FX or rates. That said, they have raised their 10y US Treasury forecast for end 2017 from 1.50% to 2.25% (and 2.5% in 2018) on a combo of higher fiscal deficits (and issuance), a correction to the under-pricing of breakeven inflation and higher growth needing to translate into higher expectations for the neutral Fed Funds rate. We expect 10y German bunds to increase to 50bp and, because the Eurozone curve re-prices more quickly than the US curve (we think the ECB tapers its bond purchases mid-2017), and the US-Eurozone current account differential widens, we think EUR/USD has bottomed and will rise back up to 1.13 by end-2017 (and 1.17 in 2018). Barring major shifts in currencies and rates from current levels, the oil market rebalancing should continue and Jon Rigby's team still assumes Brent oil averaging $60/bbl in 2017 (ending the year around $65/bbl vs futures around $52/bbl).

"Fat tails" around our forecasts

So if you're still with us you'll have noticed this all sounds pretty benign and awfully similar to the environment we've been in the last few months. And that's the problem with baselines: ex ante optimism about the future (or assumed convergence to some aspirational potential growth rate in the medium term) gets overtaken by low-probability economic shocks that weren't in the baseline. Those shocks have mostly been of the negative variety in recent years and it could happen again. And it's why everyone's forecast has been a bit like a hockey stick projection: flat/disappointing reality followed by magical improvement in the projection. So a bit further down we show some detailed scenario analysis on the various ways in which we could be wrong. That's more interesting and some of it downright scary (teaser: 40% decline in S&P in two of our five scenarios…).

Increasing EM weight "skews up" projections

But sticking with the baseline for a moment, there is also a mechanical reason why the future is projected to look better than the past, even in the face of trend declines in potential growth in developed markets (DM), China and elsewhere. Yes, welcome to the wonderful world of rolling PPP weights used for the construction of global GDP aggregates.[2] The weight of EM has gone up by 10% since 2007 in global aggregates and so, on our EM growth forecast of 5%, that adds an additional 50bp to global growth that wasn't there in 2007. And as long as China continues to grow at triple the pace of developed markets, that 'weight effect' should continue to be important. To that point: we expect China to contribute only 50bp less to global growth in 2016 than it did in 2007 even though it was growing more than twice as fast (14.2% then vs 6.7% estimated for

[2] Throughout this outlook we use Purchasing Power Parity GDP weights from the IMF to create aggregates for GDP and CPI and, in keeping with IMF convention, we use market GDP weights for fiscal and balance of payments aggregates. We also use the IMF categorization of 'Advanced Economies' for DM and their grouping of "Emerging and Developing Economies" for EM.

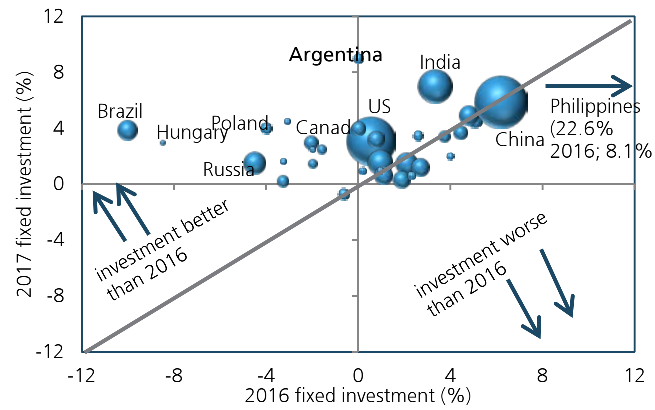
2016. This also helps the EM-DM growth differential recover somewhat: we are projecting EM to grow 2.8pp faster than DM in 2017. That's a far cry from the '03-'08 boom years (or indeed still below the entire '08-'13 period) but it's a full 70bp above the post-1980 average and faster than at any point prior to 2003.

Global investment to recover from anaemic levels

Investment rebound driven by recession recovery and oil prices

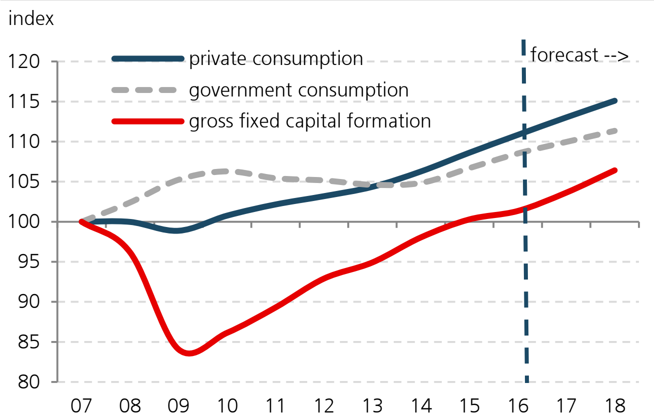
Perhaps the most pivotal economic question for the economic outlook is whether investment will start to improve. In the four years prior to the global financial crisis, investment globally was contributing 160bp on average to growth every year. This year that contribution is expected to be only 67bp. And next year we expect the contribution to go back up to about 109bp (gross fixed capital formation globally accelerates from 2% to 3.8% yoy, which is roughly back at 2013 pace). As Figure 5 shows, investment in DM has taken nine years to recover back to 2007 levels.

Figure 4: The projected improvement in investment (gross fixed capital formation) is broad-based



Source: UBS estimates (Bubble size reflects PPP weight)

Figure 5: DM investment this year finally got back to pre-08 levels



Source: UBS estimates

Investment weakness explains about 60% of global trade weakness

How close the 2017 projected investment pace is to a new normal is a bit unclear because pre-crisis investment levels were artificially high (construction booms, China property surge, credit bubbles in CEE). Behind the narrow 'growth accounting' impact of investment there are also important spillovers to other sectors, notably exports. We have estimated that 60% of the slowdown in global trade in recent years may be due to demand weakness (Big Macro 07), and the IMF thinks investment may account for as much as three-quarters of the weakness[3]. So investment recovering means global trade recovering, at least somewhat.

The scatterplot in Figure 4 above shows how broad-based we project the investment recovery to be. All countries above the diagonal line have higher investment growth in 2017 than 2016, and the size of the 'bubble' indicates their importance to the global economy (PPP weight).

- **Brazil** is projected to continue to recover from 10 consecutive negative quarters of investment growth, which ended earlier this year. Fiscal crowding-out should stop, a more stable currency should allow increased capital imports, and business confidence is surging.

[3] See the International Monetary Fund's October 2016 World Economic Outlook, chapter 2.

- In the **US** business fixed investment has been declining and it's extremely rare to see capex increasing less quickly than consumption outside of recessions. Equipment spending on aircraft, railroad, trucks, mining and oilfield and construction equipment has been particularly weak. A big drag has been energy structures spending (declining oil rigs) which subtracted 9pp from YTD business structures (ex-energy structures investment was growing +5.8% yoy in Q3). And the dollar amount of energy capital investment is now worth only 30bp of GDP, down from 92bp at the start of 2015. Energy-price stabilization should reduce that drag and rig counts YTD are up.

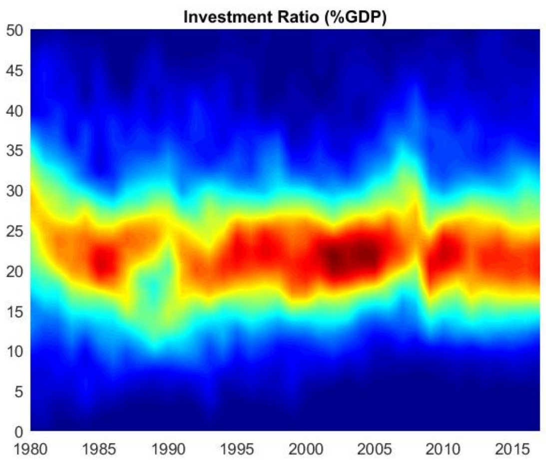
US investment recovery drives global investment recovery

- **China** is not part of our projected investment recovery story next year. We expect fixed investment growth to slow to below 6% in 2017 led by weaker real estate and related investment, for which higher infrastructure investment will only partially compensate. There is upside risk to that forecast if we are wrong on the policy-induced property market cooling (inventories are back down to 2013 levels or so and at some stage new building needs to start) and the extent of frontloading in demand.

China's investment decline remains a small drag

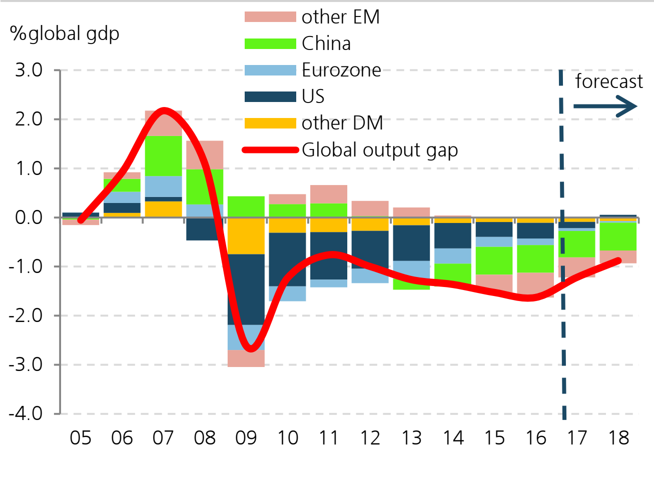
- **Russia**'s investment should recover somewhat from recessionary levels helped by higher oil prices but fiscal policy should remain tight so investment growth remains relatively anaemic.
- In **Poland** and **Hungary** investment was negative this year due to the EU fund absorption cycle: 2015 was the last year when funds were paid out from the 2007-13 framework and governments scrambled to absorb every cent while also starting to draw funds from the "current" 2014-2020 framework. That pushed EU fund absorption to the highest ever recorded level in CEE, and the decline this year in investment was payback for that. Looking ahead, absorption under the new framework should pick up, which will allow investment to recover.

Figure 6: Dispersion of investment to GDP ratios across 186 countries



Source: IMF, UBS estimates

Figure 7: EM is projected to account for 77% of the global output gap in 2017



Source: UBS estimates

One nice way of visualizing the dispersion in global investment is the heatmap in Figure 6.[4] The "hotter" the red, the greater the number of countries with an

[4] The chart uses investment to GDP data for 186 countries from 1980 to 2016. To compute each distribution, we rank the country ratios in increasing order, place them in regularly spaced bins, and count the number of countries in each bin. Smoothing these bins and counts produces a density measure of the ratio for each year. To represent this three-

investment ratio around a particular value. The colour cools off to blue towards the extremes of the distribution. The centre of the distribution (the mode) is between 20% and 25% of GDP, with extremes up to 50% (China in its heyday). Although the centre does not appear to move much, the distribution does change quite a bit over time. In particular, note how it bunches and shifts up on the eve of the GCF, and drops and broadens (hence the lighter red) afterwards. So investment is now more dispersed than pre-crisis but less so than in the 1980s when average investment was also higher.

73% of countries still have output gaps

Despite the projected (modest) improvement in investment in 2017, we estimate the global output gap will still exceed 1% of global GDP and that 73% of the countries under our coverage will still be operating under excess slack. As you can see in Figure 7, the majority contribution to the global output gap comes from emerging markets (77% of the gap in 2017E) and in particular China (43% of the global output gap). That may seem counterintuitive given the perception that China's growth is probably being kept artificially above potential with excess stimulus/credit growth. But that stimulus has also created new excess capacity, particularly in steel, aluminium and industrial sectors. Case in point: producer prices have been declining for 4½ years. And because we are forecasting China to run growth close to (declining) potential, the output gap basically doesn't close, unless we see more capacity (and capital) destruction.[5]

The energy-price-driven turn-around in global inflation

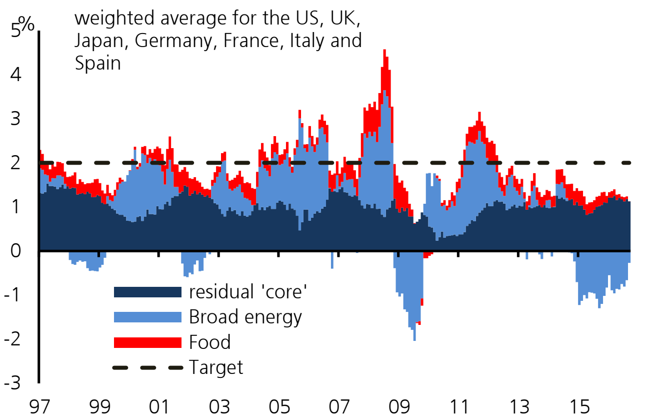
This has been one of the weakest post-crisis recoveries we've ever seen and outside of those countries that experienced significant currency depreciation there is still little sign of inflation pressure. But if we were a central banker (and those writing this piece used to be) then we'd be worried about the chart below left. Energy prices—which we have defined very broadly for cross-country comparison purposes, i.e. we've included the entire transport component alongside gasoline and other energy-related prices—have subtracted an average of 81bp from headline inflation over the last two years versus historically (since '97) adding an average of 55bp.

---

dimensional object (time x bins x counts), we opt to capture the density by a smooth colour scheme.

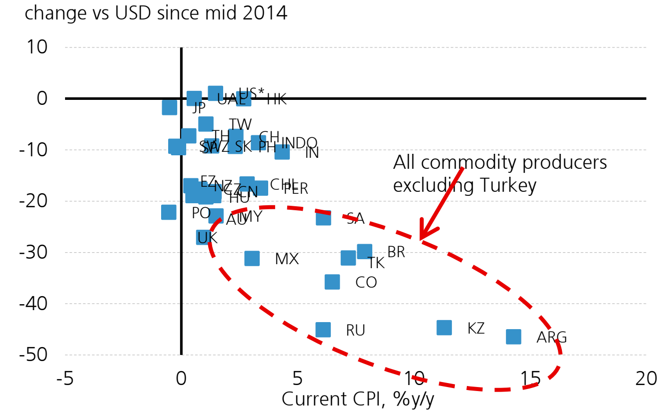
[5] China's output gap opened up when growth declined from about 10.6% in 2010 to 7.9% in 2012. Between 2008-2012 China injected massive stimulus into infrastructure but corporate investment and industrial capacity was also still strong and new capacity continued to come on line after 2012. Then growth suddenly slowed due to the property market slowdown and stalling global exports.

Figure 8: Energy prices the main reason DM countries are falling short of their inflation targets



Source: Haver, UBS estimates

Figure 9: Commodity vs non-commodity producers



Source: Haver, UBS estimates

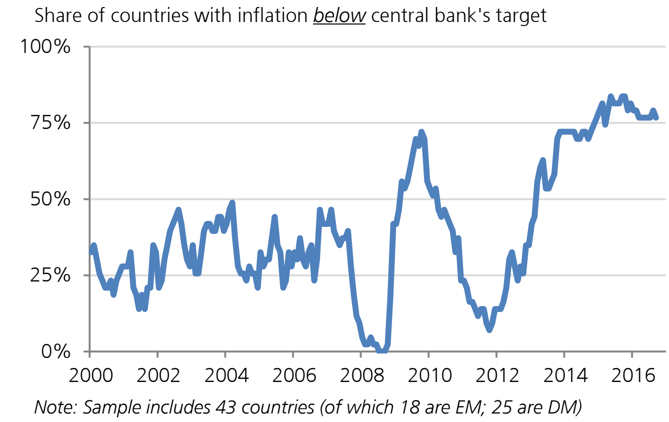
Over that same two-year period headline inflation has averaged 47bp (currently 86bp), or about 153bp below target. But if you assume energy prices revert back to their historical average, that adds 136bp, which takes inflation back to 1.83%. So, only just shy of the target. And given a collective inability of central banks to forecast energy prices – they mostly use futures prices, which we think is a bad idea, as we discuss below – that's a pretty thin basis on which to base extreme levels of monetary accommodation.

Energy prices to push DM inflation back towards their inflation targets by end 2017

That's a major theme for us in the year ahead. IF we (i.e. our commodity team) are right on oil prices moving back up to an average of $60/bbl then that will be the primary driver lifting DM inflation by 116bp on average (PPP weighted) by the end of next year from current levels. For EM, in contrast, we are forecasting a decline in inflation of -13bp, but there is a lot of variation around that number. Some, like Poland, have an inflation profile very similar to a developed market, whereas in others (commodity producers or markets that experienced sharp exchange-rate weakness over the last 12-18 months) base effects are reversing and neutralizing higher energy prices (see Figure 9).

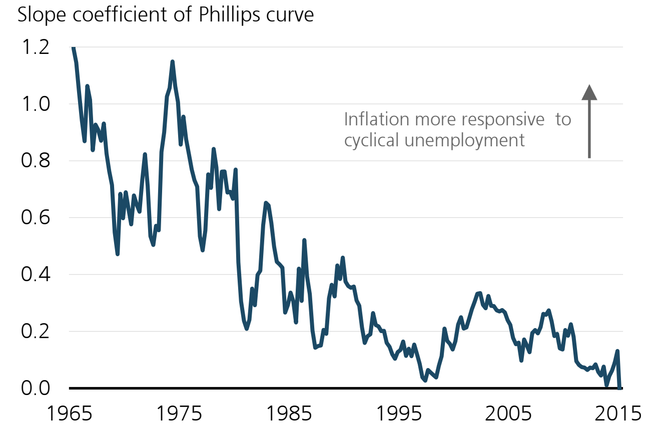
For DM central banks that poses a challenging narrative. Central banks have understandably used the shortfall vs inflation targets as additional justification to pursue extremely accommodative policies in support of growth. But the shortfall vs inflation targets (see Figure 10) had little to do with output gaps (see the declining slope coefficient of the Phillips curve in Figure 11) and everything to do with a variable over which they have little control (see Disinflation-felt locally, spread globally). That becomes a problem when that same variable (oil) starts to move in the opposite direction.

Figure 10: Over three-quarters of all countries currently have inflation below target



Source: Bloomberg, UBS calculations

Figure 11: The importance of the output gap in explaining inflation has declined over time



Source: Bloomberg, UBS calculations

Now we're being a little unfair of course. Inflation pressures have been subdued for some time now, outside of the US it's difficult to see any real wage pressure, and the current OK-ish core inflation data in DM should be viewed in a context of extraordinary policy accommodation (i.e. the counterfactual = even lower inflation). Moreover, a little bit of inflation will probably be welcomed by everyone at this stage. But the risk is that if we get too much of it – even if coming from non-core price components – the Fed and ECB will suddenly run out of accommodative runway and struggle to explain why they should not be scaling back their stimulus. We don't think central banks have any intention of changing direction quickly, but we've seen how adversely the market can react to even minor lane changes (2013 taper tantrum).

Central banks still like it 'hot'

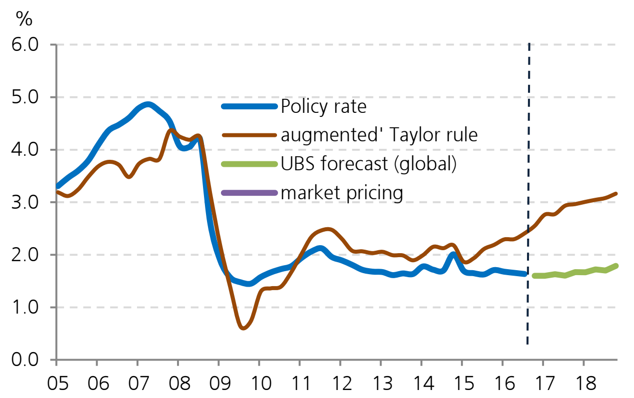
There is a narrow reflationary path next year. Despite trend declines in potential growth, there are some upside risks to growth from fiscal policy (hopefully not offset by trade policy), some signs of wages picking up (again mainly in the US), financial conditions remain easy (everywhere) and energy prices should/could lift prices closer to their target (all of DM).

Central banks on average 100bp behind the curve?

One way to show how far central bank is (deliberately) behind the curve is with a Global 'augmented' Taylor rule (Figure 12). We say 'augmented' because we let the regression choose the output gap and inflation coefficients itself, based on how central banks have historically responded to deviations away from target/neutral, and we've added in an exchange rate variable as well.[6] What it shows is that—relative to how central banks have responded to improvements in inflation and growth in the past – they are now already 100bp behind the curve, on average, and by the end of our projection horizon will be 174bp behind the curve (based on our forecast of policy, which is very close to market pricing).

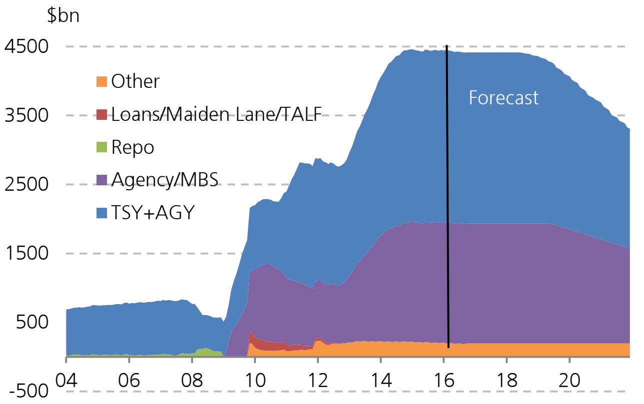
[6] The constant in the regression is effectively the 'neutral' policy rate. The flipside of this approach is clearly that the equilibrium rate is not time-varying, but the point of the exercise is to show how different the current policy reaction is from historical behaviour. Our inflation coefficient for DM is 0.42 and our output gap coefficient is 0.81, with an r-square for the regression of 0.69.

Figure 12: A Global 'Augmented' Taylor rule suggests central banks are falling further behind the curve



Source: UBS estimates

Figure 13: Fed balance sheet



Source: UBS estimates, Haver

The median monetary policy normalization priced into markets is zero over the next 12 months.

This is deliberate of course: there have been too many head fakes on growth (every up-tick in recent years was followed by disappointment) and many are trying to look through the energy-driven improvement in headline inflation. But IF there were suddenly any sign of wage pressure or core inflation drifting higher, we suspect central banks would be scrambling to change their 'low for longer' narrative. And that's clearly not priced by the market. The 12-month-ahead forecast for the 15 major central banks used in our estimates have median policy normalization of 0bp and an average of -20bp, with 12 out of 15 central banks expected to hike less than 10bp or cut. We think the Fed might finally deliver on its dot plot next year (so 2 x 25bp, i.e. more than priced), but that the market is right in assuming the ECB and BoJ won't cut. The UK we actually think will ease more once the reality of delayed investment and hiring decisions sets in during H1-2017 (we project unemployment to increase from 5% to 6.3% in 2018).

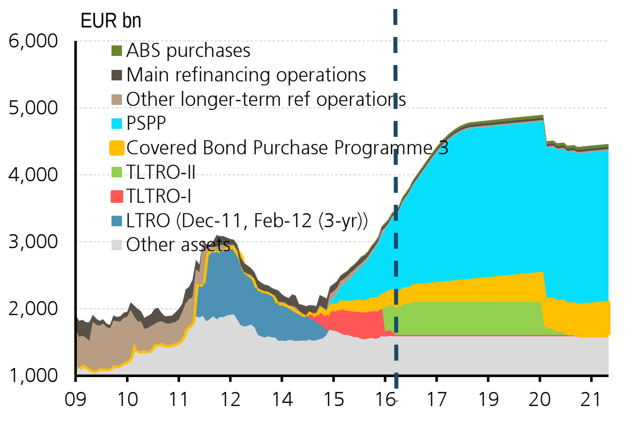
Liquidity policies by the major central banks are projected to remain accommodative as well, and we show the expected evolution of the Fed, BoJ and ECB balance sheets in Figures 13, 14, and 15.

The Fed's balance sheet could start to passively contract mid '18

- The **Fed** is expected to start balance sheet normalization 6 months after rates have reached "normal" levels[7]. The Fed has described sub-1% rates as abnormal. As such, we put the start of the balance sheet roll-off at FF reaching 1% + 6 months (July 2018). 2). The roll-off begins with US Treasury securities, and only a fraction of those to start (20%). The Fed will want to gauge the market response and maintain sufficient on-the-run securities to maintain the health of its sec lending programs. Within two years the roll-off is 90%. MBS roll-off begins at Treasury roll-off +12. We assume a quite low prepayment speed (7%). This is about half of normal but most mortgages held are 4%-or-lower mortgages. By the end of 2021 the balance sheet would be $3.3 trillion. While significantly lower, it is still roughly 2x historically normal.

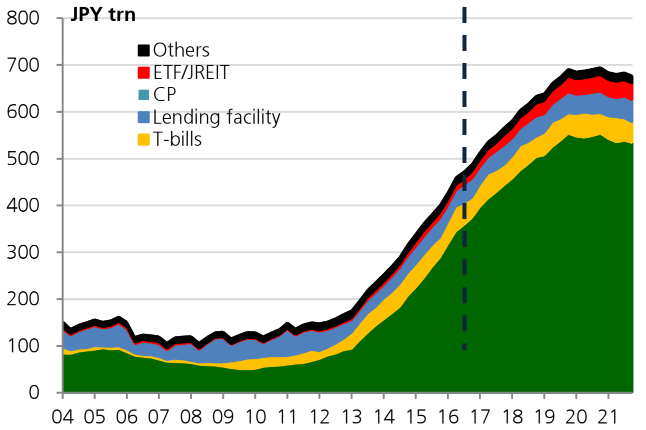
[7] The Fed's 'Normalization Principles and Plans' state that it will maintain its current reinvestment strategy "until normalization of the federal funds rate is well under way". https://www.federalreserve.gov/newsevents/speech/yellen20160826a.htm. That to us implies balance sheet roll-off starts before the hiking cycle is over, i.e. before it gets to neutral.

Figure 14: ECB balance sheet (EURbn)



Source: Haver, UBS estimates

Figure 15: BoJ balance sheet



Source: Haver, UBS estimates

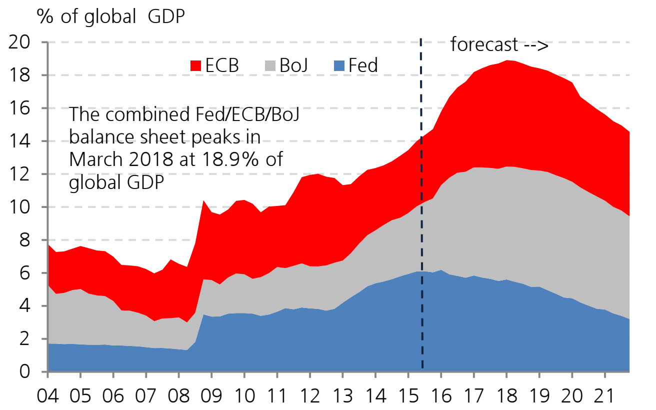
We project the ECB to taper its asset purchase program by mid-2017

- The **ECB** we believe will extend its asset purchase program by six months (EUR80bn/month), letting it run through to September 2017. By June '17, however, we expect the ECB to announce a tapering of its purchases, winding those down to zero by Sept '18. That still means the balance sheet would not shrink until 2020 which is when the TLTRO 2 loans start to mature (in June, September and December 2020 and March 2021). We assume no early repayment so balance sheet contraction starts in June 2020 at the latest. We've also assumed that the corporate bond purchase program is tapered along the sovereign purchases and we've assumed maturing purchases are reinvested over the forecast horizon (which is debatable). We've also assumed the covered bond and ABS programs run one year longer than the other programs to allow these markets to continue to grow.

BoJ to start tapering by April

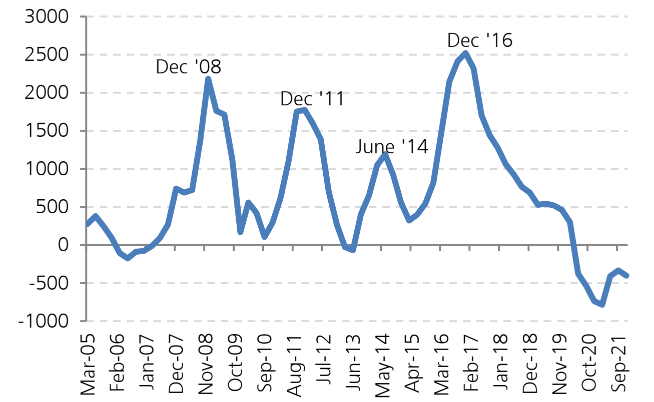
- The **BoJ** we think maintains its JPY80 trillion purchase pace for now despite the seeming inconsistency with having a JGB yield target (if it is below the target, it could stop purchasing JGBs or in theory sell them) given the asymmetry in the reaction function (happy with yields below target but not above). By April 2017 or so we assume the purchases get scaled back to JPY 70 trillion and then JPY 60 trillion by April 2018. We assume the BoJ balance sheet doesn't peak until 2020 and will start shrinking after 2021. That roughly coincides with the end of Abe's term and the BoJ will have reached its limit in purchasing from financial institutions. The risk is that BoJ reduces purchases earlier, but for now it's unclear how it would do that without driving USD/JPY sharply lower.

Figure 16: Combined G3 balance sheet as % of global GDP



Source: UBS estimates, Haver

Figure 17: Four-quarter change in G3 central bank balance sheets (in $bn)



Source: UBS estimates, Haver

Fed, ECB and BoJ have added 10% of global GDP in liquidity since the crisis (>$9trn)

The upshot of all that is that, as a % of global GDP, the combined size of the balance sheet of the three major central banks should peak in March 2018 at 18.9% GDP, up from about 6% of global GDP just before the crisis. Although any run-off in balance sheet should be slow, a major uncertainty for 2017 is how the market digests tapering by the ECB and/or BoJ, given the 2013 Fed experience. It's a clear asymmetric downside risk to our forecast.

The 'CB impulse' peaks in Dec '16

And to underscore the potential sensitivity the market may have to changes in policy, look at Figure 17. We show here the four-quarter change in the amount of liquidity provision extended by the three large central banks in dollar terms (i.e. the second derivative) which we expect to peak in Dec '16 (!). The Fed's balance sheet is no longer growing and the ECB starts to reduce the purchase pace next year. So if you think of the balance sheet as a 'liquidity impulse', the pace of stimulus should now start to slow but won't turn contractionary until mid-2020, on our forecast (in USD terms).

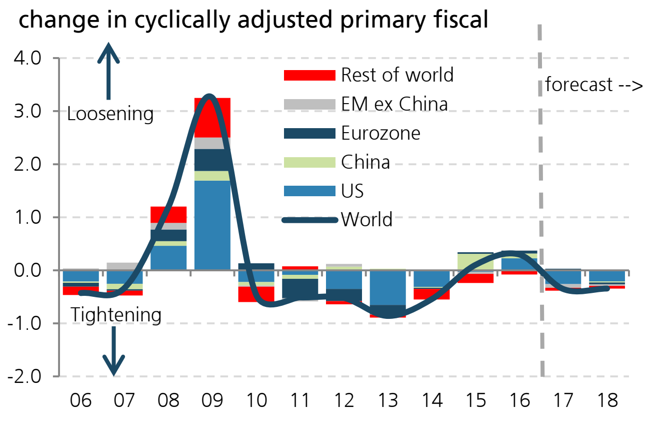
Why are governments not using their 'fiscal space'?

One of the reasons growth in the Eurozone, in particular, seems to be getting a bit better is that the large fiscal drag (and major adjustment programs in the periphery) from 2012 to 2014 has dissipated. Indeed the global fiscal impulse (Figure 18) shows 2015 and 2016 have been the first two years since the crisis without fiscal headwinds.

Fiscal impulse globally turns contractionary but all depends on the US

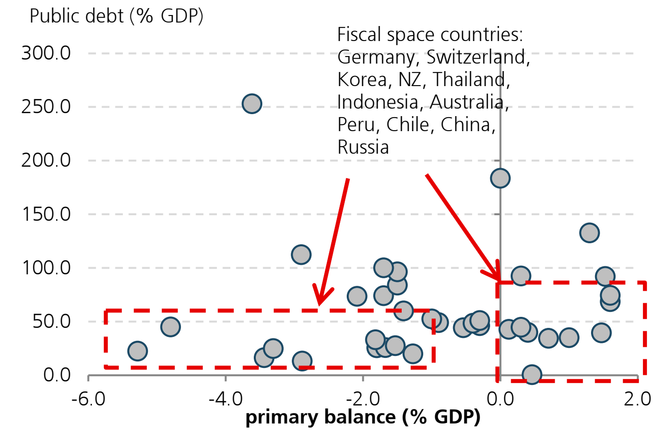
Looking ahead at 2017, however, we again expect fiscal policy to be slightly contractionary, posing a potential headwind for growth. Whereas in 2016 we estimate 17 out of 25 countries saw some slippage in their cyclically adjusted primary balance (= stimulus), in 2017 only four out of 25 will (within that 25 subsample, the Eurozone is counted as a single entity). But as you can see in the chart, at a global level, whether fiscal headwind emerges in any material way hinges mostly on what the US will do (our chart does not yet assume any implementation of Trump's proposed plans) and so what now looks like a modest headwind could well change to a modest tailwind.

Figure 18: Fiscal impulse chart



Source: UBS estimates

Figure 19: Plenty of countries with 'fiscal space'



Source: UBS estimates

Germany can't continue to sustain the fiscal boost created by refugee spending

Notwithstanding IMF pleas at the G20 for countries like Germany and Korea to use their 'fiscal space' to give an additional boost to global demand, we expect political constraints will prevent most of that from happening. Despite 2017 being an election year, **Germany** is a reluctant spender and we project a small surplus of 0.1% next year (down only a tenth from this year). From an impulse perspective the problem is that refugee-related spending has already boosted growth by ½ pp of GDP since Q4-15 and tax cuts and increased child benefits in 2016 (adding 0.3pp) increase the bar for adding more stimulus: you need to spend even more than you did this year to sustain the growth impulse. But refugees already exceed 1 million and that inflow (and related spending) should slow considerably. In the rest of Europe, six countries are under the excessive deficit procedure (mainly for exceeding the 3% GDP deficit limit) and **Spain** is scheduled to undertake a large adjustment. **France's** fiscal plans could slip a bit in an election year, and there is some uncertainty over what happens after the Italian referendum. So, at best, we can only come up with a fiscal impulse in the Eurozone of about 20bp. That doesn't really add anything at a global level. **Korea**, likewise, is reluctant to press the fiscal stimulus button. However, the government envisages an increase in spending of 3.7% that will almost certainly be below nominal GDP growth. It may again pass a supplementary budget later though to ensure growth stays in a 2.5-3.0% range, with a view to the presidential election in Dec '17.

China will add as much stimulus as needed

In **Japan**, we estimate that the supplementary budget adds only 0.2% GDP extra stimulus relative to 2016 despite the large headline number. **China** could do more fiscal stimulus, with government debt still low, though the augmented fiscal deficit (including local governments) is already running at -10% GDP. Despite a 2014 law imposing tighter constraints on local governments, new quasi-fiscal channels have been created. We expect the government to continue to use these channels (PPPs, policy bank special construction bonds, etc) to boost infrastructure spending in 2017 (possibly to the tune of 2pp of GDP annually in additional spending the next two years). Formally, however, the official 2017 budget plan will only be revealed next March. **India** is subject to a budget consolidation framework which calls for a 3% central government deficit in FY 2016/2017 (i.e. further consolidation). The major development in 2017 should be the long-awaited introduction of the GST but this should be revenue-neutral (rates still need to be decided).

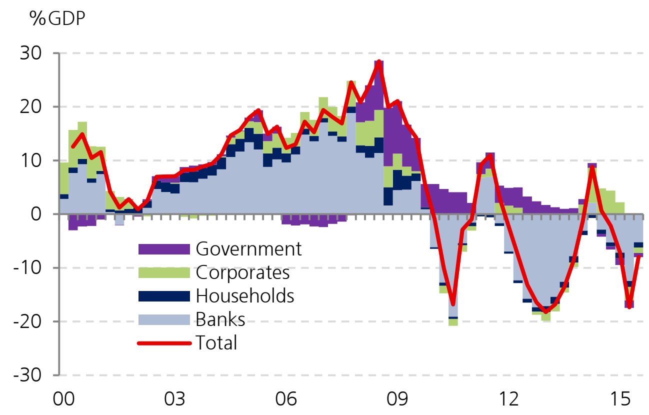
Finally, in the **UK** we expect a slightly more accommodative fiscal stance as the government acts to offset the anticipated slowdown in private activity from the EU referendum. Other than frontloaded infrastructure investment, we don't expect major changes in the budget, but the deficit should deteriorate as automatic stabilizers work their way through. The budget forecasts should change significantly once the OBR changes (i.e. lowers) its GDP assumptions on 23 November.

UK spending largely in wait-and-see mode

Is the end of the debt super-cycle approaching?

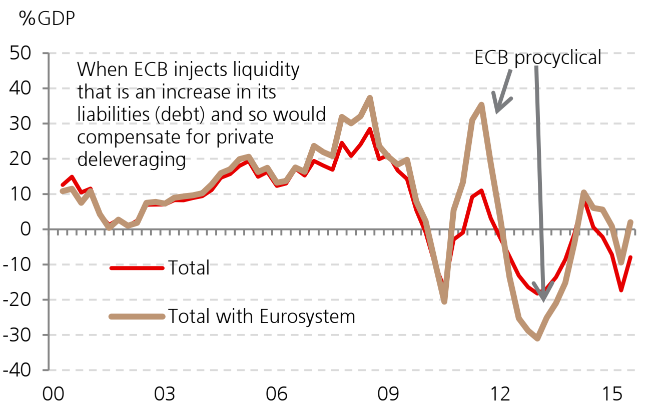
Even though central banks are unlikely to get much stimulus support from governments in 2017, there is potentially some upside risk coming from unexpected quarters: banks. The often-heard claim is that there has been no real deleveraging post GFC (indeed the IMF devoted its entire Fiscal Monitor to the topic in October) and that is largely true if you only focus on households, corporates and governments.

Figure 20: Eurozone four-quarter changes in debt by sector in % of GDP



Source: Haver, UBS calculations

Figure 21: Four-quarter changes in Eurozone debt, including the Eurosystem



Source: Haver, UBS calculations

Eurozone banks have cut 48.5% GDP in liabilities from their balance sheets since mid-2010

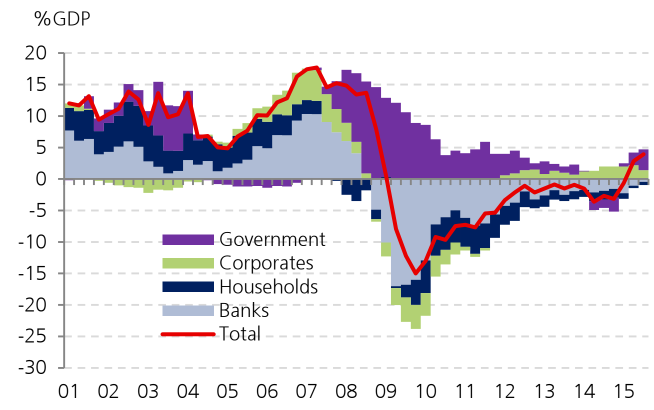
However, what should be obvious to anyone working in the financial sector, banks have done enormous deleveraging. Look at Figure 20 for the Eurozone. The purple bit shows the sharp increase in government debt during the crisis as policymakers increased deficits and tried to compensate for weak activity. You can see that, in the initial wave of the crisis, banks cut their balance sheets by more than that. However, there were two further major waves of deleveraging in the European banks: first in the aftermath of the Eurozone crisis and then again more recently. How much in total? 48.5% of Eurozone GDP in debt reduction since mid-2010 (!). That compares to -4.6% GDP in debt for households, +3.1% GDP for corporates and +10.1% GDP for governments over the same period (net deleveraging -40% GDP).

Rule No 1 when thinking about the world in 'debt super-cycle' terms is that it is a very bad idea for sectors to try to de-lever at the same time. But look at what the ECB did (Figure 21): it was shrinking its balance sheet precisely at the time when bank deleveraging was hitting its peak (2013). [8] Now to be fair to the ECB, what is

[8] It also expanded its balance sheet when the banks were not aggressively cutting debt in 2012 but that's more defensible given the wider turmoil/uncertainty at the time during the Eurozone crisis.

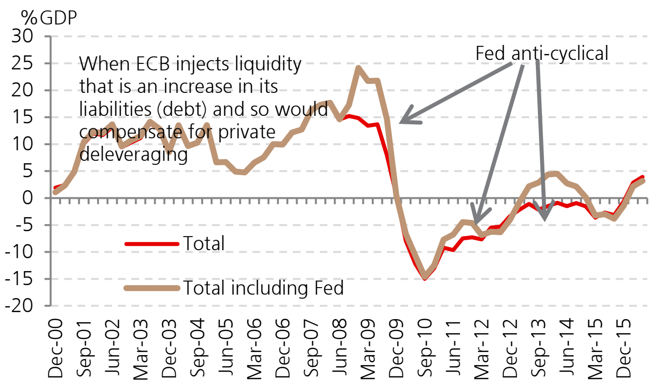
striking is that this cycle of deleveraging seems to have almost no correlation with domestic demand growth—in contrast to the credit impulse which has a correlation of 0.67 for development markets (see further down). So what were banks cutting if not their loan books? Mostly wholesale and interbank funding, and external loans.

Figure 22: Four-quarter changes in US debt by sector



Source: Flow of Funds, UBS calculations

Figure 23: Four-quarter changes in US debt including Fed

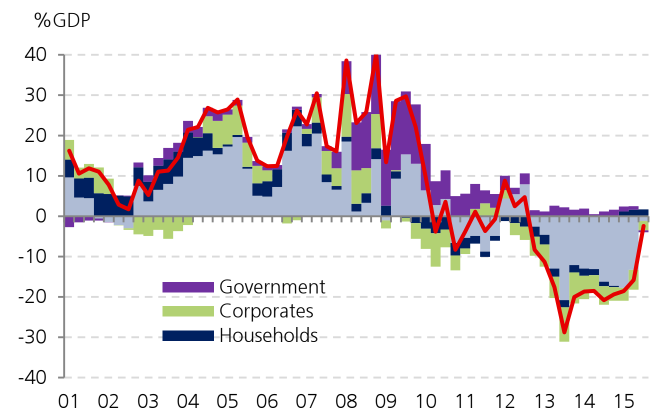


Source: Flow of Funds, UBS calculations

US banks have cut 36.7% of GDP in liabilities since mid-08

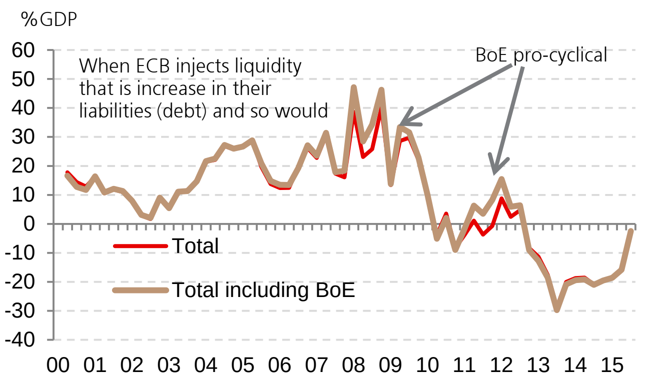
For comparison we look at the same charts for the US in Figures 22 and 23. You see a very different deleveraging cycle: banks cut their debt quickly during the crisis and by 2013 or so the job was largely done. The Fed also was also consistently anti-cyclical (adding stimulus when banks were deleveraging), as shown in the chart on the right. If we compare the total changes in debt – and let's do that since mid'-08 given that the US banks delevered early – we see household debt having contracted -18.3% of GDP, corporate debt 0% of GDP, bank debt -36.7% of GDP and, against all that, government debt has increased around 39.9% GDP (net deleveraging of -15.1% GDP).

Figure 24: UK Four-quarter changes in debt



Source: Haver, UBS calculations

Figure 25: BoE vs other sectors



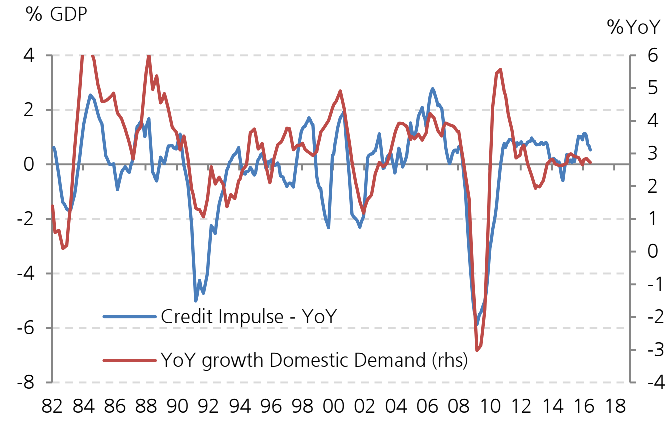
Source: Haver, UBS calculations

UK banks have cut nearly 35% of GDP in liabilities

Finally, the UK (Figures 24 and 25) banks seem to have started reducing debt (in size) a bit later than both the Eurozone and US banks. In total, though, they too have cut about 34.8% GDP in debt off their balance sheet since mid-2010, compared to -8.4% GDP for households, -19.9% GDP for corporates and +15.9% GDP for the government (over that period). So, a 'net' -47.2% GDP.

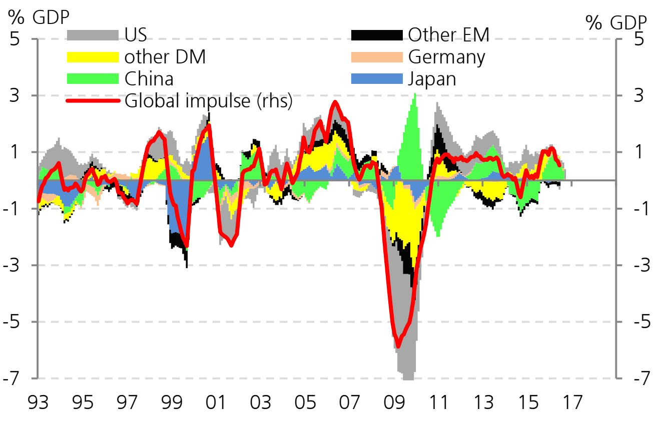
What is most intriguing about the charts is that the process seems to be nearing its end. There is still uncertainty over the changes in Basel rules that are forthcoming – and implementation timetables could run another couple of years – but regulators have suggested capital levels at banks are more or less adequate (on average). And so that raises an interesting possibility: even if it's the case that there is little correlation between changes in bank debt (as opposed to loan books) and activity, would the counterfactual not be more loan growth when bank balance sheets stabilize? That would certainly be our intuition. So watch this space. This could be part of the transitory headwinds that Rogoff and Reinhart famously wrote about in 2009.[9]

Figure 26: The global credit impulse vs global domestic demand (correlation 0.66)



Source: UBS estimates, Haver

Figure 27: Contributions to global credit impulse (market GDP weighted)



Source: UBS estimates, Haver

(Bad) Global Scenarios and Tail Risks

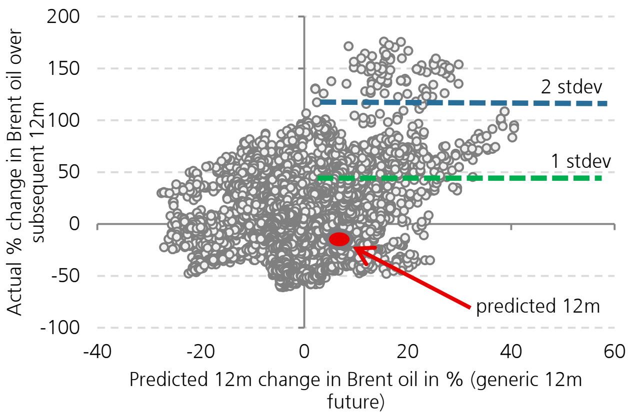
So there are some potential upside risks (more supportive bank lending, fiscal stimulus out of the US), but we find it most instructive to think about the downside risks given how elevated valuations in bond and equity markets are.

So, we have run five different scenarios: (i) oil prices going to $80/bbl; (ii) oil prices going to $120/bbl); (iii) US growth 2pp below our baseline; (iv) EMU growth 2pp below our baseline; and (v) China growing at 4% (roughly 2½ pp below our baseline).

Why so much focus on seemingly extreme/implausible oil-price scenarios? Mainly because it's the one shock that we think would be 'nuclear' for the system, given perceptions that inflation is 'dead', the significant build-up of duration and fixed income exposure on investors' books, and the fact that the market is pricing near-zero central bank action on our forecast horizon.

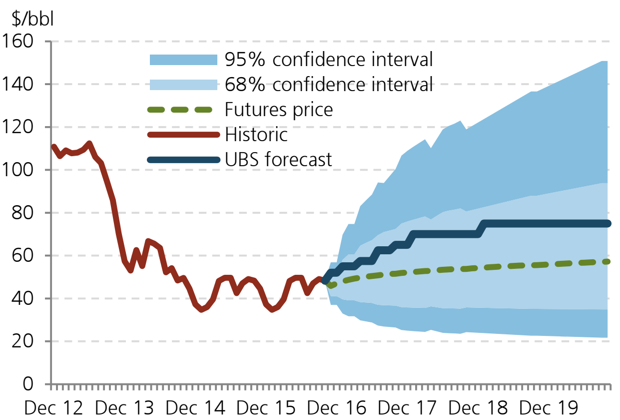
[9] "This Time is Different – Eight Centuries of Financial Folly", by Carmen Reinhart and Kenneth Rogoff (2009).

Figure 28: Futures are a terrible predictor of oil prices 12m ahead (avg forecast error 32%)



Source: Bloomberg, UBS Calculations

Figure 29: Option-market implied confidence intervals for Brent oil vs futures and UBS forecast



Source: Bloomberg, UBS Calculations

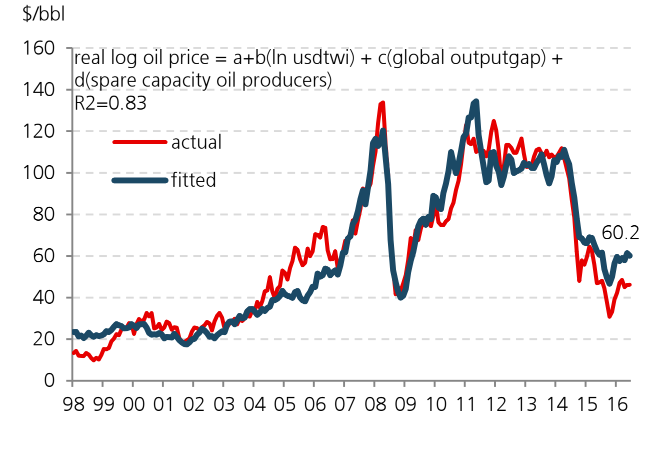
The average 'forecast error' of oil futures 12 months ahead is 32%

We owe Jon Rigby and his commodities team a debt of gratitude in thinking about these issues because they are the oil experts, not us. And what they point out is two things. First, futures are a terrible predictor of oil prices 12 months ahead, with an average forecast error of about 32% over the last 20 years – coincidentally roughly the same forecast error as Bloomberg consensus over the last 10 years. Figure 28 illustrates how bad a basis futures are for forecasting – and yet most central banks use it as the input in their inflation forecasts. Second, what is more useful in thinking about scenario analysis is to look at how the options market is pricing things.

A two-standard-deviation band around the futures price gives you a $120/bbl uncertainty band

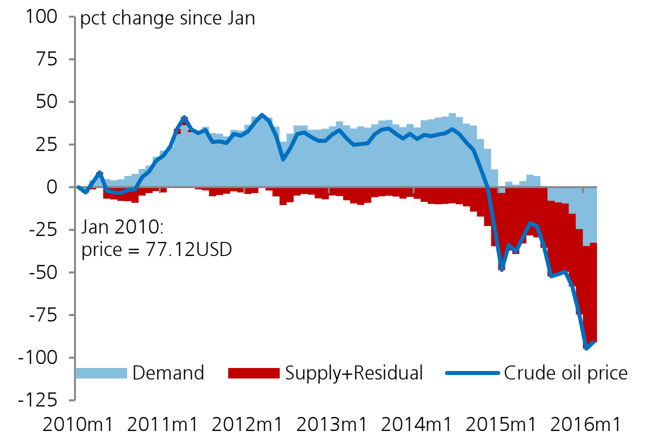
We show that in Figure 29: basically $80/bbl oil would equate to a one-standard-deviation shock vs futures pricing and $120/bbl oil is a two-standard-deviation shock (a 5% probability event). The chart also shows how our house view ($60/bbl oil in 2017E) is less than one standard deviation away from futures.

Figure 30: A simple macro model for oil prices



Source: UBS estimates, Haver

Figure 31: Decomposition of oil price into demand & supply factors (structural Bayesian VAR model)[10]



Source: Haver, UBS estimates

For emphasis, we are not forecasting anything; just trying to think through how bad things could happen. So let us make two simple macro points. The first is that if you construct a simple model based on a global output gap, the trade-weighted dollar, and spare capacity among oil producers, you actually get something close to our house view ($60/bbl). That's maybe more coincidence than anything else because the rebalancing that is going on in the oil market seems primarily a supply rather than a demand story.

Don't believe us? Look at Figure 31. Here we have decomposed prices in the oil market using a structural Bayesian VAR (see footnote for explanation). As you can see, a large part of the decline in oil was due to supply and other non-demand factors (e.g. OPEC withdrawing its support for the market in late '14).[11] Supply growth has now stalled and investment has largely stopped, and our commodities team believes this could create a 4 Mb/d 'hole' in supply that will begin to emerge in 2018 (though inventories draw substantially ahead of that). See Major projects database update and A month of superlatives. So imagine a scenario where demand starts to exceed supply and either Saudi Arabia doesn't have the spare capacity it says it has (global spare capacity is almost entirely concentrated with Saudi Arabia) OR shale oil in the US can't cover the shortfall quickly enough (e.g. because labour markets are tight, it takes a while for production to come back on line) OR there is a disruption in Venezuela (production equal to global spare capacity, which currently is at low historical levels). It's certainly not inconceivable that the market would overshoot on the upside the way it did on the downside (the fall in oil in Jan '16 was nearly a two-standard-deviation move away from the model shown in Figure 30).

[10] The model is a structural Bayesian VAR estimated with 5 variables: US IP, US PPI, World activity, Brent oil price and world production (barrels per day). All in logs. PPI, oil price, world activity are deflated by US CPI. It identifies structural shocks through sign restrictions inspired by the two-country (US-World) general equilibrium model with endogenous oil prices of Baxter and Crucini (2000). The identification of the oil supply shock is that the impulse generates a decrease in oil price concurrent with an increase in oil quantity, and an increase in both US and world output. We find that supply shocks have a level effect but little effect on monthly price variability.

[11] Our model looks somewhat similar to a different type of decomposition done by the NY Fed. See: https://www.newyorkfed.org/research/policy/oil_price_dynamics_report.

Now the way this plays out in our models is interesting. If all that happens is oil moving up to $80/bbl then that's a scenario where inflation is a little higher, the loss of real purchasing power is not really enough to dent consumption, you get some additional recovery in oil-related investment and central banks don't really behave any differently because higher headline inflation is offset by slightly weaker growth. It's essentially a modest inflationary shock in non-core prices and it's not big enough to really lift core inflation that much.

The impact of oil moving to $80/bbl would have a relatively modest impact on our growth and policy rate forecasts

However, if oil goes to $120/bbl, i.e. overshoots too much, the scenario suddenly turns rather catastrophic. The first-order impact is for US CPI to jump to 6% and Eurozone inflation to peak at over 4%. What our macro-strategy colleagues assume will then happen is for breakeven inflation to track the oil move (150-170bp) and for 10y Treasuries to get pushed to 3.10% or so (bunds to 2%). The offset from real rates is modest because the Fed will have to tilt hawkish to address the inflation shock; it is suddenly above its inflation targets (PCE peaks at about 4% in Q3 and core PCE would exceed 2% very quickly). That's essentially a major financial conditions shock à la 2013, but it's potentially worse in that it's difficult for central banks to react to the shock by turning more dovish. All that monetary space they thought they had is gone. Because both the US and Eurozone curves reprice in sync, there is not too much impact on major G10 crosses, but our fixed income colleagues suggest that 70-80% of the multiple expansion in stocks was due to term-premium compression. That essentially implies a 40% drop in the S&P and an average decline in EMFX of 17% vs USD. Yikes.

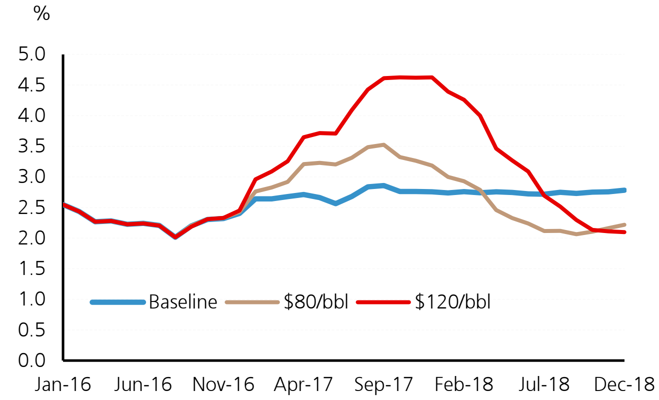
Oil at $120/bbl, however, leads to a massive overshooting of inflation targets

As that financial-conditions shock works its way through the system – we estimate it lowers global growth by about 70bp in 2017 and 90bp in 2018. The shock is worse in DM because there are fewer oil-producer beneficiaries (such as Russia in EM) and so DM growth falls by 80bp and 130bp, respectively, over those two years. At that stage this is a full-blown stagflationary shock and central banks reverse course, particularly when oil stabilizes and base effects start to fall out of their inflation forecasts. Eventually, 10y Treasuries move back down towards 1.8% or so and both EMFX and equities recover somewhat.

The shock becomes stagflationary, forcing DM central banks to ultimately cut rates relative to the baseline but EM central banks (mostly) to hike

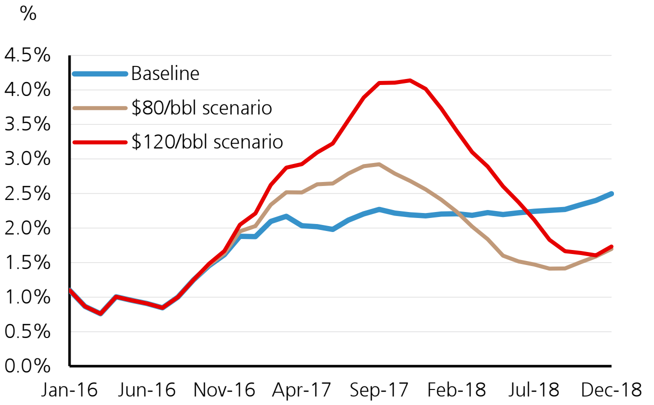
Relative to the $80/bbl scenario, central banks in DM are suddenly cutting rather than hiking. In EM, in contrast, the opposite happens as the inflation shock there is compounded by exchange-rate weakness and more generalized inflation, and central banks have to hike (rather than cut in the $80/bbl scenario). We will publish the full country-by-country detail in a separate piece so this is just a taster.

Figure 32: Global CPI YoY (ppp-weighted)



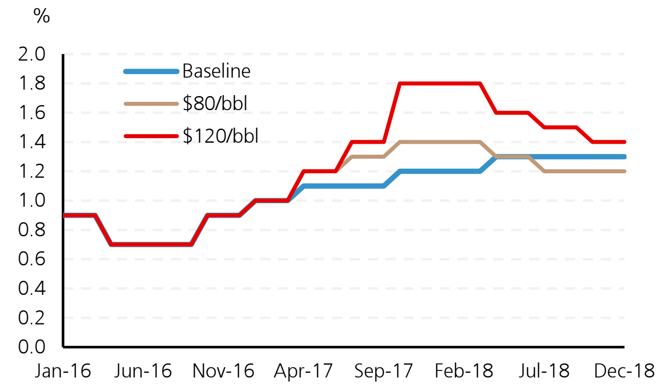
Source: UBS estimates

Figure 33: US PCE inflation YoY (%)



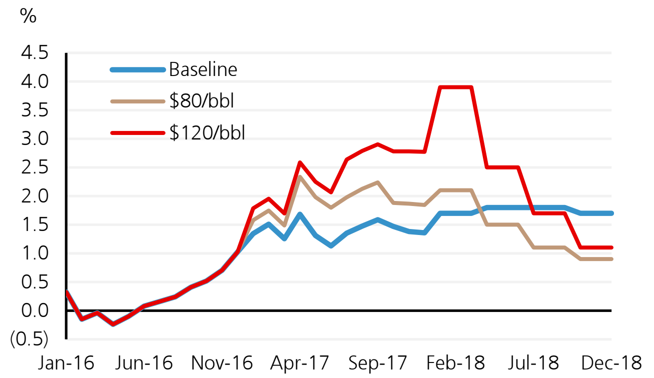
Source: UBS estimates

Figure 34: Eurozone core CPI YoY (%)



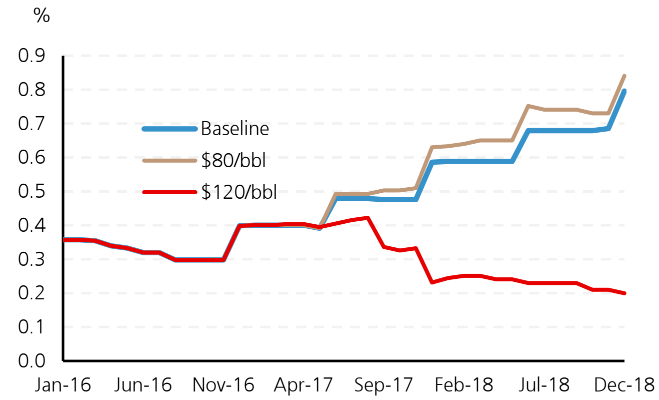
Source: UBS estimates

Figure 35: Eurozone CPI YoY (%)



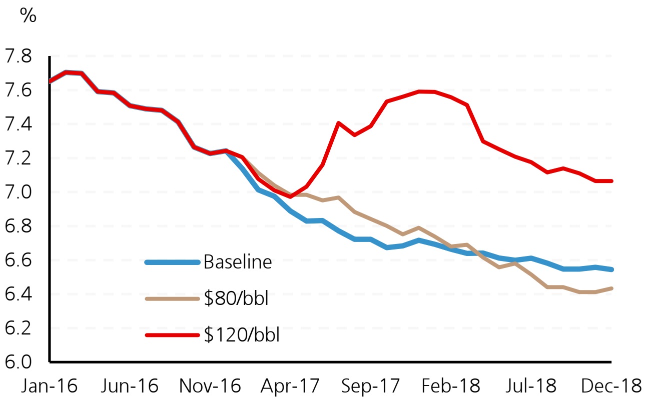
Source: UBS estimates

Figure 36: Average DM policy rate (%)



Source: UBS estimates

Figure 37: Average EM policy rate (ex China) in %



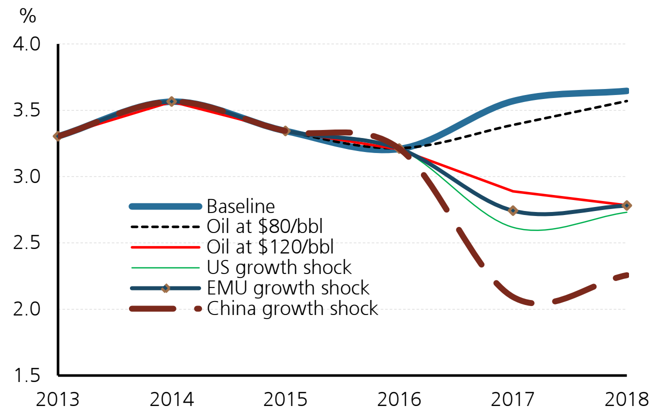
Source: UBS estimates

Now in terms of the growth shocks, things are a bit more straightforward, as we've lived through variants of some of these over the last few years. A Eurozone growth shock could occur in a scenario where, for instance, the ECB starts to taper, concern about peripheral debt sustainability re-emerges, and politics turns fiscally unorthodox. A US growth shock could come from a tightening in credit conditions, or a disruption to trade relations. A China shock could occur if the government gives up on artificially trying to boost growth and withdraws credit and fiscal support.

China shock more disruptive to EM growth than a US or EMU shock

The surprise, perhaps, is that for the world as a whole a China growth shock would be more disruptive than a US or Eurozone shock. However, that's because of the disproportionate impact on EM and a relative overweighting of Asian countries in our EM sample (and of course China itself, with the biggest PPP weight, starts at -2% vs baseline). We (or more precisely Yianos Kontopoulos and his team) model that under an EMU or China shock, 10y Treasuries fall to 1.3%, and under a US growth shock, they fall to 1.0%. EMFX is assumed to sell off most under the China growth shock scenario because that gets compounded with commodity price weakness. The most benign – from an FX perspective – is actually for US growth to disappoint because that is associated with some USD weakness.

Figure 38: Growth scenarios – global



Source: UBS estimates

Figure 39: First-order financial market impacts

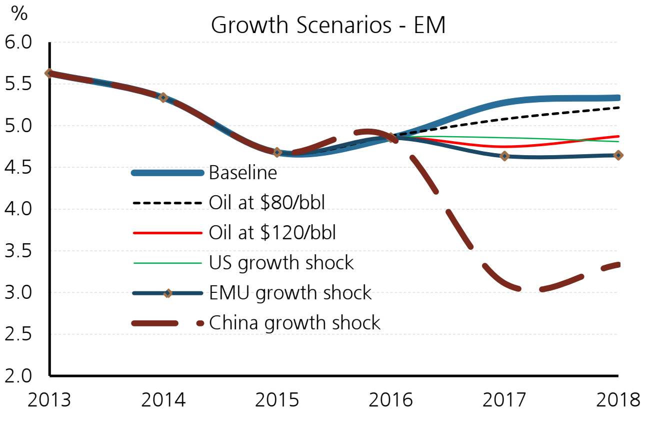
Growth shocks	US10y	Bund	EUR/$	SPX (%)	USDEM (%)
-2% US Shock	1.0	-0.3	1.16	-40.0	5.0
2% EMU shock	1.3	-0.6	1	-25.0	10.0
4% China growth	1.3	-0.3	1.05	-25.0	15.0
Oil shocks					
Oil at 80	2.4	1.1	1.2	-5.0	0.0
Oil at 120	3.1	2.0	1.3	-40.0	17.0
Baseline 2017	**2.1**	**0.5**	**1.15**		

Source: UBS estimates

For DM a US growth shock would be most painful

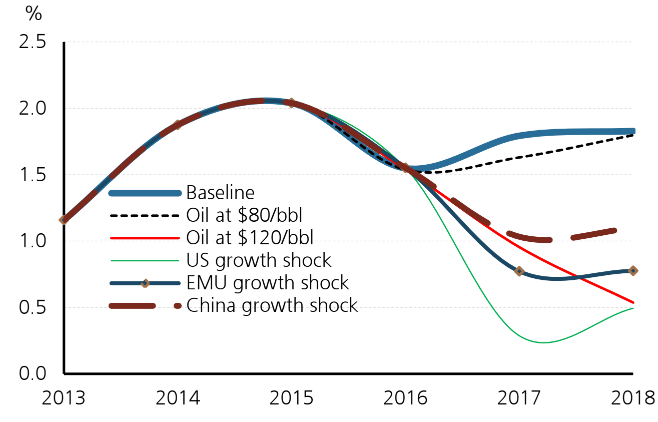
The two charts below show the growth impact for each scenario split into EM and DM. As you can see, for EM the "order of pain" (from most to least) is: China growth shock, Eurozone growth shock, $120/bbl, US growth shock, $80/bbl oil. For DM the order of pain is: a US growth shock, a Eurozone growth shock, $120/bbl oil, a China growth shock, oil at $80/bbl.

Figure 40: Growth scenarios – EM



Source: UBS estimates

Figure 41: Growth scenarios – DM



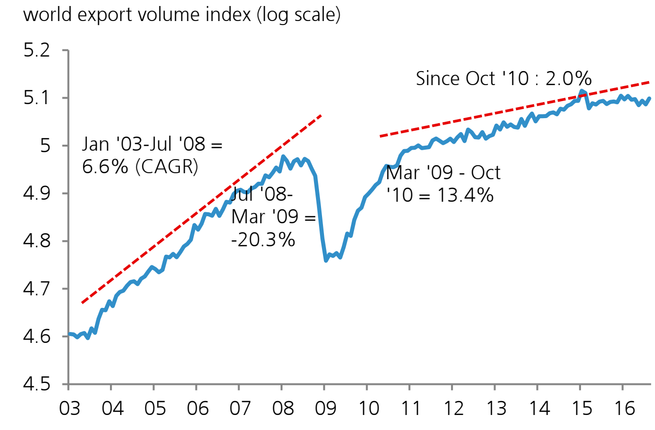
Source: UBS estimates

Global trade weakness and the new DM savings glut

The last theme we discuss is the outlook for: (i) trade – will increasing investment lead to a trade growth recovery or will increased protectionism offset that; and (ii) what's happening in terms of global imbalances (does it matter that the global savings glut has turned from an EM to a DM glut?).

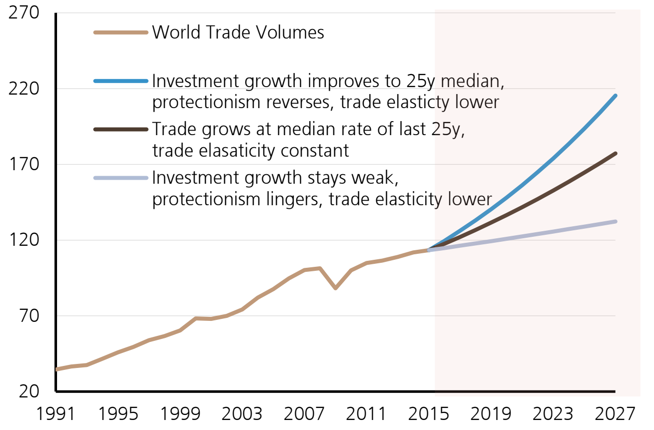
There are three basic issues on the trade side. First, as explained earlier, the global investment weakness that we've experienced over the last several years explains up to 60% of the weakness in trade volumes. Export volume growth has averaged only 2% since 2010, roughly one-third of the pre-GFC pace. Bhanu Baweja has written a series of excellent pieces on the issue (See big macro 06, big macro 07, big macro 08), which also identify the other main headwinds: China on-shoring of production (explains an additional 23% of the slowdown), shrinking value chains (11%) and creeping protectionism (7%).

Figure 42: Export volume growth post GFC is one-third or pre-crisis levels



Source: UBS, Haver

Figure 43: Projected trajectory of trade volumes: scenario analysis



Source: UBS, Haver

The investment recovery we project should roughly lift global export volumes 1:1

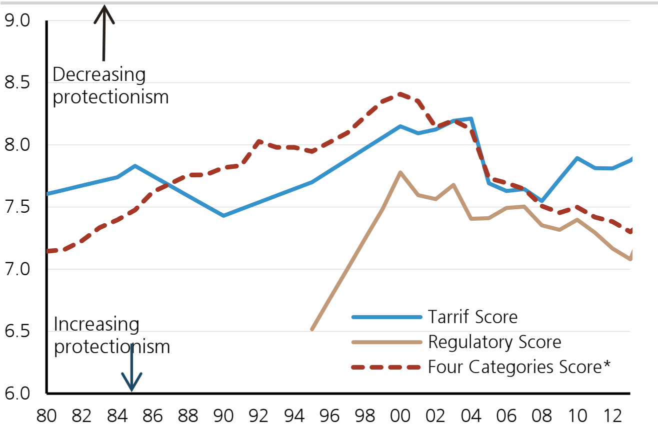
Does the increase in investment we project mean that trade volumes pick up? Yes, but we doubt the pick-up (an additional 1.8pp of global investment growth) moves the needle very much unless there is also a reversion back to pre-GFC import elasticities (the propensity to import for every dollar of investment). But all else equal, and abstracting from protectionism, our numbers imply some improvement in trade growth relative to previous years, from roughly 1.6% export volume growth in goods and services in 2016 to 2.7% in 2017. Difficult to get overly excited about that.

But increased protectionism could reverse those gains

Second, although trade protectionism has only been a minor factor in the trade slowdown so far, it has the potential to be a much more important headwind for trade growth in the future (see the simulation in Figure 43). The economic insecurity created by the global financial crisis provides fertile ground for increasing tariff and non-tariff barriers and, as Figure 44 shows, most recent protectionism has been of the non-tariff kind. The change in US administration in all likelihood means the TPP trade deal will not be approved, and the question for trade globally is now whether already existing agreements (NAFTA, but also the UK's position relative to the common market) get dismantled or fundamentally changed.

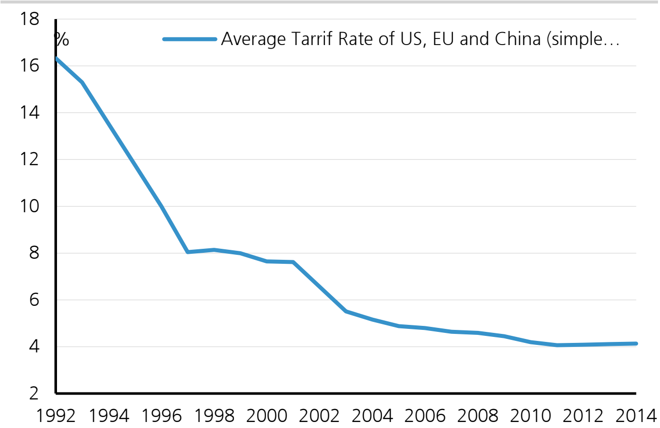
Candidate Trump has said that he would seek to designate China as manipulating its currency (under the Omnibus Trade and Competitiveness Act of 1988). The immediate implications of that are relatively limited (it limits Chinese goods in US government procurement), but if the US imposes unilateral tariffs on China (formally subject to the WTO safeguards agreement) there is a risk of escalating retaliatory action.[12]

Figure 44: Global freedom of trade indices (higher = freer)



Source: Fraser Institute, UBS [*= an average using (i) Tariffs, (ii) Regulatory trade barriers, (iii) Black market exchange rates and (iv) Controls of the movement of capital and people. The score is GDP weighted across 130 Countries.]

Figure 45: US, Euro Area and China (simple average tariff rate, all products)



Source: Haver, UBS

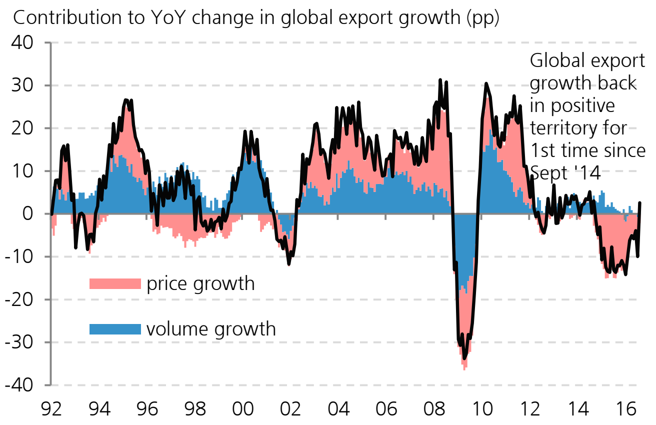
The stabilization of the US dollar is also stabilizing global export growth

The third issue for the outlook in trade is what happens with global trade deflators. Declining prices, rather than volumes, explain all of the decline in trade values over the last two years, but the disinflationary effect of USD strength is now subsiding and commodity prices have increased somewhat. Figure 46 shows how, prior to the oil collapse in 2014 export prices had contributed roughly one-third of global trade growth (average annual growth of around 2.2% since the early 1990s) and volumes the other two-thirds (average annual growth of 5.5%). Since mid-2014, however, prices have declined at an average annual rate of -8.6% and

[12] The Peterson Institute in Washington published a paper titled "Assessing Trade Agendas in the US Presidential Campaign". The paper suggests that if the US implemented Trump's proposal to impose a 35% tariff on Mexico and a 45% tariff on China, and extended it to other trading partners, it could push the US economy into recession and cost 4 million jobs (particularly in export-dependent industries such as information technology, aerospace and engineering sectors). Those simulations were based on a macroeconomic model from Moody's Analytics.

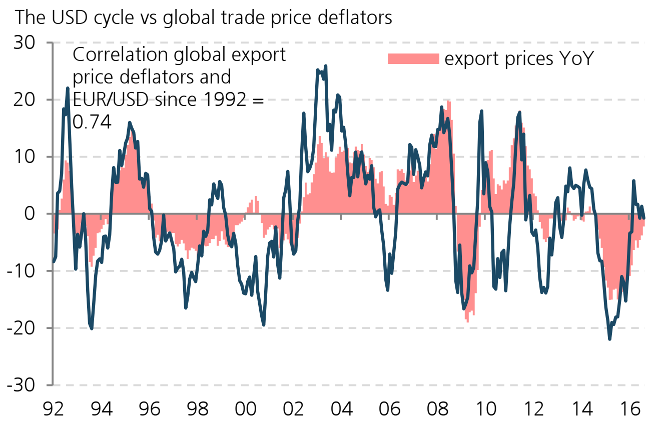
volume growth was up only 1.7%. Figure 47 shows the remarkable correlation (0.76) between global export prices and the US dollar. The good news is that prices have stopped falling (which matters for profitability and the overall demand outlook). The bad news is that it's not obvious what would drive them higher, barring USD weakness or further commodity price increases.

Figure 46: Global export growth: prices vs volumes



Source: Haver, UBS

Figure 47: The USD cycle explains most movement in export prices

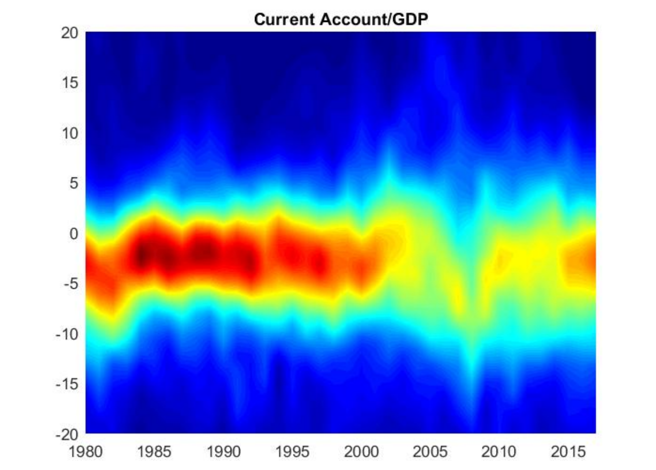


Source: Haver, UBS

One of the features of the post GFC-period is that current account balances have become substantially more dispersed. You can see that in the heatmap below left, which shows that prior to the crisis the modal current account balance was somewhere between 0 and -5% GDP (the dark-red bit in the chart). The global crisis then obliterated that distribution (think of a normal distribution being flattened severely) and one aspect of the redistribution of current account imbalances was that the share of DM surpluses went up and EM surpluses went down. Within DM, improvements in the European periphery, in particular, raises the share of countries with a surplus from 54% of countries just prior to the crisis to 68% now. Within EM, declining commodity/oil prices eliminated surpluses in the Middle East and Africa, lowering the share of surplus countries from 31% to 23%.

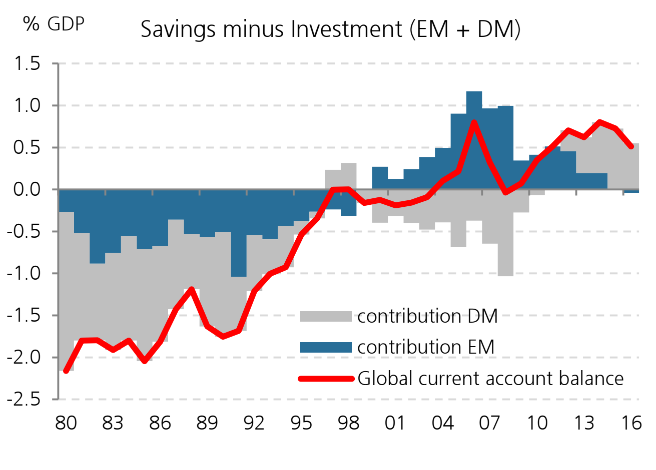
Current account imbalances are more dispersed with more surpluses in DM

Figure 48: Current account heatmap – imbalances increasingly dispersed



Source: IMF, UBS estimates

Figure 49: Saving glut shifts from EM to DM



Source: IMF, UBS estimates

Does that compositional shift in the global 'savings glut' matter? The point of these charts is that distributional aspects of national variables may have an impact on global variables such as global interest rates. Recall that global rates must clear the market for saving and investment at the global level. Under the hypothesis that interest rates have a non-linear impact on national saving and investment behaviour, greater dispersion of national saving and investment ratios may weigh down on rates, even though global aggregate saving and investment are unchanged.[13] To wit, if net saving could decrease where it is high and unresponsive to rates and increase where it is low and more rate-sensitive, this may help put upward pressure on rates. A similar argument would hold for investment. This 'fund market mismatch' may be under-perceived as risk to the level of world rates.

Global savings levels are roughly unchanged but the demand for safe assets has gone up.

But if it's the case that the global savings surplus (excess) is more or less unchanged, why are rates so much lower?[14] Part of the answer is that the savings curve itself has shifted. Risk aversion may have gone up, leading people to want to save more even at a lower rate. Another reason could be that the income effect is dominating the substitution effect: lower rates in principle should induce more spending because the opportunity cost of savings goes down, but lower rates also affect the income stream, which may lead savings to go up. There is no obvious pattern globally: some countries have seen savings go up and others go down. But as a point of intuition on the income stream: the total outstanding debt of the US government, agencies and GSE's has gone up from 23% of global GDP in mid '08 to 32.4% of GDP now. However, the income stream on that larger stock of debt is down by 60% as the average cost of servicing the debt has declined from 4.5% to 2%.

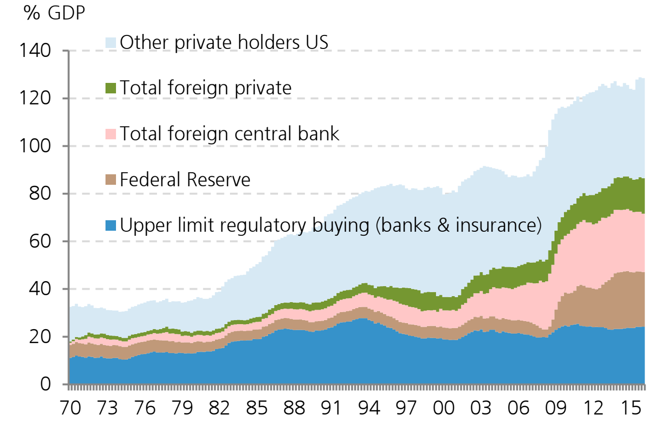
But the supply has also gone up…by a lot

So isn't that just a different way of saying that there is a scarcity of safe assets? Well, 'yes' to the extent that yields are being driven to zero and investors want to still buy at that price. That's the very definition of scarcity. But 'no' if you define scarcity as a lack of bonds or duration. In the final two charts we show something that may seem counter-intuitive. It's our impression that most investors believe that buying by central banks as well as banks and insurance companies (to meet regulatory ratios and more stringent capital requirements) has shrunk the part of the market that's left for others. It turns out that's not true.

[13] China's share of global savings has gone up from 15% in 2008 to 25% in 2016. At the same time, its share of global investment has gone up from 12.5% to 26.4% (an important factor behind global investment ratios being roughly unchanged from pre-crisis levels, despite DM investment ratios being 2pp lower. Because China's investment went up more quickly than its savings, it current account surplus declined by about 8pp of GDP.

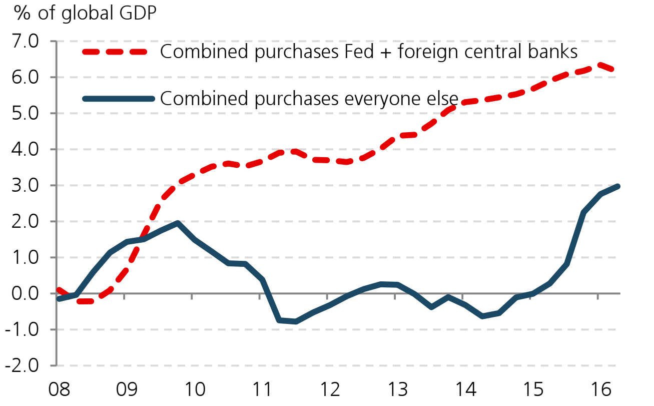
[14] At a global level surpluses and deficits should cancel out as we don't trade with outer space. But the mismatch is a long-standing phenomenon and aside from poor data has to do with the fact that we are not plotting current account levels but ratios to GDP, and the varying nature of the denominator means the sum of the ratios does not cancel out.

Figure 50: scarcity of safe assets? Supply of US govt paper is up by $9.9 trillion (13% of global GDP) since Jan '08



Source: US Flow of Funds, UBS

Figure 51: Cumulative purchases of US Treasuries, Agencies and GSE debt since '08



Source: US Flow of Funds, UBS

It is not obvious that central banks have reduced the supply of papers for others in absolute terms (only relative to preference)

To show that, look at the final two figures above. On the left we've charted the total outstanding stock of US government paper, agencies and GSE debt and separated it by holder (using Flow of Fund data). What you can see is that the total supply of paper is actually up by $9.9 trillion, or roughly 13% of today's global GDP.[15] So is it the case that buying by banks and insurance companies crowded out supply for other investors? Not really: it's true that banks and insurance companies had to change the composition of their balance sheets, but that was in the context of a massive shrinkage of the overall balance sheet (remember the debt supercycle charts we showed you). If we take total holdings by banks and insurance companies as an upper limit for 'financial repression', it's still the case that their total holdings did not increase from the 6% of global GDP they held in 2010, for instance. So the notion that regulatory-related buying by banks and insurance companies has reduced available securities for other investor groups is not strictly true, at least not if you scale the overall supply of US debt by global GDP (put differently: available debt for other investors has not gone down as a % of global GDP).

What about central banks? Yes, they were major buyers (see chart on the right) but all they seem to have done is taken the additional issuance coming from higher government deficits out of the market. No more, no less. Of course, that's still a different way of saying that had they not been buying, rates would have been higher.

An inflation shock is perhaps the single biggest risk to the outlook

And therein lies one of our biggest fears for the outlook. The net liquidity injection from central bank is currently near its peak, the ECB and BoJ may slowly start to taper, the Fed starts passive roll-off of its balance sheet in 2018, and investors in aggregate are sitting on a lot more duration risk (because low rates led to a lengthening of maturities). Yes, there is a scarcity of safe assets but it's not because investors don't have fixed income risk on their books—quite the opposite. So we better hope we don't get an inflation shock of any kind (as per our tail risk scenarios) because the market doesn't look like it's remotely set up for that. The sell-off taking place in bond markets as we are writing this report is a taste of that.

[15] If you subtract the ratios to GDP in 2008 from 2016 the increase is 9% of global GDP.

Political Calendar 2017-2018

Country	Date	Political Event/Election	Outlook	Macro Implications
Argentina	August and October 2017	Mid-term legislative elections to renew 1/2 of the lower chamber (127 seats) over 2017-2021 and 1/3 of the upper chamber (24 seats) over 2017-2023. Primary elections to be held on Aug and general legislative elections scheduled in Oct.	Key elections for President Macri's PRO party. Currently, the government – in alliance with other smaller political forces – counts on approximately 87 seats at the Lower Chamber versus an opposition that has 170 seats. In order to get bills passed, the Executive has to resort to negotiations with other parties, especially the Peronists aligned behind Sergio Massa. In the Senate, the government and its allies make up 17 out of 72 seats. Yet, as the upper chamber has a territorial representation basis, support is easier to obtain through the negotiation of the Central Government with provincial governors. Results to monitor: whether the government and its allies gather force, whether Kirchnerists lose momentum, whether the Peronist party unites behind one single leading figure or remains split in at least two branches.	President Macri's administration has taken a rather moderate approach to the correction of the economy's fiscal imbalances. In order to advance the government's reform agenda, President Macri needs a stronger backing in Congress, which he can only obtain from a good performance in these elections. If his party does poorly, the remaining two years in office could prove an uphill battle, especially with Peronist presidential hopefuls trying to gather support ahead of the 2019 presidential elections.
Australia	December 2016	Mid-Year Economic and Fiscal Outlook (MYEFO)	The Commonwealth (Federal) Budget should finally show signs of improvement after material slippage in recent years, albeit 'channel checks' suggest the spike in coal prices through Q3/Q4 of 2016 is likely to be 'looked through' in the Budget.	S&P currently has the AAA rated sovereign on negative outlook, suggesting a one-in-three chance of a downgrade within two years. S&P has highlighted the need for the Government to hit published Budget deficit numbers (following years of downgrades). However, with the Budget tracking better than expected in recent months, we think deficits should finally at least avoid slippage, reducing the near-term worry over the rating.
	December 2016 to January 2017	Mid-Year Reviews (State Budgets)	State Budgets will update the public capex boom & Budget figures following asset sales.	An upgrade to already significant investment plans would add upside to our already above-consensus forecasts for 2017 growth.
Brazil	February 2017	Elections for President of the Lower House and Senate	Early next year the Lower House and Senate will hold elections for president. Although the Brazilian government has given indications that it commands a sufficiently large majority in Congress to pass the necessary structural reforms, it is important to have leaders of the House and Senate that support the pro-fiscal adjustment agenda pursued by president Temer, to facilitate the legislative process.	The strongest candidates for both houses are from the government's coalition base, which should help facilitate the reform process. However, it's important to highlight that the positive performance of the Brazilian markets and the constructive outlook for the Brazilian economy depends heavily on the government's ability to re-establish the equilibrium of the fiscal accounts (i.e. approve the spending cap, expected before 2016YE, and the Pension Reform, Q2-Q3'2017).
	Q2-Q3 2017	Pension Reform	We expect the Brazilian government to send the pension reform bill to Congress before end-2016 but the final approval of the bill is only expected in Q2-Q3'2017.	A pension reform that stabilizes the pension deficit (as a percentage of GDP) is critical to making the spending ceiling credible and also to help the government re-anchor fiscal expectations.

Brazil	Q4 2017	Labor Reform and Political Reform	Beyond the spending cap and the pension reform, the government is also likely to submit to Congress a labor reform, to give more flexibility to firms/employees contracts, and a political reform, to reduce the number of political parties.	With the current labor laws, wages are inflexible, meaning the recession weighs heavily on employment (job losses). More flexibility on wages would not only help reduce wage inflation, but should guarantee that the expected economic rebound translates into employment growth. This is important to help increase the political support of the government's coalition base looking ahead to the election in 2018. Meanwhile, a political reform should help reduce the number of political parties for 2018, facilitating the legislative process and reform approval in the medium to long term.
Canada	27 May 2017	Conservative Party leadership elections	The Conservative Party comprises 29% of the Commons, and 38% of Senate. It is the main opposition party.	
	October 2017	NDP leadership elections	NDP comprises 13% of Commons.	
	2017	Bloc Quebecois leadership elections	Comprises 3% of the Commons. Separatist party.	
Chile	18 November 2017	First round presidential election; election for both houses of Congress and for regional parliaments. If a second round presidential election is necessary, it will be held on Dec 17.	It is early days to make a prediction on the outcome of the presidential election, but the two front-runners in the race at this stage are Sebastian Piñera and Ricardo Lagos, both ex-presidents of the Republic and respected by the market. However, their overall acceptance levels remain low, suggesting that this remains an open election and that new candidates – perhaps even an independent – could emerge as we head into Nov '17.	Opposition to the current administration's policies – from fiscal reform to labor reform by way of education reform – by the business community helps to explain why business confidence is currently running at close to historical lows. The probability that a more business-friendly president is elected next year is high, which may lead to an improvement in sentiment and a recovery in investment in 2018.
China	October 2017	19th National Congress of the Communist Party of China	New leaders for the next five years for the party will be decided at this event.	Expect policies to be supportive of growth leading up to and around this event – but may be sustained thereafter if needed to offset downward growth pressures.
	March 2018	People's Congress	The next new government will be decided at this event.	
Czech Republic	1 October 2017	Parliamentary elections	Polls point to a lead by the centrist junior coalition partner ANO, followed by the senior coalition partner, the left-wing Social Democrats (CSSD).	The government is planning some increases in public sector, education and healthcare sector wages for 2017. Thus the deficit is likely to rise in 2017 from 2016.
	January 2018	Presidential elections		
France	23 April 2017	Presidential elections (first round)	Attention now focusses on who will be the presidential candidates from the Republican and Socialist parties to run against Marine Le Pen from the Front National. Polling so far suggests that Le Pen is likely to win the first round.	The Front National in its programme calls for France to leave the Eurozone.
	7 May 2017	Presidential elections (second round)	Current polls suggest that the Republican candidate is likely to be best positioned to win the second and decisive round of the presidential election.	An election victory of Marine le Pen would likely result in a substantial increase in uncertainty over the future path of French politics, and France's role within the broader EU project.

Germany	5-7 December 2016	Party Congress CDU	Angela Merkel is set to announce whether she runs for Chancellor again in the September 2017 general election.	Angela Merkel's approval ratings have declined in recent months along with polling of her party, increasing uncertainty about whether she would be willing to run again. With no apparent alternative candidate from her party and given her importance for broader European discussions, the market is likely to pay close attention.
	14 May 2017	State Election – North Rhine-Westphalia	The state is currently governed by an SPD-Green coalition. Current polling suggests they will lose their majority. Important to watch will be how strong the anti-immigration AfD polls.	State elections in Germany's most populous state are likely to be seen as an important test run in the run-up to the September general elections.
	September 2017	General/Parliamentary	The coalition of CDU/CSU and SPD has lost support, but according to current polls narrowly maintain their majority. Important to watch support for the anti-immigration AfD, which is not currently in parliament.	Should the current grand coalition lose its majority there may be a need for a three-party coalition (possibly with the Green Party or the liberal Free Democrats). Main implication is likely to be at the European level as additional compromises would be necessary on foreign policy.
Hong Kong	26 March 2017	Chief Executive election	The new leader of HK (the Chief Executive) for the next five years will be elected by the 1,200-member Election committee.	In recent years, there have been a series of protests aimed at influencing government policy. There is a risk of civil protests that could dampen investor and consumer confidence.
Hungary	April 2018	Parliamentary election	Polls suggest that the incumbent Fidesz government has a very significant lead (20-44pps) over the opposition. Opposition is fairly divided on the left of the political spectrum (there are three parties competing from the left), which plays into the hands of the government.	Government has already announced some fiscal stimulus for 2017 when the budget deficit is likely to bounce to 2.5% of GDP in 2017 from around 1.6% of GDP in 2016. The deficit is likely to remain flat at 2.5% of GDP in 2018.
India	February 2017	Union Budget	Union budget FY 2018 will be the first held after the review of the Fiscal Responsibility Budget Management (FRBM) framework. Should be a budget that includes introduction of GST. Note that Union budget to be held earlier in February than in previous years.	Introduction of GST (perhaps in April 2017 or later in the year) has potential to be a medium-term driver of productivity by promoting India as a single market for goods and services. Near-term impact on fiscal impulse unclear due to uncertainty over applicable rates and disruptive impact on supply chains.
Indonesia	August 2017	Central Government Budget	Central government budget for 2018 will be presented to parliament. Key question will be new revenue sources post tax amnesty.	Given proximity of 3%-of-GDP fiscal deficit limit, ability to raise revenue will be a key determinant of government spending growth.
Italy	4 December 2016	Constitutional Referendum	Referendum is about a reform of the Senate (Upper House of Parliament) and part of a package aimed at making the political system more stable and facilitating decision-making. Opinion polls suggest the result is too close to call.	PM Renzi has in the past suggested he might step down in case of a "No" vote, likely impacting sentiment negatively and increasing political uncertainty. However, even in case of a "Yes" vote, attention may then shift to the general election in 2018.
	May 2018 (at the latest)	General/Parliamentary election	Current polling sees the ruling PD party of PM Renzi close to the M5S Five Star Movement. If the constitutional referendum passes in December, the 2018 election will be the first one held under the new electoral law that guarantees a majority premium for the party with the highest share of votes (potentially determined in a second-round run-off).	The M5S Five Star Movement has called for a referendum to leave the Eurozone.
Japan	5 March 2017	LDP convention	Abe will try to change the rules to allow for a third term to 2021 or to eliminate the term limit.	Political stability under PM Abe might support corporate and consumer sentiment.

Japan	July 2017	BoJ's two board member will end their terms	BoJ's board members Kiuch and Sato will be changed. Diet approval is necessary after PM Abe's nomination.	Kiuchi and Sato have been against the BoJ's aggressive monetary policy. Depending on who replaces them, perceptions of the BOJ's likely policy stance may change.
	March 2018	BoJ's two vice governor will end their terms	BoJ's board members Iwata and Nakaso will be changed. Diet approval is necessary after PM Abe's nomination.	Iwata is well known as a monetarist. And Nakaso is from the BoJ. The stances of two new vice governors would affect the outlook of the BoJ's easing/tightening schedules.
	April 2018	BoJ governor Kuroda will end his term.	Diet approval is necessary after PM Abe's nomination.	Whether PM Abe chooses a dovish candidate or not will be the market's focus.
	September 2018	LDP representative election	After changing LDP rules to allow for a third term until 2020, PM Abe is likely to continue Abenomics until Sep 2021.	If Abe is re-elected, political stability under PM Abe would support corporate and consumer sentiment.
	By November 2018	The Lower House election	PM Abe might decide the timing of the election earlier than originally planned (earliest Dec 2016-Jan 2017). Currently the ruling parties (LDP + Komei) hold 329 out of the 475 seats (LDP 294, Komei 35). In order to change Japan's Constitution which is PM Abe's ultimate goal, a 2/3rds majority (317 seats) is necessary. Komei is currently against changing Japan's Constitution.	One of the opposition parties, Ishin no Kai, which supports changing Japan's Constitution, holds 15 seats in the lower house. If LDP gets a 2/3rds majority with Ishin no Kai and without Komei, PM Abe may be able to change the constitution. But in order for LDP to maintain its current seats, further improvement in its support is needed.
	July 2019	The Upper House election	There is no rule to have an earlier Upper House election. Currently ruling parties (LDP + Komei) hold 148 out of the 242 seats (LDP 123, Komei 25). In order to change Japan's Constitution, which is PM Abe's ultimate goal, a 2/3rds majority (162 seats) is necessary. Komei is currently against changing Japan's Constitution.	
Kazakhstan	2017	Upper House - Senate (half of the elected members)	The parliament is currently dominated by pro-presidential parties.	Historically, parliamentary elections appeared to have very limited effect on economic policy direction.
Korea	20 December 2017	Presidential election	Term limits prevent the current president from running for office next year. Her ruling party is generally viewed as conservative and has promoted labor-market liberalisation, free trade, and fiscal conservatism.	An opposition win would likely result in a more pro-growth fiscal policy and an emphasis on social spending. However, any shift in fiscal priorities will likely only emerge in 2019 as the 2018 budget will be decided before the president is elected in late 2017.
Malaysia	August 2017	Federal Budget	The Federal Government Budget for 2017 will likely be a pre-election budget.	After several years of fiscal consolidation, weak real GDP growth and a looming election could lead to looser fiscal policy, supporting growth at the possible expense of higher funding costs.
	Before August 2018	General election	General election is not due until mid-2018, but Prime Minister Najib could take country to the polls during 2017.	Policy should be supportive of growth in the run-up to this event.

Mexico	4 June 2017	Gubernatorial elections in the states of Mexico, Cohauila, and Nayarit	The most important of these three elections is the one in the state of Mexico, the country's most populous state and a traditional PRI stronghold, in particular for President Peña Nieto, whose political career was forged there. Failure to win and renew here would signal that the PRI's chances of maintaining the presidency in 2018 would be very low. Politically, this is highly fragmented state, a situation that has traditionally helped the PRI. A PAN-PRD alliance like we have seen in other states would pose a risk for the PRI's chances, but looks unlikely at this stage.	The macroeconomic impact of this election is uncertain. If the PRI loses the state of Mexico, it may perceive that a surge in pre-election spending may not be warranted and that fiscal discipline should be maintained instead, but the outcome could well be the opposite. Likewise if the PRI wins: it would most likely embolden the party going into 2018, but it is unclear that it would necessarily lead to much looser fiscal policy.
Netherlands	15 March 2017	Elections for Lower House	Current coalition of VVD and PvdA holds 79 out of 150 parliamentary seats, but its support in the Ipsos polls, for instance, is down to 41 seats. Although VVD (the centre-right liberal party) remains the largest party with about 30 seats in the polls, the far-right PPV is now the second-largest party with 23 seats. The current polls suggest the number of parties required to form a coalition would be one of the largest in decades, which could complicate the formation of a government and subsequent governability.	The PVV's 'concept electoral program 2017-2021' calls, inter alia, for the Netherlands to leave the EU, to 'de-Islamize' the country, and to take the Netherlands out of the EU. Although several parties (e.g. CDA and PvdA) have ruled out joining PVV in any coalition, it cannot be fully ruled out that they form part of a wider multi-party government. This may increase market concerns about a possible EU referendum in the Netherlands.
New Zealand	By 18 November 2017	Parliamentary general election	The National Party (led by Prime Minister, John Key) secured a third term (of three years) at the September 2014 election. National won 60 of the 121 parliamentary seats under the Mixed Member Proportional system in use since 1996 and formed a coalition with the ACT Party, United Future and the Maori Party. The latest NZ Roy Morgan Poll shows National as the most preferred party on 43.5%, with the main opposition party, Labour, attracting 33.5%. On these poll results, National would need the support of the NZ First Party (8.5%) to form a government.	NZ First leader Winston Peters has typically stated the party would talk to the highest polling party following an election result – NZ First formed governments with National in 1996 and with Labour in 2005. If a National-NZ First coalition were to be in government at the end of 2017, the main question would be what concessions NZ First were able to extract in order to agree to support National. These would likely be in areas like migration policy (where NZ First favours tighter rules and fewer migrants), but would most likely leave the major monetary/fiscal policies largely unchanged.
Philippines	August 2017	National Gov't Budget	The Budget for 2018 should include further increases in infrastructure spending. An additional question is whether the budget deficit will be widened from the 3% projected in 2017.	If the deficit continues to trend wider in 2017 and 2018 then investors may grow less confident of fiscal stability.
Russia	March 2018 (though there has been some discussion in the press about moving it to 2017)	Presidential Elections	Current President Vladimir Putin can run for another six-year term, but has not yet indicated whether he will. Pollsters put Putin's approval ratings in the range of 70-80%, indicating that should he choose to run, he will likely be re-elected.	On the one hand, Putin's re-election would imply policy continuity; many of his core economic team have been occupying key posts for as long as he has been in power. On the other, the end of the extended election cycle (which began in 2016 with Duma elections) could give impetus for long-debated but unpopular decisions, including an increase in the retirement age. Former Finance Minister Kudrin has been tasked with writing the economic program for the next term; the previous "Strategy 2020" was left largely unimplemented, though.
Singapore	Late February 2017	Government Budget	The government will probably have to decide how much to support a weak economy.	Expect policies to support retraining of unemployed workers and household income support.

South Africa	December 2017	Election of ANC President	The election of the ANC president is important as the new president is going to lead the ANC in the 2019 election.	A change at the helm of the ANC could influence the party's drive to pursue economic reforms.
Thailand	May 2017	Government Budget	Potentially a pre-election budget.	Could be an expansionary budget – supporting growth at the possible expense of higher funding costs.
	November 2017	General election	The military government's roadmap for a return to democracy calls for general elections in November 2017.	Political uncertainty could rise if the elections are delayed or the results are contested. Policy should be supportive of growth in the run-up to this event.
UK	December 2016	Supreme Court appeal on Article 50 challenge set between 5 and 8 December 2016, with a decision to be announced shortly after		
USA	3 January 2017	115th Congress begins		
	6 January 2017	Counting of Electoral College votes		
	20 January 2017	New president inaugurated		
	21 January 2017 to 1 May 2017	First hundred days	Symbolic period for president's policy plans.	None.
	15 March 2017	Debt ceiling suspension ends	Past suspensions have led to contentious negotiations with Congress on taxes and spending plans. As this comes during the first 100 days of the new President, there is the potential for this to focus resistance to the President.	First test of new president.
	7 November 2017	Election day	Main elections: Governors of New Jersey (R) and Virginia (D). Mayors of Atlanta, Boston, Los Angeles and NYC.	
	H2 2017	Search for new Fed Chair?	Possible names are Taylor, Hubbard, but too soon to tell.	Could represent a shift in Fed policy
Venezuela	End of H1 and end of H2 2017	Governors and municipal elections	Utter uncertainty regarding Venezuela's political outlook. The National Electoral Council decided, without revealing its reasons, to extend the current governors' term over a six-month period from Dec'16 (when the constitutionally determined elections should have been held). A similar approach was taken with municipal elections, likely to be held at the end of H2 2017. While the National Electoral Council made this announcement, it has not yet fulfilled the formal procedures to summon elections. The political outlook for 2017 is complicated further by the unresolved issue of the recall referendum to revoke President Maduro from office. An unfavourable referendum against President Maduro beyond 10 January 2017 would mean that the remainder of the presidential term (until 2019) would have to be completed by the current VP, otherwise presidential elections should be immediately summoned.	The doubts surrounding the political process cast uncertainty over the macroeconomic situation. A base-case scenario would be some sort of political transition that would lead a consensus-building member of the current ruling party to remain in power. In an alternative scenario President Maduro would stay in office with much narrower margin of manoeuvre. In any case, macro imbalances are not fully addressed.

Source: UBS

Country Pages

Drew T.Matus
Economist
drew.matus@ubs.com
+1-212-713-4448

Samuel D. Coffin
Economist
samuel.coffin@ubs.com
+1-203-719-1252

Dave Liang
Economist
dave.liang@ubs.com
+1-203-719-1246

USA & Canada

2017-18 Outlook: Fewer drags to boost growth

PIVOTAL QUESTIONS

Q: What is the US growth outlook for 2017/18?

We expect an acceleration in GDP growth from 1.5% in 2016 to 2.4% in 2017 and 2.5% in 2018. The acceleration is a function of fewer drags on growth. Capital expenditures related to energy appear unlikely to exert significant drag going forward. After the declines already seen we believe that there is little further room for reductions that would be significant enough to materially affect the outlook. Similarly for inventories, it would be unusual for there to be a sustained drag on growth from this component. Finally, another drag from the dollar looks unlikely.

Q: Will US inflation recover?

Yes, inflation has gradually been moving higher for some time. Core measures of inflation have been flat to rising, and there are growing signs that wages are beginning to move higher. Headline inflation is rising as a consequence of base effects related to energy prices.

Q: How will the Federal Reserve react?

Above-potential growth will continue to put pressure on capacity, particularly for the labor market. This pressure will put an upward bias on inflation readings and, as a consequence, keep the FOMC on its forecast gradual rate hike path. We expect the Fed to move rates up to 1.00-1.25% by year-end 2017 and to 1.50-1.75% by year-end 2018. Furthermore, we anticipate that the Fed will implement a scheme to allow for a gradual decline in its balance sheet by mid-year 2018.

UBS VIEW

We believe the economy has few imbalances that could result in a recession developing absent a shock.

EVIDENCE & SIGNPOSTS

Jobless claims, bank lending, and ISM surveys all point toward stable growth. The dollar amount of energy capital investment is now worth only 30bp of GDP, down from 92bp at the start of 2015. Likewise, the long-term contribution of inventories to US growth is zero. That is, the most recent sharp decline is not likely to be an ongoing event. We would watch any deterioration in credit conditions with concern as a significant shift in bank willingness to lend would raise the risk of an outlier outcome in 2017.

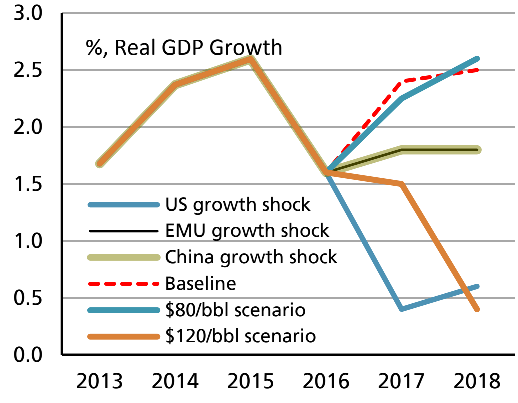
WHAT'S PRICED IN?

The Blue Chip consensus for 2017 is 2.2% versus our forecast of 2.4%. Other consensus forecasts for 2018 suggest UBS is about 50bp above consensus for 2018. Despite the slower path of growth forecast by the consensus, the Blue Chip survey shows 50bp of tightening in 2017, in line with the UBS estimate.

UPSIDE/DOWNSIDE RISKS:

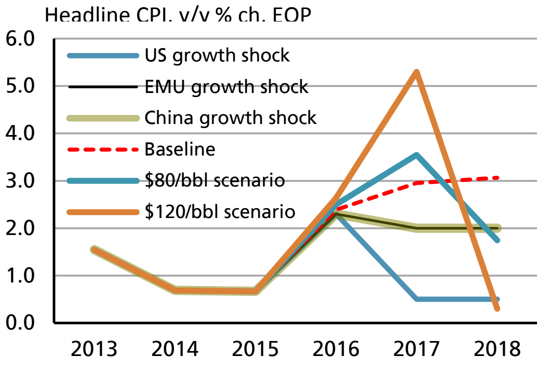
Key **downside risks** would be: a credit shock, a disruptive Fed tightening process, trade disruption, restrictive immigration policies, or a sharp rise in oil prices. **Positive risks** could come from a constructive response to Fed tightening, a rebound in productivity or fiscal stimulus.

Figure 52: GDP growth scenarios



Source: Haver, UBS. US Growth shock = 2pp below baseline. China Growth shock = 4% growth. EMU Growth shock= 2pp below baseline.

Figure 53: Inflation scenarios



Source: Haver, UBS. US Growth shock = 2pp below baseline. China Growth shock = 4% growth. EMU Growth shock= 2pp below baseline.

United States

- **GDP growth accelerates from 1.5% in 2016 to 2.4% in 2017 and 2.5% in 2018 as the impact of large drags on the economy – capital spending, inventories, oil, and the dollar – fades.**

- **Slack in the economy continues to dissipate, putting upward pressure on wages and highlighting inflation risks. The Fed responds by following its forecast gradual rate hike path, bringing rates up by 50bp in both 2017 and 2018. A measured balance sheet reduction begins in 2018.**

- **The election results introduce more uncertainty into our outlook, particularly for 2018. Key uncertainties include the size and composition of individual tax reductions, corporate tax reform, immigration reform and trade and tariff policies.**

The lack of obvious imbalances suggests continued growth

The expansion is likely to persist as the lack of any obvious significant imbalances in the economy suggests it would take a sustained shock of significant proportions to push the economy into a recession. Consider that the past two recessions took either an ongoing pattern of moderate shocks (2001) or the near collapse of the financial system (2008). It is difficult to see what would drive either possibility given the current state of the US economy, in particular, the health of the US consumer.

Accelerating growth is due to fewer drags

Indeed, although we expect 2017 to show a faster pace of expansion than 2016, the story for 2017 is not a story of significant acceleration in activity but, rather, less drag. Growth this year should be buoyed by less of a drag from inventories and from a rebound in capital spending as the impact of the sharp drop in energy prices and investment works its way out of the economic data. These two factors comprise almost the entire growth "acceleration" we anticipate this coming year.

With less to weigh on growth, the pattern of consumption should drive the overall pattern of growth in 2017. The consumer is in particularly good shape. Few workers are being laid off, wages are on the rise and the combination of low debt service and a healthy savings rate suggests the consumer can weather any modest shocks that may appear.

Potential growth is likely below 2% which means that even modest growth will result in inflation pressure

Potential growth is likely below 2% as slowing population growth and tepid productivity have lowered the "speed limit" for the US economy. While there is some chance that productivity will rebound if growth moves higher, our baseline assumption results in rising inflation pressures even with our modest growth outlook. We expect to see pressures on the economy continuing to build, particularly with regard to the supply and demand for labor. With the drag on inflation caused by falling energy prices abating and the push to inflation caused by rising wages just beginning, we expect to see inflation edging higher over time.

The Fed is likely to hike by 50bp in 2017

Federal Reserve policy is likely to follow the path it has forecast, moving rates up to 1.00-1.25% by year-end. We do not believe the change in the composition of the FOMC will prove significant this year. Despite its past downward adjustments to the path of policy, we believe the combination of growth and developing inflation pressure will keep the Fed on pace absent a sustained shock.

Government policy is now a key forecast uncertainty. Tax reform, trade and immigration policy could all impact the outlook for growth and interest rates. Of these, the proposed changes to tax policy would likely act to boost growth within the medium-term outlook. Other policies that may have more of a negative effect – trade and immigration – would likely have that effect on the economy over a longer time frame. Given the difference in the timing of these impacts, the market response to policy proposals may be more important to our shorter-term outlook for growth and interest-rate policy than the proposals themselves.

Government policy is now a key forecast uncertainty.

Consumer confidence

The consumer is the keystone of our outlook. This may be obvious as the consumer is 70% of GDP, but not only do they comprise the largest proportion of GDP, they also represent a stable source of growth. Why should this continue?

The consumer is the keystone of our outlook and is in fine shape

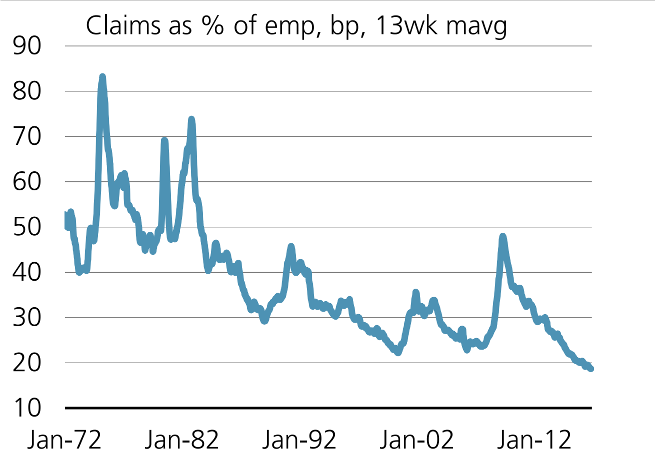
The labor market remains healthy. Employment growth is still healthy and is likely to remain high enough to continue pulling down the unemployment rate over time. At the same time, layoffs remain at historical lows and job openings are outpacing hiring, indicating that labor is scarce. Wages are showing signs of accelerating. Against this backdrop, consumers have been boosting their savings rate, an oddity given the low need for precautionary savings the health of the labor market would imply.

As a consequence, 2017 will see a consumer with rising wages, who has experienced wealth gains, who has historically low debt-service ratios and expanded access to credit, and who possesses enough savings to reduce consumption volatility.

High savings should reduce consumption volatility to shocks

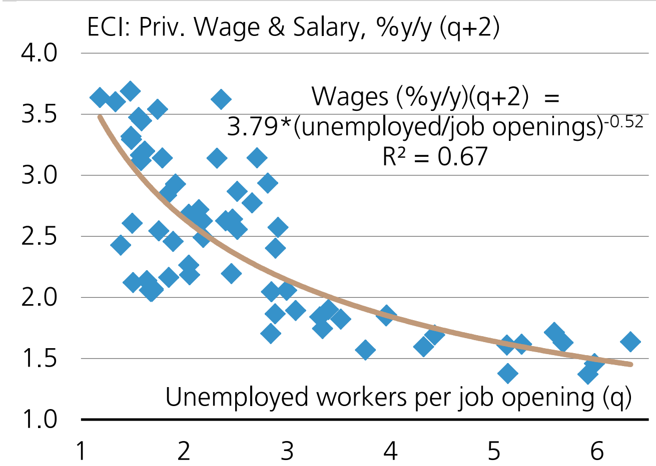
This would seem to be a recipe for ongoing consumption strength. The one oddity: Why are consumers saving so much? We believe part of the answer lies in demographics. With persistently low interest rates, those nearing retirement need to save more. If true, a gradual rate hike cycle may prompt more, not less consumption and, as a result, represent an upside risk to the outlook. A further upside risk to the consumption outlook is the potential for individual income tax reductions in 2017.

Figure 54: Why worry about getting laid off?



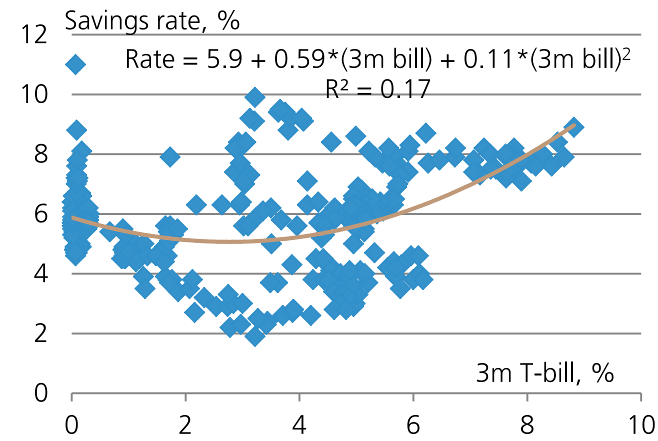
Source: DOL and UBS

Figure 55: With only 1.4 unemployed workers for each job opening, the outlook for wages is getting better



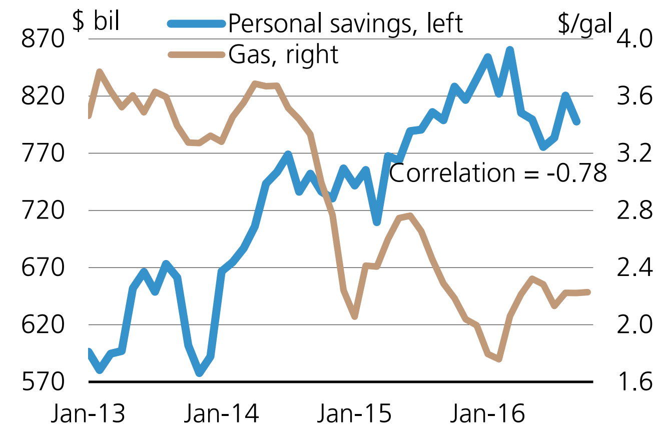
Source: BLS, BEA and UBS

Figure 56: Low rates may not always depress savings



Source: Haver, BEA and UBS. Note: 1988 forward (Greenspan Era forward).

Figure 57: Consumers appear to be using savings to offset volatility in gasoline prices



Source: Bloomberg, BEA and UBS

Capex accelerators

The positives:

- Tighter labor markets may encourage capital substitution
- A reversion toward trend would suggest a faster rise in capital/labor ratios
- Lower corporate taxes
- Higher oil prices support renewed energy-related capex
- The potential for lowered regulatory burden
- "Accelerator effects"

The negative—a big one:

- Uncertainty around US trade policy and, consequently, export demand and import prices

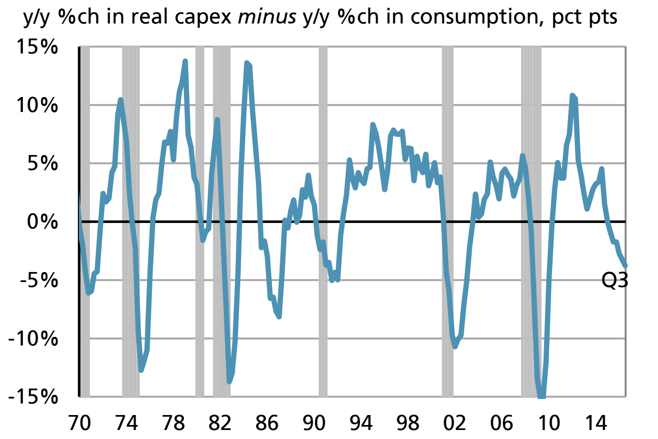
Modest acceleration in business investment

Business fixed investment fell sharply in Q415-Q116 and inched up only 1% at an annual rate in Q2-Q316—on net, a 1.2% y/y decline. We forecast stabilization in early 2017 and a modest acceleration thereafter—a 4¾% growth rate, just a bit more than enough to make up for depreciation of the capital stock.

Accelerator effect: spillover of broader growth into capex

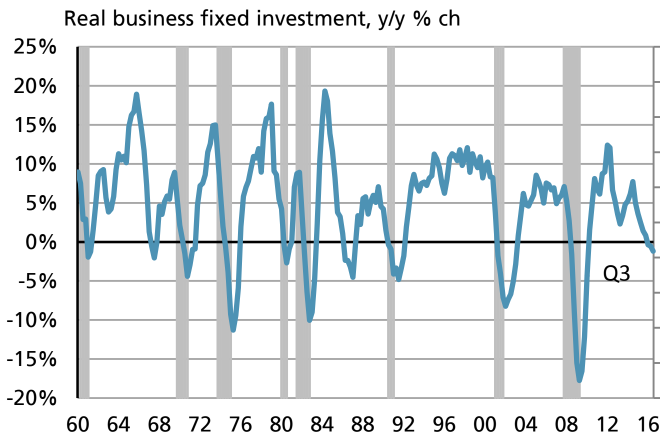
Broad growth tends to spur capex. One of the unusual elements of the last year and a half has been the weakness in business fixed investment relative to GDP growth or to consumer spending growth. Capex is rarely so weak relative to domestic demand except during recessions. The exception, shown in the chart below, was in the mid-80s. Then and now, as growth slowed, capex slowed even more sharply—suggesting some overexuberance earlier in the recovery. During the current expansion, at least through mid-2014, capex growth rates did not look so different from during the mid-00s recovery—but GDP growth rates have been slower and the economy has faced more frequent and severe shocks. It is partly the absence of those shocks that explains reacceleration in capex growth. Also, that it is hard to see the job and consumer spending growth we envision for the next two years without imagining a more expansionary business sector.

Figure 58: Accelerator effects: except during recessions, consumption rarely increases more quickly than capex, as it has in the last year and a half.



Note: Shaded areas mark recessions Source: Bureau of Economic Analysis & UBS

Figure 59: Capex growth rates earlier in this recovery matched those of the prior recovery. The more frequent shocks to growth and the slower growth trend demanded some correction to capex.



Note: Shaded areas mark recessions Source: Bureau of Economic Analysis & UBS

Capital/labor ratio likely to rise faster in a tightening labor market

More fundamentally, capital/labor ratios have been rising unusually slowly over the course of this recovery. During the recession, capital/labor ratios rose rapidly as firms laid off employees (without a coincident cut to capital stock). Some payback was credible. However, the persistently slow rise in capital/labor ratios argues for eventual acceleration. Why now? Faster growth, a tighter labor market, the absence of dollar or export shocks, and other capex positives listed above.

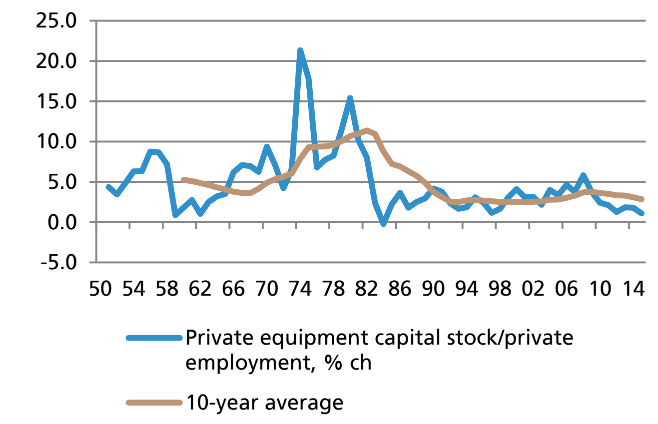
Modest acceleration in equipment investment

Equipment spending has been persistently weak, especially for aircraft, railroad, trucks, mining and oilfield, and construction equipment. Energy-price stabilization (or increase) is likely to benefit these, as is the end of rapid dollar appreciation.

No further drag from the oil patch on structures investment

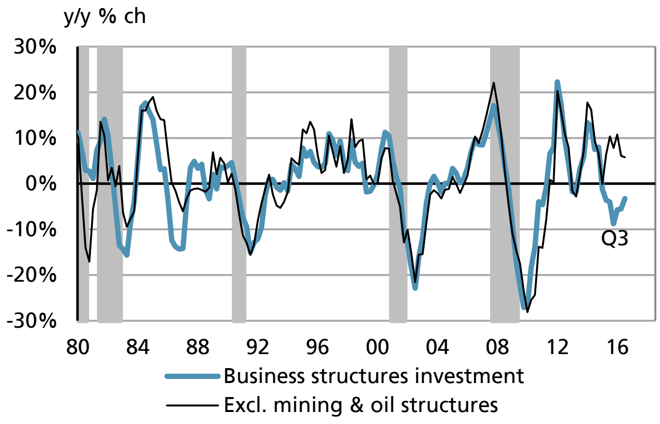
Structures investment excluding energy structures has maintained momentum over the past year and half—up 5.8% y/y in Q3 and 10.3% y/y a year earlier. The plunge in oil rigs has been the problem, subtracting -17pp from business structures investment growth at the peak during 2015 and -9pp year to date through Q3. With oil prices rising, that drag is likely to end. (See chart.) Rig count rose in Q3.

Figure 60: Capital/labor ratios have been rising far more slowly than in the past.



Source: Bureau of Economic Analysis, Bureau of Labor Statistics, and UBS

Figure 61: The oil drag on structures investment has been severe but has probably passed.



Note: Shaded areas mark recessions Source: Bureau of Economic Analysis & UBS

The Trump presidency

Federal tax, spending and trade policy represent risks to our outlook for 2017 and 2018. Candidate Trump offered a number of policy proposals during his candidacy. Some of these could stimulate the economy over our forecast horizon (tax and spending plans) while others could prompt concerns that feed into financial markets and act as a constraint on growth (trade and immigration).

Our analysis of Candidate Trump's tax and spending plans suggests a modest impact on growth, a boost of roughly 21 basis points per year if they are implemented in their entirety. However, this comes at a cost. The projected 10-year increase in the debt resulting from his plans works out to $6.9 trillion. Much of this impact is outside the horizon of our forecasts.

Fully implemented, the tax and spending plans as proposed could boost growth by about 20bp per year

Proposed policies on trade and immigration raise the potential for some negative effects on the economy. Regarding trade, there are limited concrete proposals, mostly involving more aggressive negotiations. One concrete proposal is the "renegotiation of the NAFTA". What impact could this have? The US International Trade Commission attributes only 0.2% of the cumulative 24.4 percent GDP growth between 1992 and 1998 to NAFTA. Assuming linearity, this implies a +0.03 percent annual contribution to GDP growth. These figures could serve as upper bounds of unrealized benefits to GDP if the U.S. weakens NAFTA.

Proposed trade policies can be short-term losers if they create financial market disruption…

…but otherwise they would simply eliminate the modest annual gains that are cumulative in the long term

The candidate has proposed that legal immigration flows be kept "within historical norms". However, if policies reduce legal immigration flows to the United States, this may negatively impact the trend potential growth rate.

The path of policy

Despite a moderate growth rate we believe that the Fed will continue to inch towards policy normalization. The tepid growth rate is nonetheless above the potential of the economy and, while inflation pressures are not excessive, the labor market is showing signs that slack has largely been absorbed.

The Fed will continue to inch towards policy normalization

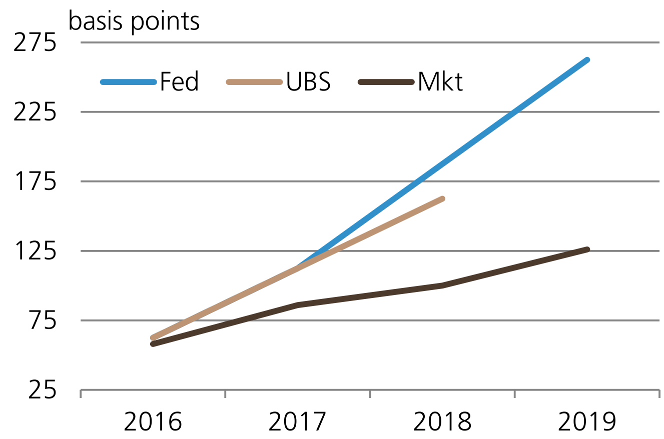
We anticipate that the FOMC will raise rates by 50 basis points in 2017 and by a further 50 basis points in 2018. Furthermore, we expect the FOMC will signal its desire to begin the process of normalizing its enlarged balance sheet at the end of 2017 and to implement a policy to reduce the balance sheet by mid-2018.

We expect 50 basis points of hikes in both 2017 and 2018

Risks to this outlook are many. Given the extended period of time rates have been held at exceptionally low levels, it is possible that the market response to rate hikes will be sharper than it has been in the past. Alternatively, perhaps consumers and companies will respond more favorably to actions that suggest a return to "normal". And, although the terminal rate is likely lower than it has been in the past, this rate is sensitive to changes to potential growth resulting from changes in the growth of the labor force (via immigration) or productivity (via better resource utilization).

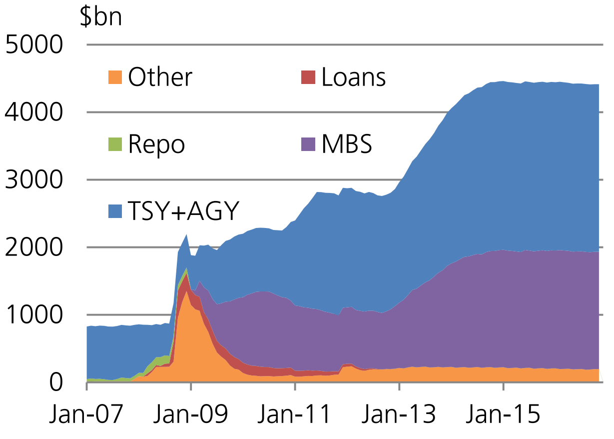
A key risk to this outlook is how markets, consumers and companies respond to policy normalization

Figure 62: UBS expects the Fed to tighten at a more gradual pace than the Fed itself forecasts but at a faster pace than the market is anticipating



Source: Federal Reserve Board, Bloomberg, and UBS.

Figure 63: Once the Fed reaches a 1% target rate we would expect the Fed to begin considering balance sheet reduction via tapered rollovers of maturing debt in 2018



Source: Federal Reserve Board and UBS.

USA	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	15518	16155	16692	17393	18037	18549	19348	20209
GDP, USD bn	15518	16155	16692	17393	18037	18549	19348	20209
GDP per capita, USD	49710	51370	52688	54484	56066	56693	58565	60555
Real GDP growth, %	1.6	2.2	1.7	2.4	2.6	1.5	2.4	2.5
Private consumption, % y/y	2.3	1.5	1.5	2.9	3.2	2.6	2.6	2.6
Government consumption, % y/y	-3.0	-1.9	-2.9	-0.9	1.8	0.9	1.1	1.0
Gross Fixed Capital formation, % y/y	6.3	9.8	5.0	5.5	4.0	0.6	3.1	4.1
Exports, % y/y	6.9	3.4	3.5	4.3	0.1	0.5	1.7	2.3
Imports, % y/y	5.5	2.2	1.1	4.4	4.6	0.7	2.7	3.1
Unemployment rate, %	8.9	8.1	7.4	6.2	5.3	4.9	4.6	4.5
Industrial Production (%)	2.9	2.8	1.9	2.9	0.3	-1.0	1.2	2.0
Prices, interest rates and money								
CPI inflation, % y/y (average)	3.2	2.1	1.5	1.6	0.1	1.3	2.3	2.3
CPI inflation, % y/y (year-end)	3.0	1.7	1.5	0.8	0.7	1.7	2.6	1.7
Broad money M2, % y/y (end-year)	9.8	8.2	5.4	5.9	5.7	5.5	4.5	4.5
Domestic private credit, % y/y	4.2	5.9	6.0	7.2	6.6	5.1	3.1	3.3
Domestic bank credit/GDP	0.5	0.5	0.5	0.6	0.6	0.6	0.6	0.6
Policy rate, % (end-year)	0.1	0.1	0.1	0.1	0.4	0.6	1.1	1.6
10 year bond yield, % (year-end)	2.0	1.7	2.9	2.2	2.2			
EUR/USD (year-end)	1.3	1.3	1.4	1.2	1.1	1.10	1.13	1.17
USD/JPY (year-end)	77.0	86.6	105.3	119.9	120.3	107.0	110.0	110.0
Fiscal accounts								
General government budget balance, % GDP	-8.5	-6.8	-4.1	-2.8	-2.5	-3.2	-3.5	-3.4
Revenue, % GDP	15.0	15.3	16.8	17.6	18.2	17.6	17.1	16.8
Expenditure, % GDP	23.4	22.1	20.9	20.4	20.7	20.8	20.6	20.2
of which interest expenditure, % GDP	1.5	1.4	1.3	1.3	1.2	1.3	1.4	1.5
Primary balance, % GDP	-7.0	-5.4	-2.8	-1.5	-1.3	-1.8	-2.1	-1.9
Public sector debt (gross),% GDP	65.3	69.8	71.8	73.5	72.7	74.2	75.3	76.0
of which domestic public debt, % GDP	65.3	69.8	71.8	73.5	72.7	74.2	75.3	76.0
of which external public debt,% GDP	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
% domestic public debt held by non-residents	28.7	32.1	32.4	33.8	33.2	32.4	32.0	31.6
Public debt held by the central bank, % GDP	10.8	10.3	13.2	14.2	13.6	13.3	12.7	12.0
Balance of payments								
Trade balance, USD bn	-548.6	-536.8	-461.9	-490.2	-500.4	-478.9	-563.9	-654.7
Exports, USD bn	2127.0	2219.0	2293.5	2376.6	2261.2	2206.5	2256.1	2306.9
Imports, USD bn	2675.6	2755.8	2755.3	2866.8	2761.5	2685.4	2820.0	2961.6
Current account balance, USD bn	-460.4	-446.5	-366.4	-392.1	-463.0	-469.4	-506.2	-474.7
as % of GDP	-3.0	-2.8	-2.2	-2.3	-2.6	-2.5	-2.6	-2.3
Foreign direct investment (net), USD bn	183.0	135.2	117.7	136.1	-30.8	-35.0	-20.0	-30.0
Total FX reserves, USD bn	51.9	49.9	47.6	41.9	39.2	39.2	39.2	39.2
Foreign exchange reserves excl gold, USD bn	40.8	38.9	36.6	30.9	28.2	28.2	28.2	28.2
Total FX reserves, % GDP	0.3	0.3	0.3	0.2	0.2	0.2	0.2	0.2
Total external debt, % GDP	99.9	97.1	98.9	99.2	97.4	96.4	96.0	95.7
Net International Investment Position, % GDP	-28.7	-28.0	-32.2	-40.5	-40.4	-40.2	-40.0	-40.0
Credit ratings								
Moody's	Aaa	Aaa	Aaa	Aaa	Aaa			
S&P	AA+	AA+	AA+	AA+	AA+			
Fitch	AAA	AAA	AAA	AAA	AAA			

Source: UBS/Haver/Federal Reserve Board

Canada

- **GDP growth accelerates from 1.1% in 2016 to 2.3% in 2017 and 2.7% in 2018 as the consumer continues to spend and the impact of two large drags on the economy – capital spending and inventories – fades.**
- **The Bank of Canada moves slowly, allowing the US Federal Reserve and the currency to do the heavy lifting for the economy. We see just one 25 basis point rate hike in 2017 and a single 25-basis-point follow-on in 2018.**

Less drag is a continental theme

We look for Canadian growth to accelerate in 2017 after two years of tepid activity. We see real GDP expanding by 2.3% in 2017 and by 2.7% in 2018. A rebound in consumer spending on services and non-durable goods should help stabilize overall consumption even if some credit-related strains emerge. This consumer profile, coupled with a rebound in capital spending as the drag from energy-related investment fades, should buoy overall growth. Additionally, like the outlook for the United States, we see less of a drag from inventories – there will not be a positive contribution from inventories over our forecast horizon, but we do not see them taking the 40bp off of GDP that they have averaged over the last three years.

Continued dollar weakness should help support a rebound in industrial production as well as helping to pull the unemployment rate lower and to push inflation higher. We see headline inflation just below 2% at the end of 2017, reaching 2% by the end of 2018.

What is the best/worst that could happen?

Upside risks to the outlook include a larger-than-forecast sustained rise in energy prices and fiscal policy, particularly on infrastructure. Downside risks include trade frictions with the United States, a downturn in housing and a further weakening of the labor market, jeopardizing the stable outlook for the consumer.

Trade friction with the United States represents a downside risk

A wait-and-see policy approach

We expect the Bank of Canada to watch the US Federal Reserve gradually increase rates in 2017 and to only follow once US policy rates have reached 1%. This wait-and-see policy supports our view for continued dollar weakness while also supporting a rebound in industrial production.

We look for the Bank of Canada to allow the rate differential with the US to widen for some time. We anticipate that the Bank of Canada will inch rates up by just 25 basis points at the end of 2017 and follow with just one additional 25-basis-point rate hike in 2018, bringing the bank rate to 1.0% versus our expectation of a 1.625% Fed funds policy rate.

We expect the Bank of Canada to allow the rate differential to the Federal Reserve to widen

Canada	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	1770	1823	1892	1973	1983	2016	2110	2219
GDP, USD bn	1790	1824	1837	1786	1551	1482	1529	1656
GDP per capita, USD	52143	52575	52345	50252	43280	40842	41817	44846
Real GDP growth, %	3.1	1.7	2.2	2.5	1.1	1.1	2.3	2.7
Private consumption, % y/y	2.2	1.9	2.4	2.6	1.9	2.2	2.3	2.4
Government consumption, % y/y	1.3	0.7	0.3	0.3	1.7	2.0	1.7	1.4
Gross Fixed Capital formation, % y/y	4.6	4.9	-0.5	0.7	-4.4	-2.1	3.0	4.1
Exports, % y/y	4.8	2.6	2.8	5.3	3.4	0.6	3.6	4.2
Imports, % y/y	5.6	3.6	1.5	1.8	0.3	-0.7	3.7	3.9
Unemployment rate, %	7.5	7.3	7.1	6.9	6.9	6.9	6.6	6.1
Industrial Production (%)	4.8	0.0	2.2	4.0	-1.1	-1.6	1.3	2.3
Prices, interest rates and money								
CPI inflation, % y/y (average)	2.9	1.5	0.9	1.9	1.1	1.5	1.8	2.0
CPI inflation, % y/y (year-end)	2.2	1.0	1.3	1.5	1.6	1.6	1.8	2.0
Broad money M2, % y/y (end-year)	6.5	5.6	6.9	4.7	6.0	5.3	5.5	5.8
Domestic private credit, % y/y	5.9	5.6	5.8	5.8	6.4	4.6	4.8	5.1
Domestic bank credit/GDP	0.7	0.9	0.9	0.9	1.0	1.0	1.0	1.0
Policy rate, % (end-year)	1.0	1.0	1.0	1.0	0.5	0.5	0.8	1.0
10 year bond yield, % (year-end)	1.9	1.8	2.8	1.8	1.4			
USDCAD (year-end)	1.0	1.0	1.0	1.1	1.3	1.4	1.4	1.3
Fiscal accounts								
General government budget balance, % GDP	-2.1	-1.5	-1.2	-0.2	-0.7	-1.6	-2.0	-1.9
Revenue, % GDP	38.4	38.6	38.5	38.5	39.1	38.5	38.0	38.5
Expenditure, % GDP	40.5	40.0	39.7	38.7	39.9	40.1	40.0	40.4
of which interest expenditure, % GDP	3.6	3.5	3.4	3.3	3.2	3.2	3.2	3.3
Primary balance, % GDP	1.6	2.0	2.2	3.1	2.4	1.5	1.2	1.4
Public sector debt (gross),% GDP	81.5	84.8	86.1	86.2	91.5	92.1	90.5	88.7
of which domestic public debt, % GDP	81.5	84.8	86.1	86.2	91.5	92.1	90.5	88.7
of which external public debt,% GDP	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
% domestic public debt held by non-residents	19.3	23.5	22.4	22.4	22.0	22.0	21.8	22.0
Public debt held by the central bank, % GDP	3.5	4.1	4.7	4.6	4.7	4.7	4.7	4.7
Balance of payments								
Trade balance, USD bn	-21.5	-35.9	-28.9	-16.9	-35.8	-48.1	-33.1	-30.0
Exports, USD bn	547.0	551.1	556.4	565.4	489.1	442.5	468.2	510.7
Imports, USD bn	568.4	587.0	585.3	582.3	524.9	490.6	501.3	540.7
Current account balance, USD bn	-49.6	-65.7	-57.9	-40.6	-49.0	-65.8	-50.9	-48.5
as % of GDP	-2.8	-3.6	-3.2	-2.3	-3.2	-4.4	-2.7	-2.9
Foreign direct investment (net), USD bn	39.7	43.1	71.7	58.6	42.5	30.5	28.5	29.5
Total FX reserves, USD bn	65.8	68.5	71.9	74.7	79.8	85.6	91.7	98.0
Foreign exchange reserves excl gold, USD bn	65.7	68.4	71.8	74.6	79.7	85.6	91.7	98.0
Total FX reserves, % GDP	3.7	3.8	3.9	4.2	5.1	4.2	4.3	4.4
Total external debt, % GDP	72.9	78.7	81.6	87.2	107.0	108.0	109.5	108.5
Net International Investment Position, % GDP	-13.5	-16.9	-16.1	-13.7	-14.1	-14.5	-14.8	-15.0
Credit ratings								
Moody's						Aaa		
S&P						AAA		
Fitch						AAA		

Source: UBS/Haver/Bank of Canada

Rafael De La Fuente
Economist
rafael.delafuente@ubs.com
+1-203-719-7127

Guilherme Loureiro
Economist
guilherme.loureiro@ubs.com
+55-11-2767-6621

Thiago Carlos
Economist
thiago.carlos@ubs.com
+55-11-2767-6933

Latin America

Latin America: The great convergence

UBS Research THESIS MAP

PIVOTAL QUESTIONS

Q: Will Latin America return to positive economic growth in 2017?

Yes. Spearheaded by a turn-around in Brazil's economic outlook, we see Latin America delivering a 1.6% expansion next year. Other countries like Argentina and Peru will see an improvement in their outlooks, and the rest, while soft, are unlikely to see their growth rates decelerate much further.

Q: Will inflation pressures subside?

Yes, for the most part. A combination of stronger FX rates, lower food price pressures, and sizable output gaps should allow inflation to fall rapidly in most countries.

Q: Is there room for policy stimulus?

It depends. Those countries experiencing large disinflationary pressures should be able to cut interest rates aggressively, most notably in Brazil and Colombia. However, on the fiscal front, most countries will have to tighten their belts, quite sharply in some cases, lest their creditworthiness be questioned.

UBS VIEW

We have a constructive view on the regional outlook, largely because **we like the chances of Brazil delivering on its structural reform proposal to anchor fiscal dynamics**. Overall, we believe the region is past the worst of its adjustment to a lower commodity price environment.

EVIDENCE

Congressional support for Temer's reform agenda in Brazil has been stronger than expected thus far and **business confidence is surging.** Elsewhere, the outlook is mixed, but generally we are seeing a drive **to sounder, more sustainable policies.**

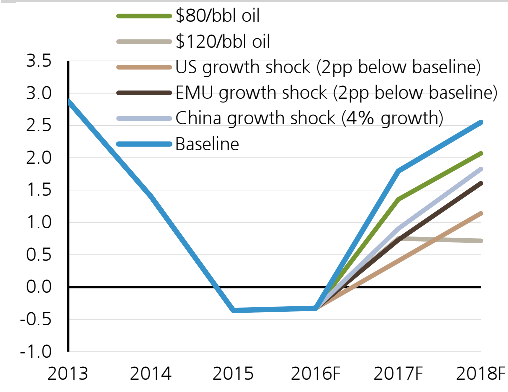
WHAT'S PRICED IN

Local investors in Brazil have bought into the country's turn-around story. **The view among foreign investors is more hesitant**, which implies that Brazil, and the rest of Latin America, could see a surge in capital inflows if reforms materialize, although not all would be impacted similarly.

UPSIDE/DOWNSIDE RISKS

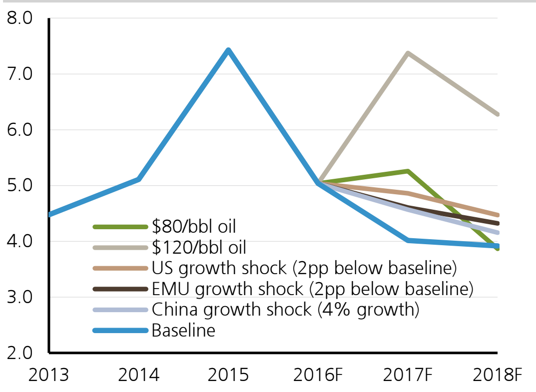
A negative shock to US, EU, or Chinese growth could dent the LatAm recovery and put upward pressure on prices through FX. Likewise a severe oil price shock. Increased protectionism spearheaded by the US is also relevant, especially for Mexico. But the bigger risks facing LatAm may be domestic: failure to deliver on reforms or to reignite investment. Upside risks are tied to reform success.

Latin America* GDP Growth Scenarios



Source: Haver, UBS. *Excluding Argentina and Venezuela

Latin America* Inflation Scenarios



Source: Haver, UBS. *Excluding Argentina and Venezuela

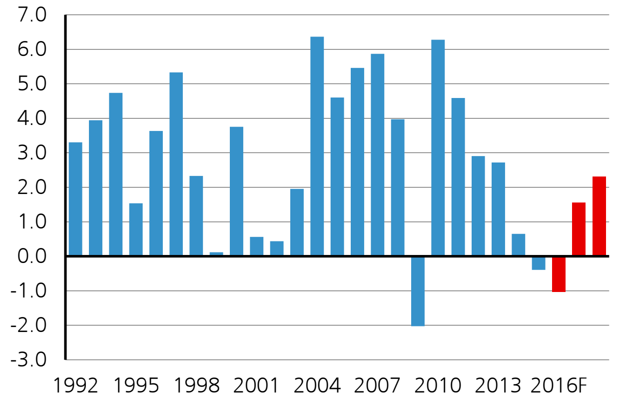
Latin America: The great convergence

- **The region should return to positive growth in 2017 spearheaded by Brazil; over time, though, we expect growth rates to converge to levels more modest than those witnessed during the commodity boom.**
- **Disinflationary forces should allow most central banks to cut interest rates, while fiscal policies will need to become more restrictive.**

Latin America: out of recession in 2017

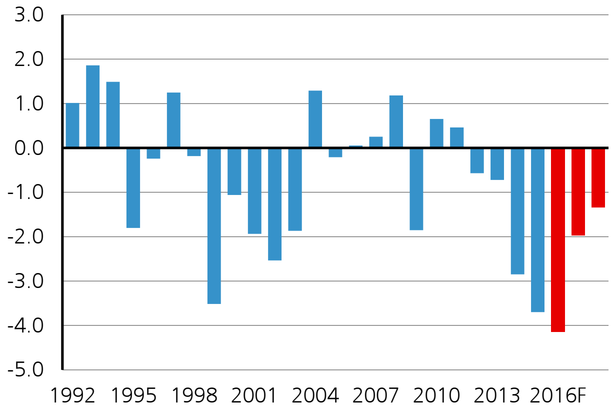
After experiencing its first two-year recession since the early 1980s – with Brazil, Argentina, and Venezuela all experiencing sharp contractions in 2016 – and after two years of gross economic growth underperformance versus the rest of the world, the Latin American economy, taken as a whole, should begin to get some respite in 2017. We are expecting the region to expand by 1.6%, still below global growth, but at least starting to converge back to it. In the absence of a meaningful export recovery, the economic response to the fall in commodity prices that started in 2013 has led to a painful contraction in domestic absorption – characterized by a collapse in investment, lower consumption, falling imports, and rising unemployment. Judging by the correction in the current account deficit, the region's macroeconomic adjustment to the new terms of trade is already in its middle innings.

Figure 64: Latin America Growth (%)



Source: Haver, IMF, UBS

Figure 65: Latin America Regional GDP Growth vs World Differential (%)

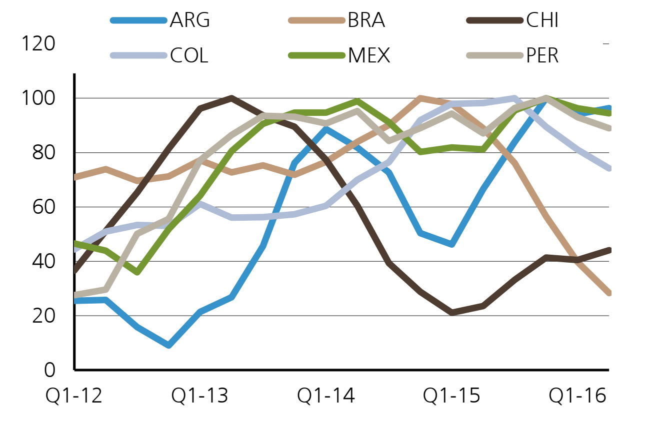


Source: IMF, UBS

A modest recovery in domestic demand – primarily in investment – should drive growth

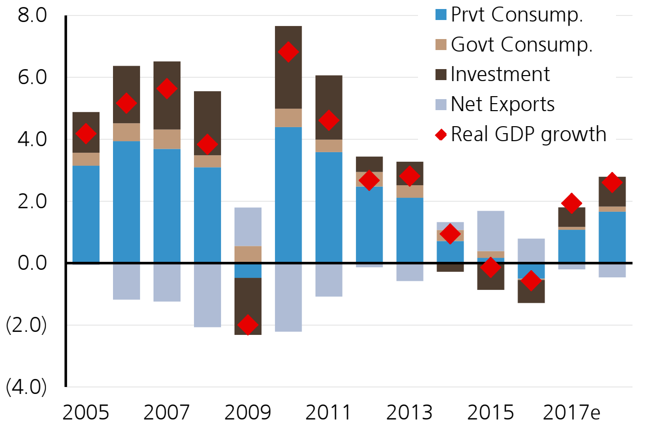
The rebound in economic activity we expect next year should largely be driven by a pick-up in investment, and to a lesser extent by a gradual improvement in household consumption. The recovery in investment will partly reflect the depth of the current downturn – a number of economies will need to rebuild inventories, for instance – but fundamentals will also be at play. Stronger and/or more stable FX rates should increase the demand for capital imports, while lower interest rates should ease credit conditions and make investing more attractive. In addition, with a higher unemployment rate in some countries – and falling real wages – a rebound in profitability could also help sustain a build-up in capital formation provided the prospects for a recovery in demand remain positive. Finally, in countries like Brazil and Argentina, an important structural component (i.e. a re-balancing in fiscal policy) should also reduce crowding-out of private investment, allowing real rates to fall and investment to pick up.

Figure 66: 2012-Present Current Account Deficit in USD, 4Q accum, max=100



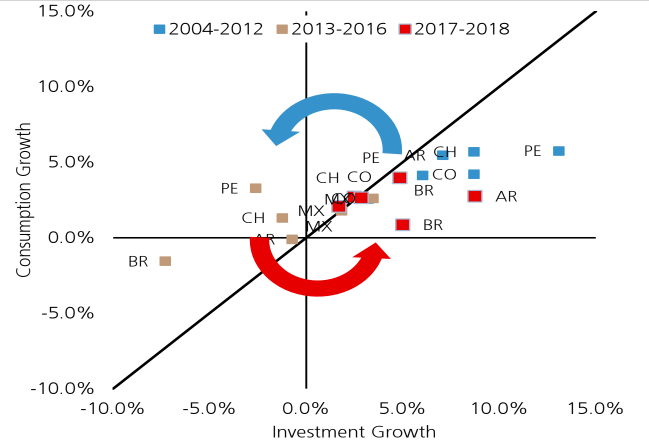
Source: Haver, UBS

Figure 67: LatAm ex Venezuela Contributions to GDP growth (pp of Headline Growth)



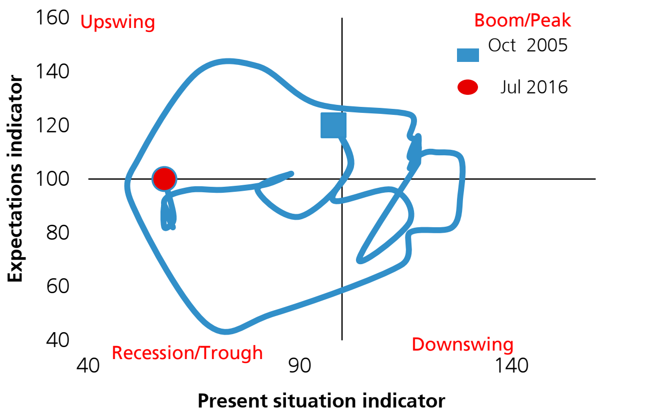
Source: Haver, UBS

Figure 68: Consumption vs Investment



Source: Haver, UBS

Figure 69: IFO-FGV Business cycle clock: Latin America



Source: FGV, UBS

Much rides on Brazil and Temer's ability to push through with reforms; in Mexico, the effect of the Trump electoral victory remains uncertain, but investment will likely be negatively affected

Of course, much of the region's recovery story – and much of the depth of this year's recession – revolves around the fortunes for Brazil. We think the region's largest economy could start to post positive q-o-q growth as early as Q1'17, buoyed by healthy export growth, improving business sentiment, and the need to rebuild inventories. That said, all is dependent on Brazil maintaining positive momentum on structural reform and delivering on its fiscal promises. Likewise, Argentina could start to post positive growth as improving real incomes boost consumption and investment starts its long-awaited recovery. Meanwhile, Peru could see its growth accelerate to over 4% on the back of positive mining momentum as well as the confidence boost provided by the arrival of Pedro Pablo Kuczynski. Growth should be more subdued in Chile and Colombia – hovering around 2% – but we do not foresee major recessionary risks in either of them. Mexico is harder to read on account of the uncertainty created by Donald Trump's victory in the US presidential elections. While we do not expect a full-blown trade war, we think investment will be impaired in Mexico; we see growth slowing, but not collapsing. The only country where we still see a deep recession is Venezuela, which continues to drift into hyperinflation and insolvency.

Key UBS macroeconomic forecasts for Latin America

Real GDP Growth	2015	2016F	2017F	2018F	Inflation (%, Dec y/y)	2015	2016F	2017F	2018F
Argentina	2.5	-1.8	3.0	3.0	**Argentina (official)**	27.0	37.0	19.5	15.0
Brazil	-3.8	-3.6	1.3	2.6	**Brazil**	10.7	6.7	4.5	4.6
Chile	2.3	1.8	2.2	2.6	**Chile**	4.4	2.7	2.5	3.1
Colombia	3.1	2.2	2.4	3.2	**Colombia**	6.8	6.0	4.0	3.6
Mexico	2.5	2.2	1.7	2.0	**Mexico**	2.1	3.3	3.9	3.5
Peru	3.3	3.8	4.4	4.3	**Peru**	4.4	2.9	2.7	2.6
Venezuela	-5.7	-10.0	-5.0	-3.0	**Venezuela**	181	720	2,200	3,000
LatAm	**-0.4**	**-1.0**	**1.6**	**2.3**	**LatAm ex Ven**	**9.1**	**8.6**	**5.8**	**5.2**
LatAm ex Arg and Ven	**-0.4**	**-0.3**	**1.8**	**2.5**	**LatAm ex Arg and Ven**	**6.8**	**5.0**	**4.0**	**3.9**

Current acc. (% of GDP)	2015	2016F	2017F	2018F	Fiscal balance (% of GDP)	2015	2016F	2017F	2018F
Argentina	-2.7	-2.1	-3.0	-3.2	**Argentina**	-1.1	-7.2	-6.9	-6.0
Brazil	-3.4	-1.3	-1.4	-2.1	**Brazil**	-10.4	-9.1	-9.5	-8.7
Chile	-2.0	-2.0	-2.2	-1.8	**Chile**	-2.2	-2.1	-1.8	-1.7
Colombia	-6.5	-4.8	-4.4	-4.2	**Colombia**	-3.1	-4.1	-3.4	-3.0
Mexico	-2.9	-2.6	-3.3	-3.6	**Mexico**	-3.5	-2.9	-2.5	-2.0
Peru	-4.8	-3.7	-3.2	-3.0	**Peru**	-2.9	-3.0	-2.3	-2.3
Venezuela	-12.4	-7.0	-1.6	1.0	**Venezuela**	-19.9	-25.0	-25.0	-22.0
LatAm	**-3.9**	**-2.5**	**-2.4**	**-2.6**	**LatAm**	**-6.7**	**-7.6**	**-7.5**	**-6.3**
LatAm ex Arg and Ven	**-3.4**	**-2.1**	**-2.3**	**-2.7**	**LatAm ex Arg and Ven**	**-6.7**	**-6.1**	**-6.1**	**-5.5**

FX lc/US$ (yr end)	2015	2016F	2017F	2018F	Policy rate (yr end)	2015	2016F	2017F	2018F
Argentina	11.43	15.65	18.00	20.00	**Argentina**	NA	NA	NA	NA
Brazil	3.96	3.20	3.00	3.10	**Brazil**	14.25	13.75	10.50	9.00
Chile	707	660	670	670	**Chile**	3.50	3.50	3.00	3.50
Colombia	3,149	3,000	2,950	2,920	**Colombia**	5.75	7.75	6.25	5.50
Mexico	17.21	20.50	21.00	21.50	**Mexico**	3.25	5.25	5.75	6.25
Peru	3.38	3.40	3.30	3.25	**Peru**	3.75	4.25	4.25	4.25
Venezuela	139	439	2,504	22,739	**Venezuela**	NA	NA	NA	NA

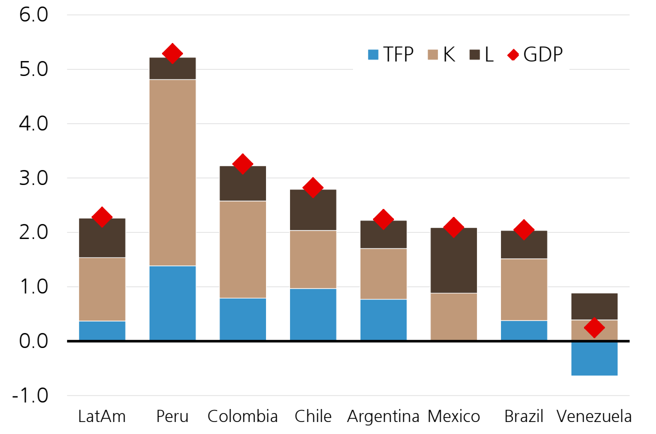
Source: UBS

What is the new growth potential for LatAm?

Beyond the rebound in 2017, great convergence to moderate rates of growth

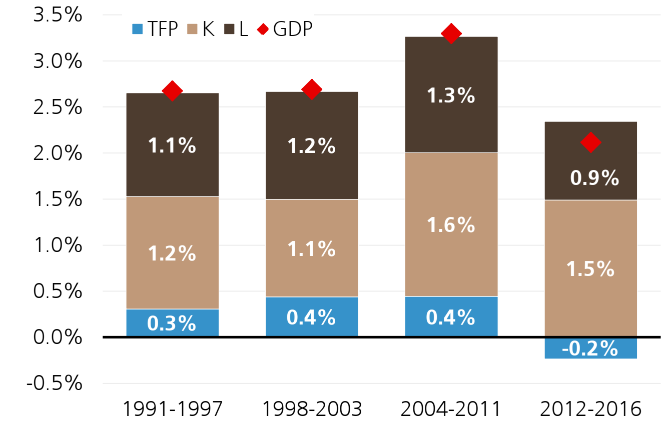
While some countries will be experiencing a "rubber-band" effect on growth coming off large contractions in output, over time we expect most Latin American economies to converge towards a modest 2-3% growth rate. Indeed, we think potential growth rates in the region have likely declined to 2.3% currently from 3.3% in the past decade. This 1p.p. drop in potential GDP in Latin America has a lot to do with countries' difficulties increasing productivity following the commodity boom. In fact, the region is living with negative rates for total factor productivity, which pushed potential GDP growth down by 0.6 p.p. Moreover, the demographic bonus is not helping as much as in past decades: while the working-age population grew almost 2.0% in the past decade and 2.5% in the early 1990s, it is currently growing only 1.4% per year.

Figure 70: Potential Real GDP Growth by Country (%)



Source: Haver, UBS [TFP = total factor productivity, K=capital, L=labour]

Figure 71: LatAm Contribution to Real Potential GDP Growth



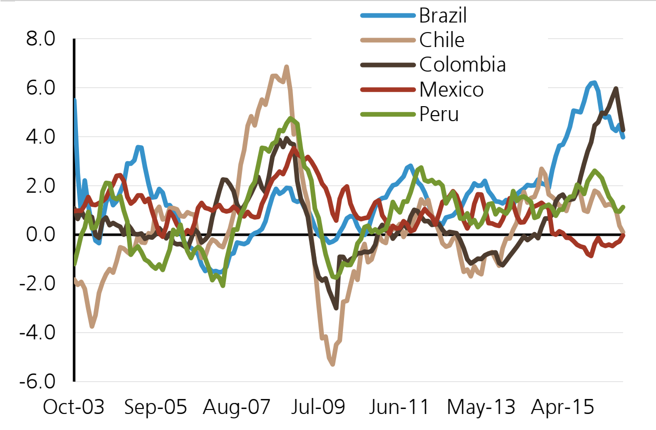
Source: Haver, UBS [TFP = total factor productivity, K=capital, L=labour]

Disinflation at play

Stronger and more stable FX rates, lower food prices, and sizeable output gaps…

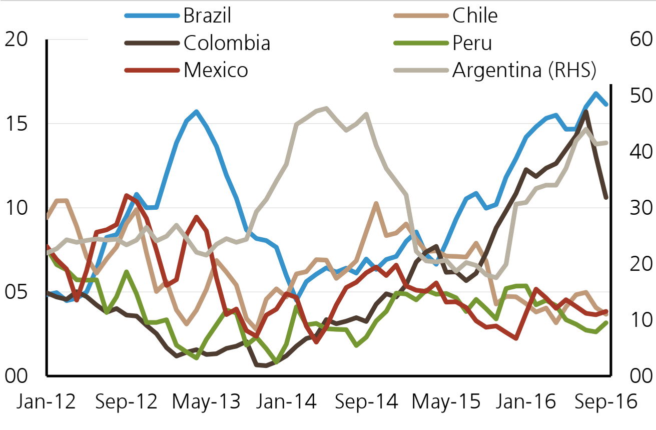
For most countries in our Latin American sample, we expect inflation to trend down in 2017. We see three key drivers of inflation we have witnessed in recent years starting to unwind and even reverse. For one thing, we are expecting greater stability in exchange rates going forward, due to a more constructive view on commodity prices and a Fed tightening cycle that should be well telegraphed. This should allow for much lower FX pass-through to prices than the ones we have witnessed in recent years. Second, food and utility price shocks related to El Niño appear to be behind us while meteorological estimates call for a mild La Niña. Lastly, we think output gaps will remain wide and will continue to keep unemployment rates – a lagging indicator of the economic cycle – on the rise, in turn reducing the second-round effects of food and FX-related price shocks.

Figure 72: CPI Inflation Minus Target, %



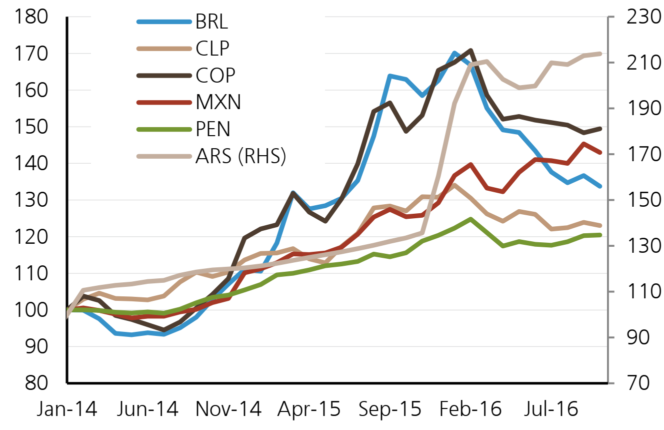
Source: Haver, UBS

Figure 73: Food Inflation, % y-o-y



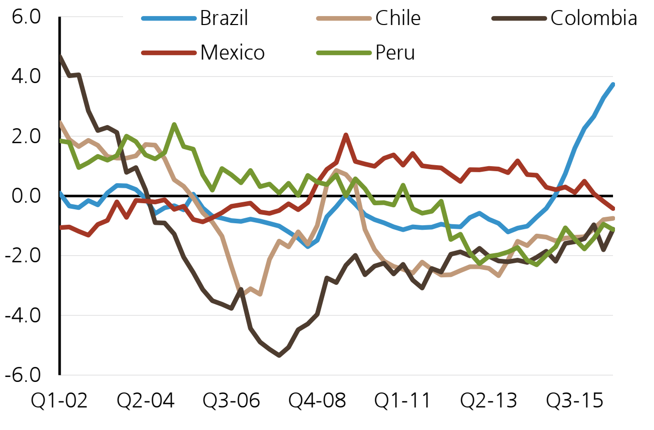
Source: Haver, UBS

Figure 74: FX Evolution (Base Jan'14 = 100)



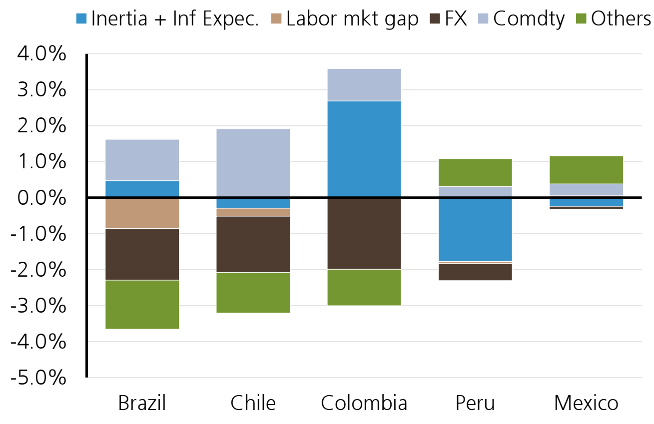
Source: Bloomberg, UBS

Figure 75: Unemployment Minus NAIRU, %



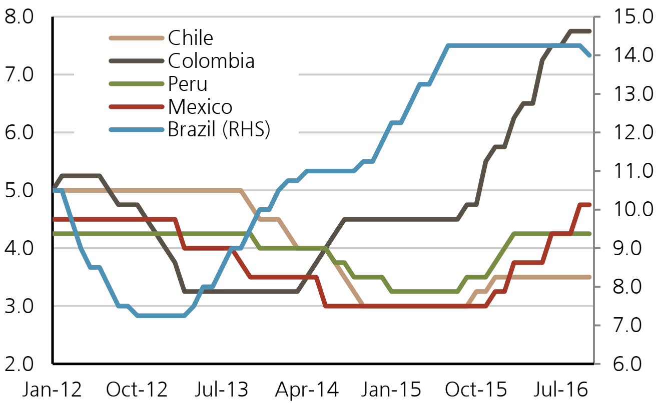
Source: Haver, UBS

Figure 76: Contribution of Each Inflation Component to Inflation Change 2016 vs 2015



Source: Haver, UBS

Figure 77: Central Bank Reference Rate (eop, %)



Source: Haver, UBS

... should reduce inflationary pressures in most countries

Brazil should again be at the forefront of this disinflationary drive, where we now see inflation ending 2017 at the CB's 4.5% target. Chile and Colombia should also experience meaningful drops in inflation, while Argentina should continue to see a gradual improvement on this front as more coherent fiscal and monetary policies start to anchor expectations. The odd man out in this drive is Mexico, which according to our estimates will see inflation rise next year towards the top of the CB's target band, fuelled by the liberalisation of gasoline prices and base effects.

Monetary policy: with room to cut

We expect countries such as Brazil, Colombia and Chile to cut rates next year

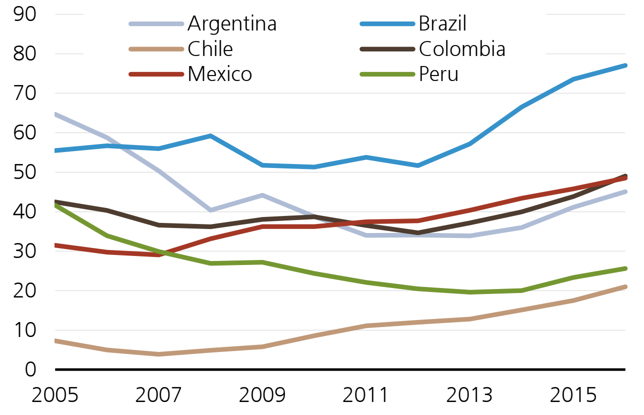
Given our outlook for inflation in the region, we think most central banks will have easing biases next year. In Brazil, which recently began its easing cycle, we see scope for greater interest-rate cuts than those currently priced-in by the market: we see the Selic benchmark rate at 10.5% and 9.0% at YE' 17 and YE'18 respectively. In Colombia, we expect the CB to deliver 150bps of interest-rate cuts next year, once the authorities are convinced that inflation expectations are converging to target. In Chile, meanwhile, we see the CB cutting interest rates by at least 50bps through H1'17, with inflation undershooting the target. The Argentine CB has recently resumed its easing cycle as the economy continues its disinflationary process. Once again, it is Mexico that should buck this trend: with inflation on the rise and MXN on a weakening bias, especially post Trump's victory, we expect Banxico to deliver a further 150bps of hikes in the next two years.

Fiscal policy out of room for stimulus

Fiscal tightening is the new name of the game

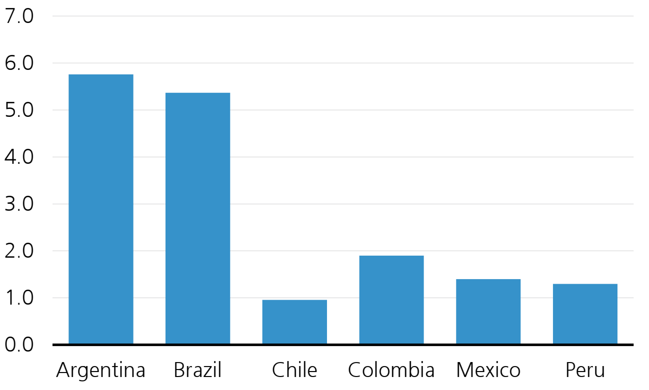
That monetary policy will have room for accommodation next year could not come at a better time, because fiscal policy has spent its bullets in Latin America in terms of its ability to provide stimulus. Three years into a terms-of-trade shock, most governments are finally realising that they need to adjust their fiscal accounts accordingly. Nowhere is this more true than in Brazil, where failure to implement the proposed expenditure cap on fiscal spending and to approve a thorough pension reform would likely lead to spiralling debt dynamics and ultimately to deficit monetization. The risk of a ratings downgrade has also focused the government's efforts in Mexico, where the authorities are now committed to delivering a further spending cut worth 1% of GDP next year and the achievement of a primary surplus. The same can be said for Colombia, where Congress is currently discussing a much-needed tax reform worth over 2% of GDP in revenues over time. Even fiscally conservative Chile has had to reduce its pace of spending.

Figure 78: Gross debt-to-GDP ratio by country (%)



Source: Haver, UBS

Figure 79: Fiscal Tightening needed to Stabilize the Gross Debt-to-GDP Ratio (% of GDP)



Source: UBS

The exception to this drive is Peru, where the Kuczynski administration has given itself greater fiscal flexibility in order to boost public investment. In Argentina, fiscal adjustment is ongoing, but at a lower pace than initially anticipated.

Risks to the outlook

Beyond outside risks, including that of increased protectionism, failure to deliver on reforms or to get investment going, worry us

A shock to growth in the US, Europe or China would have a detrimental effect on the region's economic outlook, as would an oil shock that took a large toll on DM growth. A rise in trade protectionism in the region spearheaded by the US is also a risk, especially for Mexico, where USD500bn in bilateral trade is at stake. But the largest risks we see to our outlook for the region could well be home-grown. One is that authorities in Latin America fail to deliver on their proposed fiscal reforms. In particular, if Temer's reform agenda in Brazil were to get derailed, the largest economy in the region could quickly spiral back into recession and a debt crisis. The other major risk to regional growth we see is that, in the absence of fiscal stimulus, we are expecting the private sector, particularly through investment, to do much of the heavy lifting. But as Argentina found out this year, securing a recovery in investment – even after positive structural momentum – may prove fleeting in an uncertain domestic and international environment.

Brazil

- **Structural factors should combine with cyclical, allowing a large fall in rates.**
- **We see IPCA converging to 4.5% as of 2017 and Selic rate at 9% by 2018.**
- **Brazil as a structural story**

Brazil is likely experiencing a second round of real interest-rate convergence

Brazil is experiencing what we believe could be the second round of a real interest-rate convergence. The first episode happened last decade, when a positive combination of a favourable global outlook (and BRL appreciation), the positive effects of a reform agenda[16] and sound macroeconomic policies – which consisted of fiscal discipline, inflation being under control and a free-floating currency – allowed real rates to fall to the 7% handle from their 10-15% average in the early 2000s (Figure 80).

The first leg happened in early last decade. The second attempt was 2008-09 but policymakers failed to sustain low rates for long

During the 2008-09 financial crisis, Brazilian policymakers tried to promote another leg of rate convergence. This attempt began with counter-cyclical macro policies in 2008-09 (easier fiscal and monetary policies) and culminated with the Central Bank bringing real rates further down to the 2-3% handle by 2011-12. However, the country failed to sustain low rates without generating higher inflation. In the years that followed, inflation picked up (peaking last year at 10.7% yoy), forcing the BCB to bring real rates up again. What went wrong and why do we think we are now at the edge of a long fall in real rates in Brazil?

Why do we think it is different now? Structural factors should combine with cyclical, allowing a large fall in rates

In our view, global cyclical forces – a depressed world economy and low rates in DM – helped keep rates low temporarily in Brazil during 2011-12. However, the structural component (ie, a re-balance in fiscal policy) didn't validate a permanent shift in the rate level. In our view, what was necessary to sustain low rates in the country was to cut the size of the public sector (payroll and pensions) and reduce crowding-out of private investment, allowing real rates to fall, investment to pick up and trend growth to rebound – which is exactly what we believe this administration is trying to implement. If it is adopted properly, we think it could offset potential headwinds from developed economies (eg, increase in interest rates in the US).

Reform approval: Precondition for real rate convergence

Most of the new team's efforts to re-balance fiscal policy have been focused on: 1) capping real spending; and 2) approving a pension reform

As we have extensively discussed (see *Can Brazil achieve fiscal equilibrium? Stress test our interactive model* and *Brazil reforms: Are they as unpopular as generally believed?*), most of the new team's efforts to re-balance fiscal policy have been focused on securing the approval of two measures: 1) a cap on real spending; and 2) pension reform to make the spending ceiling credible. The two measures are inherently intertwined: since pensions make up ~40% of total government spending and grow at least 4% in real terms per annum, a cap on spending can only be successfully implemented if pension spending is brought under control.

[16] Structural reforms that started in the Collor administration (1990), continued with Cardoso (1995-2002) and spread through the first years of former President Lula's first mandate (2003-06) included: 1) an increase in Brazil's trade openness; 2) inflation control; 3) the Fiscal Responsibility Law; 4) the creation of regulatory agencies; and 5) the Bankruptcy Law, among others.

The recent approval of a cap in government spending for the next two decades by the Lower House (the Senate is likely to approve it before year-end) by a very wide margin (see *Brazil spending cap: A solid step toward fiscal equilibrium*) was an important step towards fiscal stability. More importantly, it indicates the government can command a sufficiently large majority in Congress (Figure 81) and, in our view, sets the ground for pension reform in upcoming months (expected to be sent to Congress before year-end, for final approval in early 2H17).

The approval of the spending ceiling was an important step towards fiscal stability

Finally, even though most of the analysis around these measures has so far focused on the fiscal adjustment per se and their effectiveness to mitigate solvency risks, we believe they have much broader macroeconomic implications, such as their ability to raise the domestic saving rate, allowing real rates to fall and investment and potential growth to rebound – which also helps ease the fiscal dynamics. Our simulations, for instance, indicate these reforms could reduce the Central Government's expenditure-to-GDP ratio by one-fifth in 10 years (and by two-fifths in 20 years) and could boost the domestic saving rate by a full 4pp of GDP in the same period (7.5pp in 20 years) – Figure 82. If we assume the extra savings translate into investment, potential GDP growth could also rise to a 2.5-3.0% range, from ~2.0% currently (Figure 83).

But the macro implications are broader: raise the saving rate, allowing rates to fall and potential growth to rebound

Cyclical domestic factors and stronger BRL also help secure lower rates

After falling 3.8% in 2015 and remaining in recession this year (UBS-e for 2016 real GDP is -3.6%; prev.: -2.8%), we expect the Brazilian economy to show a modest recovery in 2017 (+1.3%; prev.: +1.6%) before picking up to +2.6% by 2018. The downward revisions for 2016 and 2017 reflect primarily a worse GDP performance in Q316 (new UBS-e: -1.0% q-o-q s.a., prev.: -0.2%), but we maintain the view that the economy can stabilize by Q416 (UBS-e: -0.1% q-o-q s.a.), showing a firmer recovery at the beginning of 2017 (Figure 84).

We expect real GDP to grow by 1.3% in 2017 and to pick up to 2.6% by 2018

Turning points in economic cycles are normally followed by larger upside and downside surprises of high-frequency activity data. Therefore, we believe it is premature to assume the Q316 dataflow is a new trend. Furthermore, the factors that have been suggesting Brazil was close to a turning point (probably with an investment-led recovery) remain in place: 1) a rebound in confidence (Figure 85) and 2) lower yields (from ~17% in early 2016 to ~12% now).

Q3'16 dataflow surprised negatively, but the drivers of the recovery remain in place

However, importantly, compared with previous crises, the economic recovery is still likely to be much more gradual (Figure 86) and to remain disinflationary for longer. Our estimates, for example, indicate that the GDP gap is largely disinflationary, and with unemployment at ~12%, it's at least 4pp above the non-accelerating inflation rate of unemployment (Figure 87)[17]. In addition, given ongoing fiscal consolidation; credit growth (which is unlikely to lead the economic recovery, as corporate and household leverage are still high); and the unemployment rate, which may only peak by mid-2017 (at around 13%), consumption is also likely to remain weak.

Still, this recovery is likely to be more gradual than before and to remain disinflationary for longer

Another factor that should help on the inflation front is a well-behaved BRL. Despite the recent FX sell-off, we continue to hold the view the USD/BRL is likely to strengthen, given a low current account deficit (we see it at 1.4% and 2.1% of GDP in 2017-18), strong FDI (likely to gain momentum with the concession program), and possibly more inflow of portfolio investment (bonds and equities), with progress on the reform agenda and a partial fading of the current EM market

A well-behaved BRL should also help with inflation slowdown

[17] This also suggests that growth potential could outpace GDP for some time without inflationary pressure.

sell-off (Figure 88). In fact, we now see the USD/BRL at 3.00 for YE17 (prev.: 3.15) from 3.20 in YE16 (prev.: 3.30). For YE18, we expect small USD/BRL depreciation to 3.10 – in light of the large cut we expect in the Selic rate.

Scenario is consistent with IPCA at 4.5% in 2017-18 and Selic at 9.0%

We now see inflation at 4.5-4.6% in 2017-18, from 6.7% YoY this year and 10.7% in 2015

This scenario is consistent with IPCA inflation falling to 4.5% in 2017 and reaching 4.6% in 2018, from 6.7% YoY this year and 10.7% in 2015 (Figure 89). Our view has been that services and core inflation would probably come down faster than anticipated by markets due to a high unemployment rate and increased idle capacity in the country (Figure 90); see *Brazil Inflation: Is the target at risk for 2017?*). Now, these factors are combining with the reversal of the food price shock, lower inflation expectations and a short-term downside activity surprise. This makes us cut our IPCA estimates further to 4.5% for next year (prev.: 4.7%) from 6.7% in 2016 (prev.: 6.9%), while we see 2018 IPCA at 4.6%. Our base case has services inflation reaching 5.3% in both 2017 and 2018 (and already slowing down to the low 6.0% range in early 2017) from 6.9% in Oct 2016; regulated prices at 5.0% and 4.1% in 2017 and 2018, respectively (from 6.0% in 2016); and industrial goods inflation at 2.0% and 3.0% (from 5.2% in 2016).

With inflation at the target, we see the Selic rate at 10.5% by YE17 and 9.0% by YE18

Finally, if inflation falls to the centre target next year, as we expect, we think the Copom is likely to promote a larger easing cycle than is currently priced in by the markets. The recent pause in the services' inflation fall has made the monetary authority more conservative in its pace of easing (and to begin the cycle with a 25bp cut), but for 2017, we continue to see the Copom increasing the pace of easing to 50bps, as soon as services inflation resumes its downward trend and consensus shows further downward revisions in its inflation forecast (Figure 91). In this environment, we maintain the Selic rate at 10.5% by YE17 from 13.75% this year and expect it to fall further down to 9.0% in 2018.

What are the risks?

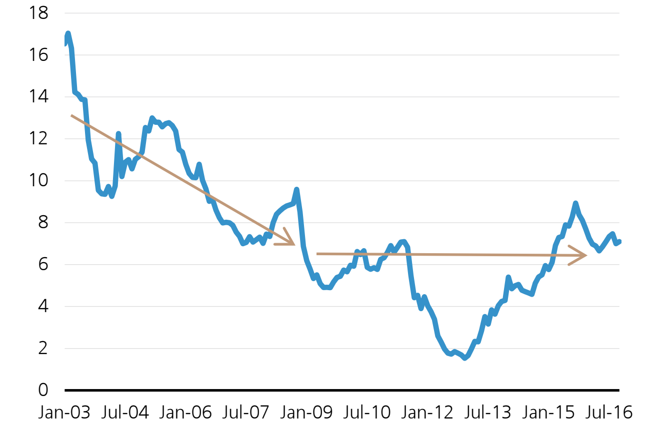
The main risks in this scenario are i) the failure to deliver on the proposed fiscal reforms and ii) a larger global market sell-off

Political opposition, leading the government to under-deliver on reforms – stabilizing the fiscal dynamics is a precondition for the positive scenario to materialize and for inflation/rates to fall (see *Brazil: Understanding how fiscal deficits could spill over to inflation*); more severe fiscal problems with local governments and/or SOE bailouts; and/or a larger global market sell-off, in light of increased concerns around economic policy in the US. Meanwhile, a broader privatization program, deeper macro reforms (such as labour and political reform) and micro reforms (such as reducing bureaucracy and facilitating cross-border trade) could lead to a faster rebound in potential real GDP growth.

Conclusion

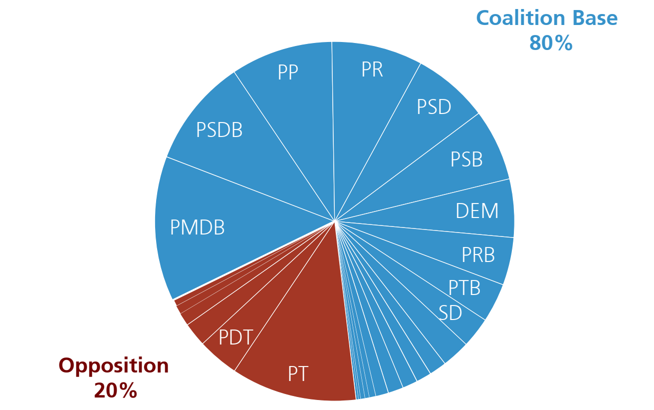
Structural changes are likely to combine with cyclical factors, providing a good opportunity for Brazil to promote a permanent shift in its rate level and boost potential GDP. The main risks in this scenario are: 1) the fail to deliver on the proposed reforms – if Temer's reform agenda were to get derailed, the largest economy in the region could quickly spiral back into recession and a debt crisis; and 2) a larger global market sell-off, in light of increased concerns around economic policy in the US.

Figure 80: Brazil 1y Real Interest Rate (%)



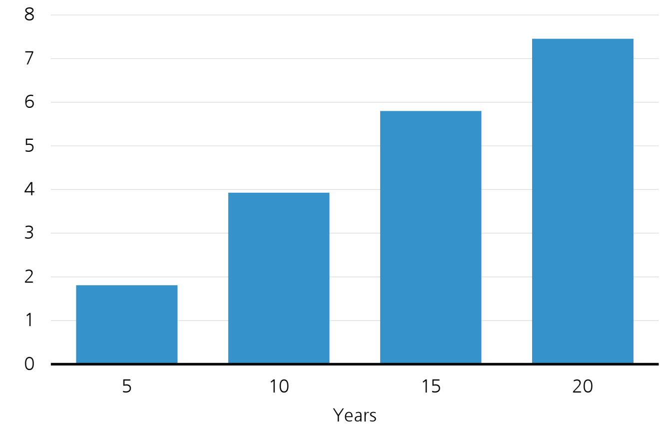
Source: Bloomberg and UBS. Note: Calculated as 1y swap Pre-DI curve minus 12m BCB Focus inflation expectation (smoothed series).

Figure 81: Govt's Coalition base in the Lower House



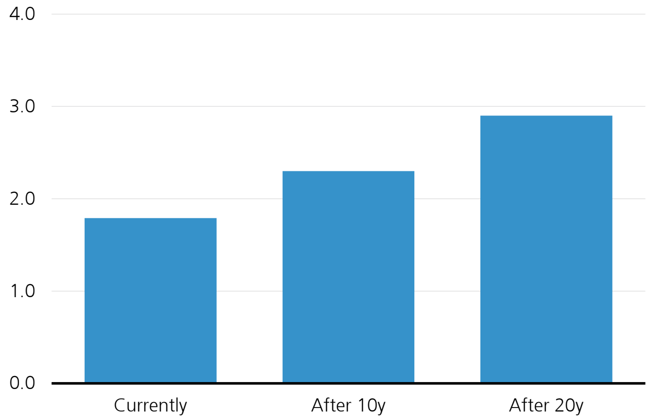
Source: Lower House and UBS.

Figure 82: Cumulative change in savings rate (p.p. of GDP)



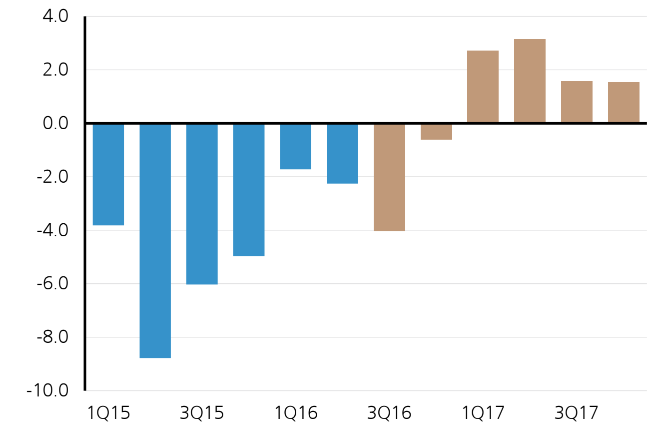
Source: IBGE and UBS. Note: Assuming stable private consumption-to-GDP ratio.

Figure 83: Change in potential GDP with rising savings %



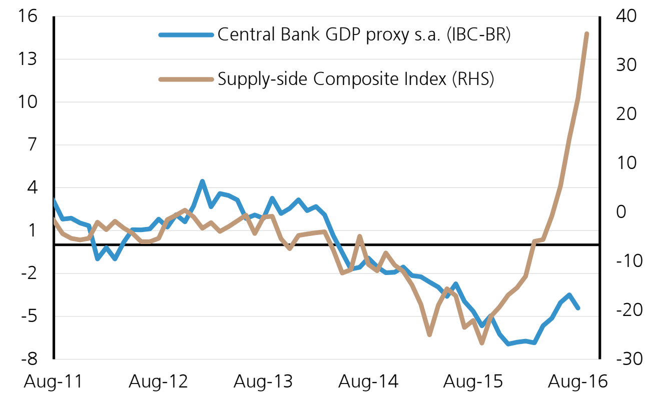
Source: IBGE, PWT and UBS. Note: Exercise assumes average 20y gain in TFP; 2015 investment-to-GDP ratio and rising with the increase in the domestic savings rate. We also consider the slowdown in working age population over time.

Figure 84: Real GDP (% q-o-q SAAR)



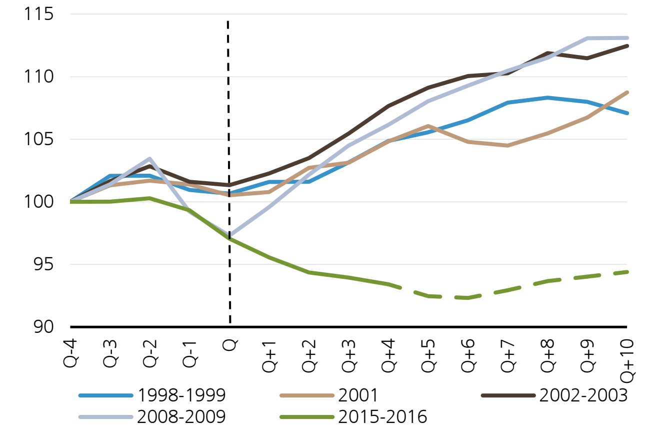
Source: IBGE, UBS.

Figure 85: BCB GDP proxy vs. Confidence Composite Index* (% y-o-y)



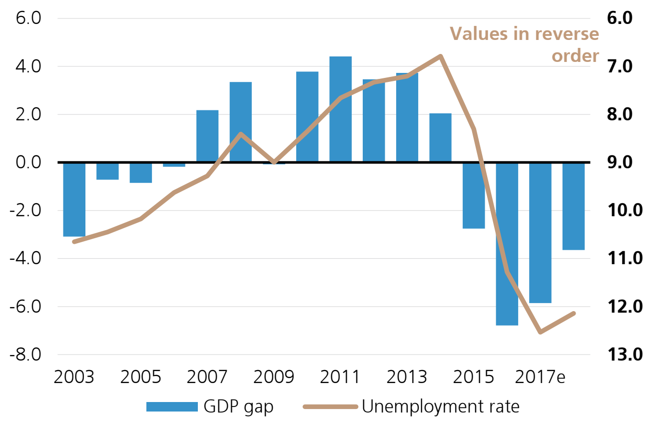
Source: BCB, FGV and UBS. See *Is Brazil bottoming out?* for more details.

Figure 86: Real GDP Index S.A.



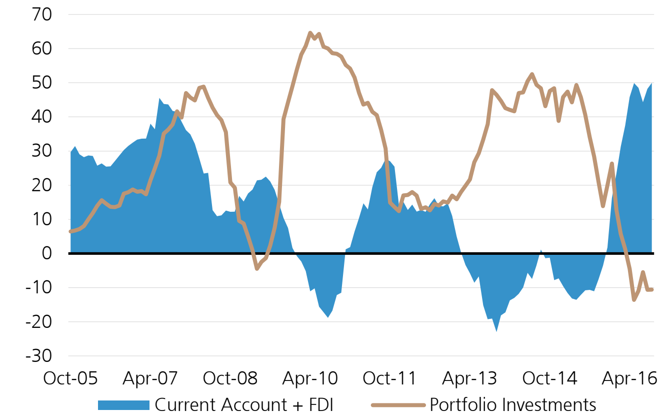
Source: IBGE and UBS. Note: Q denotes the beginning of the recession, defined as two consecutive quarters of real GDP contraction. Rebased to show Q-4 = 100.

Figure 87: GDP Gap and Unemployment rate (%)



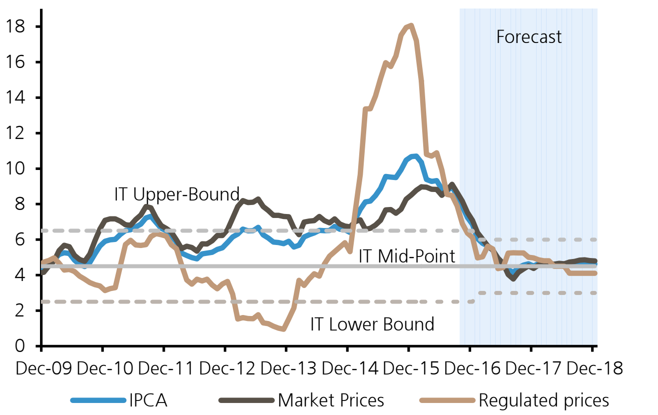
Source: IBGE and UBS.

Figure 88: Balance of Payments breakdown (US$ bn, 12m)



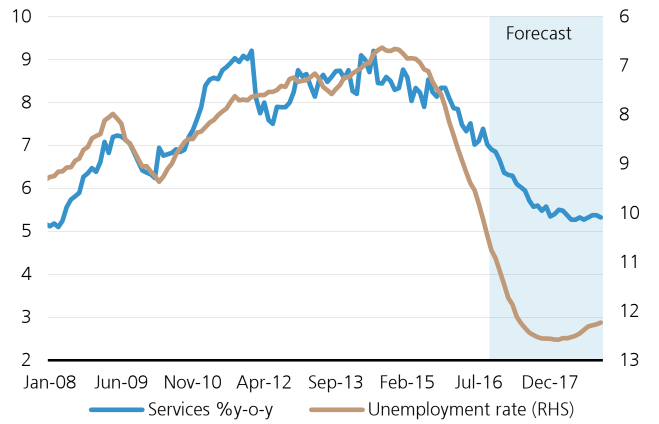
Source: BCB and UBS.

Figure 89: IPCA Inflation breakdown (%y-o-y)



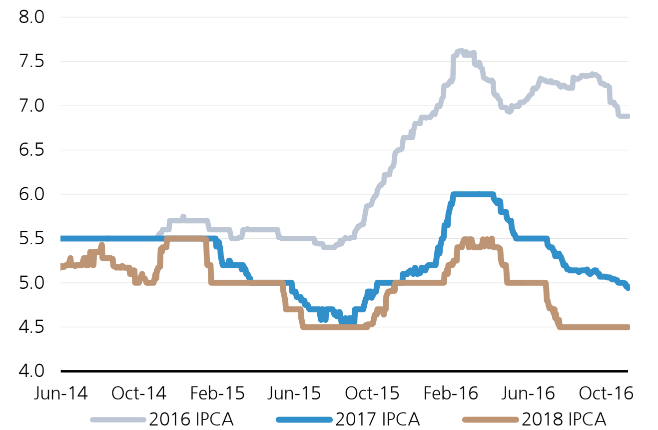
Source: IBGE and UBS.

Figure 90: IPCA Services inflation (% y-o-y) vs. unemployment rate (%)



Source: IBGE and UBS.

Figure 91: BCB Focus Inflation Expectations (2016-18)



Source: BCB and UBS.

Brazil	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	4,374	4,806	5,316	5,687	5,904	6,183	6,610	7,073
GDP, USD bn	2,612	2,447	2,437	2,406	1,741	1,798	2,138	2,316
GDP per capita, USD	13,234	12,284	12,121	11,866	8,517	8,724	10,296	11,099
Real GDP growth, %	3.9	1.9	3.0	0.1	-3.8	-3.6	1.3	2.6
Private consumption, % y/y	4.7	3.5	3.5	1.3	-4.0	-4.7	0.0	2.2
Government consumption, % y/y	2.2	2.3	1.5	1.2	-1.0	-1.8	0.0	0.0
Gross Fixed Capital formation, % y/y	6.7	0.8	5.8	-4.5	-14.1	-10.0	3.9	6.1
Exports, % y/y	4.8	0.3	2.4	-1.1	6.1	4.7	4.5	3.9
Imports, % y/y	9.4	0.7	7.2	-1.0	-14.3	-10.7	5.6	8.1
Unemployment rate, %	7.7	7.3	7.2	6.8	8.3	11.3	12.5	12.1
Industrial Production (%)	4.1	-0.7	2.2	-0.9	-6.2	-4.0	3.5	4.8
Prices, interest rates and money								
CPI inflation, % y/y (average)	6.6	5.4	6.2	6.3	9.0	8.8	4.8	4.6
CPI inflation, % y/y (year-end)	6.5	5.8	5.9	6.4	10.7	6.7	4.5	4.6
Broad money M2, % y/y (end-year)	18.7	9.1	10.9	9.9	6.3	5.4	4.9	7.4
Domestic private credit, % y/y	14.8	7.6	7.0	5.6	2.0	-3.2	3.0	8.0
Domestic bank credit/GDP	46.5	49.3	51.0	53.1	54.5	51.9	49.7	49.9
Policy rate, % (end-year) 1/	11.00	7.25	10.0	11.75	14.25	13.75	10.50	9.00
10 year bond yield, % (year-end) 3/	12.6	9.2	10.9	12.4	16.5	11.2	10.5	9.8
USD/BRL (year-end)	1.87	2.05	2.36	2.66	3.96	3.20	3.00	3.10
EUR/BRL (year-end)	2.42	2.71	3.25	3.22	4.30	3.62	3.48	3.72
Fiscal accounts								
General government budget balance, % GDP	-2.5	-2.3	-3.0	-6.0	-10.4	-9.1	-9.5	-8.7
Revenue, % GDP	34.2	33.6	33.7	33.0	32.7	32.8	33.0	33.6
Expenditure, % GDP	36.6	35.9	36.7	39.1	43.1	41.8	42.5	42.4
of which interest expenditure, % GDP	5.4	4.4	4.7	5.5	8.5	7.0	7.4	8.2
Primary balance, % GDP	2.9	2.2	1.7	-0.6	-1.9	-2.1	-2.1	-0.5
Public sector debt (gross),% GDP 2/	51.3	53.8	51.7	57.2	66.5	73.5	77.0	78.7
of which domestic public debt, % GDP	47.4	49.1	46.9	51.6	59.1	66.4	71.0	73.1
of which external public debt,% GDP	3.9	4.6	4.8	5.6	7.4	7.2	6.1	5.6
% domestic public debt held by non-residents	10.6	11.8	14.3	18.1	19.0	16.1	16.6	17.3
Public debt held by the central bank, % GDP	7.8	10.9	9.9	14.2	15.5	18.3	15.0	13.6
Balance of payments								
Trade balance, USD bn	27.6	17.3	0.3	-6.5	17.7	46.0	41.0	26.0
Exports, USD bn	255.4	242.1	241.5	224.1	190.1	185.0	196.0	204.0
Imports, USD bn	227.9	224.9	241.2	230.6	172.4	139.0	155.0	178.0
Current account balance, USD bn	-52.5	-54.2	-81.1	-104.1	-58.9	-22.7	-30.0	-48.4
as % of GDP	-2.0	-2.2	-3.3	-4.3	-3.4	-1.3	-1.4	-2.1
Foreign direct investment (net), USD bn	101.2	86.6	69.2	96.9	75.1	67.2	75.0	85.0
Total FX reserves, USD bn	352.0	378.6	375.8	374.1	368.7	375.0	375.1	375.1
Foreign exchange reserves excl gold, USD bn	350.4	375.0	373.2	371.5	366.4	372.2	372.2	372.3
Total FX reserves, % GDP	13.5	15.5	15.4	15.5	21.2	20.9	17.5	16.2
Total external debt, % GDP	11.4	12.8	12.7	14.5	19.4	18.6	15.6	14.4
Net International Investment Position, % GDP	-31.4	-33.0	-30.4	-32.2	-27.5	-36.6	-37.0	-39.5
Credit ratings								
Moody's	Baa2	Baa2	Baa2	Baa2	Baa3			
S&P	BBB	BBB	BBB	BBB-	BB+			
Fitch	BBB	BBB	BBB	BBB	BB+			

Source: UBS

Mexico

- **A tighter policy stance and falling oil production will weigh on growth; Trump's victory raises uncertainty over investment and manufacturing**
- **The government must deliver on spending cuts to avoid a downgrade; Banxico to tighten further**

Trump's victory only raises the stakes higher in terms of Mexico re-establishing its macroeconomic credentials

Mexico's hard-earned reputation as one the emerging markets' safest pairs of hands when it comes to macroeconomic management will remain under scrutiny in the next couple of years. The Mexican peso's gross underperformance vis á vis its peers, the widening of the current account deficit, the rising public debt levels, and the ongoing issues at Pemex have largely defined sentiment on Mexico in recent quarters. Add to this the uncertain impact of Donald Trump's US presidential victory on the Mexican economy – given his statements on trade and immigration – and it is clear that Mexico has its work cut out in changing this narrative, particularly with a backdrop of a complex presidential election in 2018.

Growth to slow

A dynamic service sector dragged down by weak IP

On the growth front, Mexico is a country divided at present: on the one hand, there is a dynamic service sector propped up by a healthy consumer; on the other, we have an industrial sector that is currently held back by the ongoing decline in oil production, a lacklustre construction sector, and a manufacturing engine constrained by the weakness of its counterpart in the US. We are expecting 2.2% GDP growth this year, another disappointing result given the post-structural reform expectations generated by Mexico. Still, if we exclude oil, Mexico is growing at a rate closer to 3%, a more acceptable level.

Lower oil production and a tighter policy setting will weigh on growth in 2017

For 2017, we are revising lower our growth forecast from 2.2% previously to 1.7%. There are a number of important headwinds facing the economy: a further decline in oil production (180kbd or 8% y-o-y by the government's own estimate), proposed budgetary spending cuts worth over 1% of GDP and falling partly on investment, and the monetary tightening already delivered by the CB (175bps of hikes in less than one year). Moreover, we think that consumption is starting to slow, on account of lower real wage growth (in turn due to higher inflation), softer job growth at the margin, non-accelerating credit growth, and less buoyant remittances in peso terms.

In addition, we think Trump's US electoral victory could weigh negatively on investment, employment, and the currency

However, the reason why we are now forecasting a slowdown in growth is that we are no longer convinced that the anticipated recovery in US industrial growth UBS is expecting (from -0.9% this year to 1.5% in 2017) will benefit Mexico to the same degree as before. In particular, we think Trump's victory will dent the pick-up in investment that we had expected in 2017, especially in machinery and equipment. Given the uncertain outlook for trade and NAFTA under Trump, we think that at a minimum investment decisions will be delayed, dampening the recovery in manufactured exports. By the same token, we think that employment growth will slow, while a weaker peso may put upward pressure on inflation at the margin, constraining consumption further in the process.

If US growth falters, Mexico will also disappoint, but the greatest risks could now come from US trade and migration policies

Other things being equal, we think that Mexico remains well-placed to take advantage of an industrial recovery in the US on account of its present competitiveness. But with Trump now at the helm, other things may no longer be equal. A revamping of NAFTA, higher trade tariffs and/or the return of illegal migrants would be difficult for the Mexican economy to absorb without substantially lower economic growth. In 2018, we expect a modest 2.0% rebound.

Inflation on the rise

We see inflation pressures rising; inflation should end 2017 at the top of the CB's inflation target band

We are expecting inflation to accelerate to 3.9% next year, from 3.3% in 2016, and up from a mere in 2.1% in 2015. Indeed, after over two years of inflation staying at the bottom end of the CB's 3% +/-1% band, we expect headline inflation to breach 4% in May of next year. While the biggest fear on the inflation front has revolved around a meaningful FX pass-through to prices ultimately materializing – a risk that increases with Trump-related peso weakness and unemployment's convergence to the NAIRU – our expectation of rising inflation is premised on two other factors. One, the government's planned liberalization of domestic gasoline prices in 2017, particularly in light of UBS's outlook for crude (we expect Brent prices to average USD60bp in 2017, up from USD46pb this year). And two, the fact that prices of such key products as mobile phones have collapsed in recent years to levels that make further declines unlikely.

High stakes on the fiscal and Pemex front

High time for a thorough fiscal adjustment

With public debt levels approaching 50% of GDP (28% in 2008) and putting Mexico at risk of a rating downgrade, the government has renewed its fiscal adjustment efforts going into 2017. The budget calls for the achievement of a primary surplus of 0.4% of GDP next year through a reduction in spending of close to 1% of GDP, all with a view to stabilizing debt dynamics by 2017-18.

The 2017 fiscal targets are achievable, but we question the quality of the adjustment

On the whole, we find the government's fiscal targets credible, particularly as we have a more constructive view on oil than the USD42pb forecast embedded in the budget. What we would question is the quality of the adjustment. The government will cut back on administrative costs and investments, but the ongoing rise in spending is largely explained by other rubrics (such as pensions, financing costs, and transfers to states and public entities). Moreover, the use of Central Bank profits from unrealized FX gains could again materialize next year due to the peso's current weakness. Despite some safeguards to prevent these non-recurrent monies from financing current government spending, these funds may provide the authorities with more flexibility to meet their deficit targets.

Much will depend on Pemex's ability to associate itself with the private sector

Still, from a fiscal standpoint the critical challenge facing Mexico revolves around Pemex. The oil giant received a large injection of federal funds this year worth some 0.7% of GDP. The company has made a strong effort to reduce its pension liabilities and is also chipping at general costs. However, to a large extent the success of its turnaround depends on its ability to partner-up with the private sector to develop fields and other productive activities or simply to sell assets. In this respect, Pemex's recently announced five-year business plan not only calls for the company to return to a positive primary balance by 2019, but also lays out a transparent chronogram of farm-outs, service contracts, and proposed asset sales

The proof, in the end, will be in the pudding. To regain credibility and avoid a downgrade, the government must prove that it can start to reduce overall spending, and Pemex needs to show that it can attract private investment (the outcome of the Round 1.4 opening and the auctioning of the Trion deep sea field on 5 December will be a critical signpost in this regard).

Will the current account adjust? The outlook for the peso

While Mexico's current account deficit still stands below 3% of GDP, it has widened in recent years, driven higher by an oil trade balance that has swung by USD 25bn since 2012. Part of this swing reflects falling oil prices since mid-2014, but it is also due to the inexorable drop in oil production that has taken it from its peak of 3.4mbd in 2004 to below 2.2.mbd at present. In fact, Mexico is now a net importer of oil. This fact is important given our outlook for oil prices. Rising oil prices may attract more FDI in due course, but the short-term impact on Mexico's external accounts is likely negative through a widening of the current account deficit, especially in a context of falling oil production.

Demand, more than price, is the key driver of Mexican manufacturing exports

If rising oil prices do not adjust the current account deficit, will manufacturing do the trick? Despite the currency having depreciated by some 40% since 2014, Mexican manufacturing exports have failed to get much traction, actually contracting by 2% this year. This is partly because Mexico is first and foremost a manufacturing reassembler, sourcing a large percentage of its production inputs from abroad: the effect of the depreciation on exporters' margins is therefore partly muted. More importantly, what matters more than price to Mexican manufacturing volumes is that US demand be strong, and that has not been the case in recent quarters.

The risk of increased protectionism will only add to MXN's woes; we are revising our FX forecasts down

Will this situation change? Our US economists expect US demand to pick up momentum in 2017, but Mexican manufacturing exports will now have to contend with the risk that Trump makes good on his plan to pull out of NAFTA if a better trade deal cannot be had for the US. A dismantling of NAFTA and the imposition of MFN tariffs under WTO – or even higher should the US pull out of that institution as well – would hurt Mexican export growth and bilateral trade worth USD500bn at present. In this context, we see the current account deficit widening to 3.3% and 3.6% in 2017 and 2018, respectively. Given the additional risk of protectionism, the uncertain outlook for remittances, the slowdown in portfolio inflows, and the weakness in FDI, we think the Mexican peso will need to validate its recent move weaker post the US election. We expect to see the peso against the dollar at 20.5, 21.0 and 21.5 in YE'16, YE'17 and YE'18, respectively.

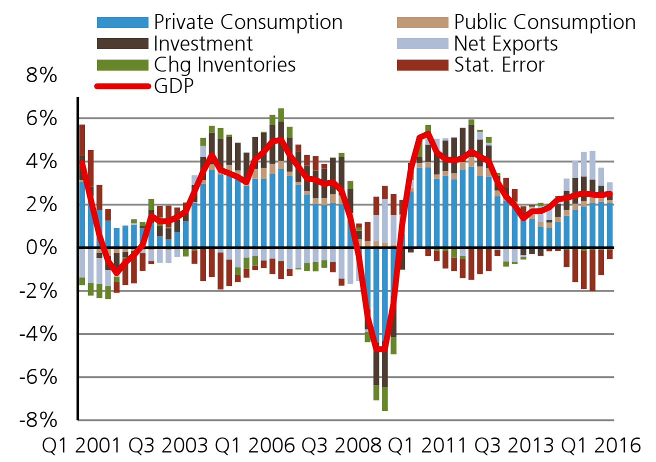
What will Banxico do?

The Central Bank's monetary tightening this year has gone well beyond that delivered by the Fed (150bps in rate increases so far this year). That Banxico has delivered such hikes despite lowly inflation and soft economic activity largely reflects concerns over the weakness and volatility in the exchange rate we have witnessed in the period seen from at least two separate angles: one, the risk that MXN poses to inflation and its expectations; and two, the risk that it represents for financial stability, defined here as stability in the domestic bond market, particularly the long end of the curve.

We see further hikes ahead, but capped by the weakness of the economy; the authorities appear more ready to consider non-conventional tools

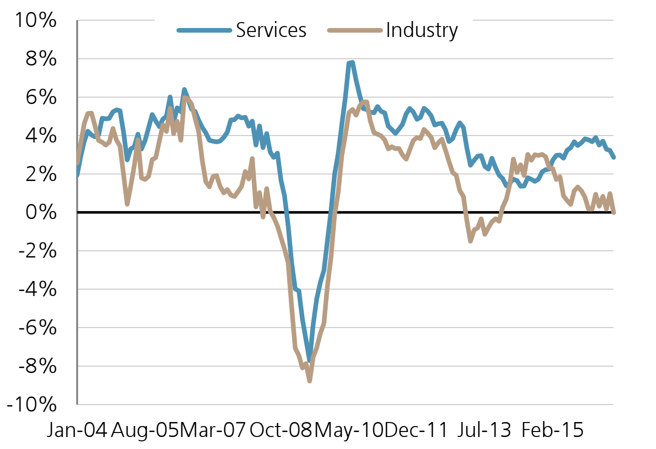
Faced with renewed pressures on the peso following the Trump victory in the US, the Mexican authorities have so far taken a wait-and-see attitude in anticipation of greater policy definition out of the US. Given the likelihood that inflation accelerates and that the peso remains weak going forward, we think further monetary tightening will be forthcoming. However, barring heightened volatility in the exchange rate, we think rate hikes will be capped by the weakness in activity. We now see the CB delivering 50bps of hikes in the remainder of 2016 (25bps previously), 50bps in 2017, and 50bps in 2018 for a 6.25% terminal nominal rate. By contrast, we see the authorities more prepared to use non-conventional tools to address MXN weakness and yield volatility, such as FX intervention in spot – potentially by tapping the IMF's FCL – or the sale of swaps in the FX and rates market.

Figure 92: Contributions to GDP growth (4q accum)



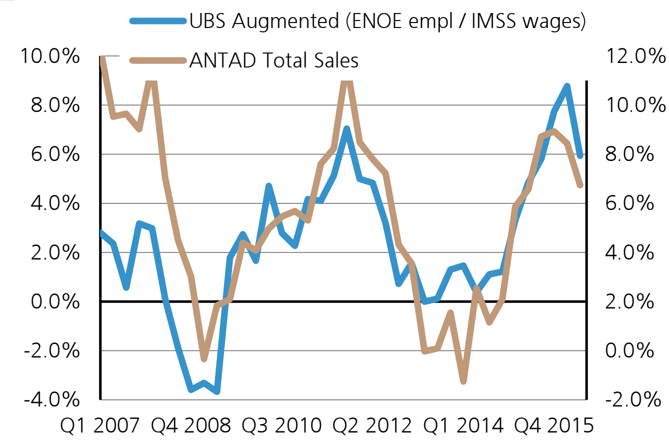
Source: Haver, UBS

Figure 93: IGAE Components ex-Agriculture (3m y/y)



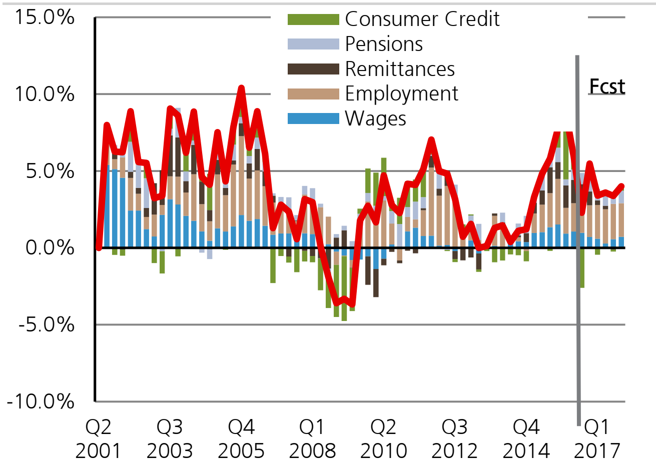
Source: Haver, UBS

Figure 94: UBS Augmented Wage Mass vs Antad Retail sales (y/y)



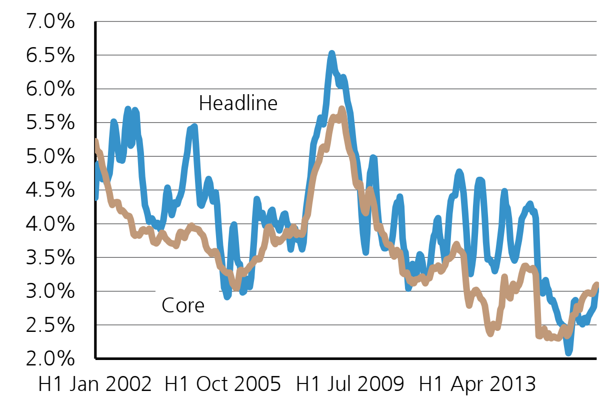
Source: Haver, UBS

Figure 95: Contributions to y/y Augmented Wage Mass Growth



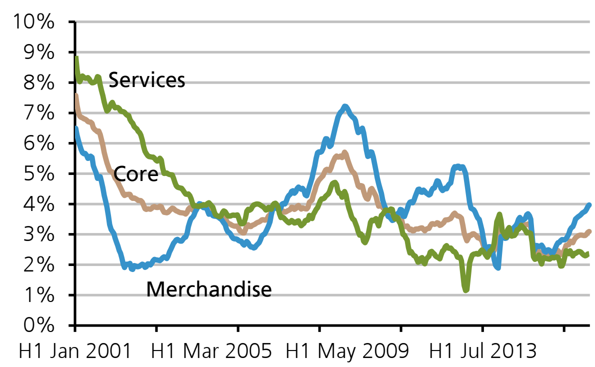
Source: Haver, UBS

Figure 96: Headline CPI vs Core CPI (Biweekly y/y)



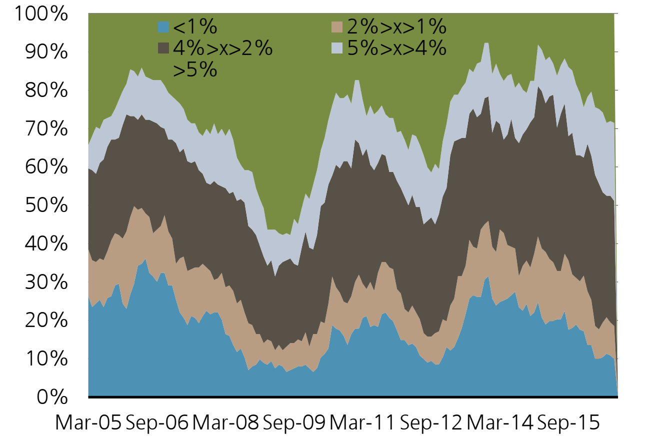
Source: Haver, UBS

Figure 97: Core Inflation and its Components (12m)



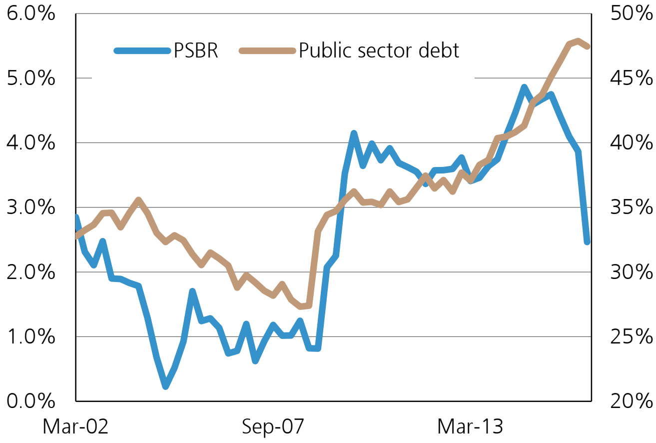
Source: Haver, UBS

Figure 98: Core Arithmetic Diffusion Index (y/y)



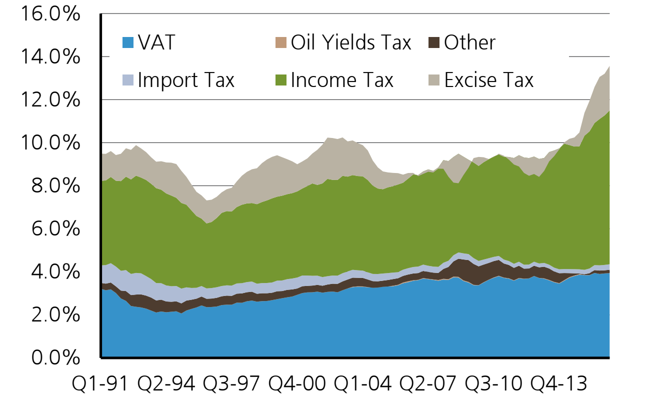
Source: Haver, UBS

Figure 99: PSBR vs Public debt (% of GDP)



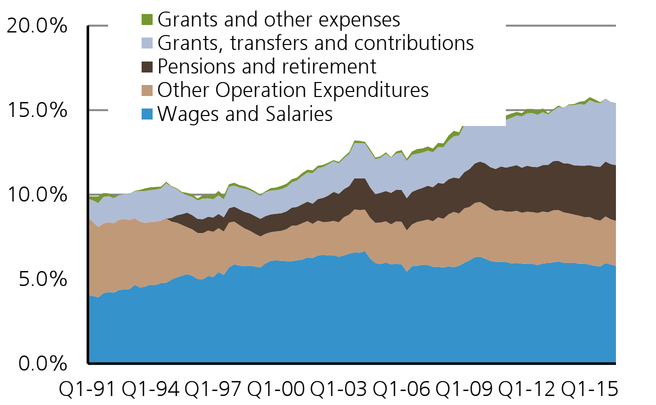
Source: Haver, UBS

Figure 100: Tax Revenues as % of GDP, 4Q accum



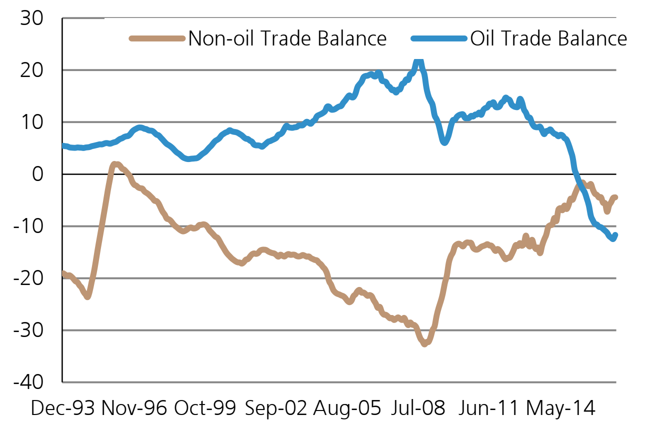
Source: Haver, UBS

Figure 101: Current Expenditures as % of GDP, 4Q accum



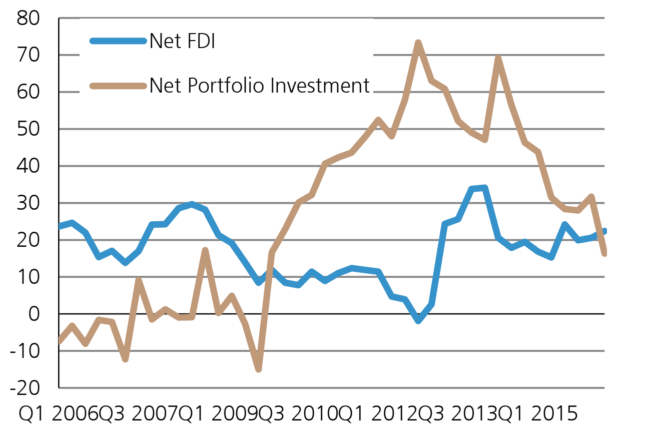
Source: Haver, UBS

Figure 102: Trade Balance Decomposed (12m accum, USD bn)



Source: Haver, UBS

Figure 103: Net FDI vs Net Portfolio Inflows (12m accum, USD bn)



Source: Haver, UBS

Mexico	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	14,550	15,627	16,118	17,256	18,127	19,122	20,214	21,145
GDP, USD bn	1,171	1,187	1,262	1,298	1,144	1,026	975	996
GDP per capita, USD	10,647	10,595	11,189	11,430	10,001	8,907	8,408	8,529
Real GDP growth, %	4.0	4.0	1.4	2.2	2.5	2.2	1.7	2.0
Private consumption, % y/y	4.8	4.9	2.1	1.8	3.1	2.7	2.3	2.2
Government consumption, % y/y	2.4	3.5	1.0	2.1	2.3	-0.1	-0.2	2.0
Gross Fixed Capital formation, % y/y	7.8	4.8	-1.6	2.9	3.8	0.7	0.7	2.7
Exports, % y/y	8.2	5.8	2.4	7.0	9.0	0.2	1.7	1.6
Imports, % y/y	8.0	5.5	2.6	6.0	5.0	1.2	1.5	2.5
Unemployment rate, %	5.2	4.9	4.9	4.3	4.3	4.0	4.1	4.4
Industrial Production (%)	3.4	2.9	-0.5	2.7	0.9	0.6	0.6	2.0
Prices, interest rates and money								
CPI inflation, % y/y (average)	3.4	4.1	3.8	4.0	2.7	2.8	4.0	4.0
CPI inflation, % y/y (year-end)	3.8	3.6	4.0	4.1	2.1	3.3	3.9	3.5
Broad money M2, % y/y (end-year)	11.9	8.4	8.8	10.9	7.2	10.4	11.0	11.3
Domestic private credit, % y/y	12.3	11.5	9.0	8.5	12.3	15.9	13.0	11.0
Domestic bank credit/GDP	14.3	15.5	16.7	17.0	18.6	21.1	25.1	26.4
Policy rate, % (end-year)	4.50	4.50	3.50	3.00	3.25	5.25	5.75	6.25
10 year bond yield, % (year-end)	6.8	5.8	6.8	6.1	6.4	7.2	7.5	7.6
USD/MXN (year-end)	13.99	13.01	13.08	14.72	17.21	20.50	21.00	21.50
EUR/MXN (year-end)	18.05	17.18	18.07	17.87	18.91	23.78	23.73	25.16
Fiscal accounts								
General government budget balance, % GDP	-2.5	-2.6	-2.3	-3.2	-3.5	-2.9	-2.5	-2.0
Revenue, % GDP	22.5	22.5	23.6	23.1	23.5	24.3	23.1	23.0
Expenditure, % GDP	25.0	25.1	25.9	26.2	27.0	27.2	25.6	25.0
of which interest expenditure, % GDP	1.9	1.8	1.9	1.9	2.2	2.5	2.8	2.9
Primary balance, % GDP	-0.6	-0.8	-0.4	-1.3	-1.3	-0.4	0.3	0.9
Public sector debt (gross),% GDP 1/	37.5	37.7	40.4	43.4	45.8	48.5	48.0	47.7
of which domestic public debt, % GDP	26.9	27.9	30.1	31.4	32.5	36.5	35.5	34.7
of which external public debt,% GDP	10.6	9.8	10.2	11.9	13.3	12.0	12.5	13.0
% domestic public debt held by non-residents	26.3	36.5	36.9	38.0	35.8	34.4	33.0	33.0
Public debt held by the central bank, % GDP	0.4	0.3	0.2	0.1	0.0	0.0	0.0	0.0
Balance of payments								
Trade balance, USD bn	-1.4	0.0	-1.2	-3.1	-14.6	-15.2	-16.8	-20.0
Exports, USD bn	349.4	370.8	380.0	396.9	380.6	369.2	381.0	394.6
Imports, USD bn	350.8	370.8	381.2	400.0	395.2	384.4	397.8	414.6
Current account balance, USD bn	-14.0	-17.0	-31.0	-26.2	-32.7	-26.8	-28.6	-32.2
as % of GDP	-1.2	-1.4	-2.5	-2.0	-2.9	-2.6	-3.3	-3.6
Foreign direct investment (net), USD bn	11.9	-1.9	33.8	19.5	19.9	21.1	23.0	27.0
Total FX reserves, USD bn	142.5	163.5	176.5	182.8	176.7	183.1	188.5	190.3
Foreign exchange reserves excl gold, USD bn	137.3	156.9	171.8	177.7	172.6	178.1	183.5	185.3
Total FX reserves, % GDP	12.2	13.8	14.0	14.1	15.5	17.8	19.3	19.1
Total external debt, % GDP	17.9	19.0	20.6	22.0	26.1	32.2	39.5	38.3
Net International Investment Position, % GDP	-33.0	-42.2	-44.8	-38.1	-38.5	-44.6	-54.5	-57.2
Credit ratings								
Moody's	Baa1	Baa1	Baa1	A3	A3			
S&P	BBB	BBB	BBB+	BBB +	BBB +			
Fitch	BBB	BBB	BBB	BBB+	BBB+			

Source: UBS

Argentina

- **Elections in 2017 should determine the pace of fiscal adjustment until 2019**
- **Deeper reforms needed after years of stagnation and disinvestment**

Effective shock therapy in a number of important areas….

Before Mauricio Macri was elected President last December, we wondered whether he would pursue gradualist or shock policies to address Argentina's macroeconomic imbalances. In the end, he has chosen to do both. His greatest successes have come in those areas where he has moved rapidly: FX unification, the lifting of capital controls, the partial elimination of export taxes, and the resolution to the standoff with holdouts have all helped cement this government's reformist credentials. By contrast, the approach taken to address the large fiscal imbalance it inherited – arguably the cornerstone of Argentina's woes – has been much more gradual. In our view, such gradualism is preventing a faster reduction in inflation and the resumption of a sustainable economic recovery.

… but too gradual an adjustment on the fiscal front…

The government is aiming for a primary fiscal deficit of 4.2% of GDP in 2017, almost 1ppt above its original target. Total expenditure is set to increase above the officially projected inflation and GDP growth rates, while adjustment comes at the expense of the private sector through the increase in public utility tariffs. We forecast the National Government's overall fiscal deficit at 6.9% of GDP in 2017, slightly below the 7.2% we project for 2016. For 2018 we expect another lukewarm decline to 6.0% of GDP. While the previous administration relied almost exclusively on monetary financing to make ends meet, Macri's team has resorted to the issue of debt (over USD 25.7bn this year in external markets alone) and to an uncertain tax amnesty. The absence of medium-term targets in the 2017 budget also suggests that they have been dropped, contrary to earlier promises.

… that could weigh on inflation convergence…

As much as the Central Bank's performance in re-building its credibility and establishing an inflation-targeting regime is praiseworthy, large outstanding fiscal deficits will prevent a quicker realignment of agents' inflation expectations with the CB's targets. In 2017 we project year-end inflation at 19.5%, above the 12-17% CB target. Our 15% year-end forecast for 2018 also surpasses the upper limit of the 8-12% target range.

… and ultimately on economic growth if investment fails to pick up.

Finally, after years of stagnation and disinvestment, Argentina needs to embark on a sustainable growth path. As much as the government has made efforts to advertise the new policy regime, not enough has been made to reduce the already burdensome tax pressure, thus stimulating the private sector's profitability. In our base-case scenario we foresee the economy growing by 3.0% in 2017 from -1.8% in 2016, with domestic demand doing the heavy lifting. We expect to see a recovery in consumption, partly on account of some improvement in real wages, but also on account of the government putting more money in the pockets of key sectors such as pensioners. However, the big thrust to growth should come from investment. After years of being at a standstill, there are now a number of important projects that could see the light (the government estimates USD 53 bn).

The government has a lot at stake in the mid-term elections in 4Q'17

That said, we recognise that in the absence of a quicker decline in inflation and in the budget deficit, the expected surge in investment could be delayed. In this regard, the mid-term elections in 4Q'17 are of paramount importance. Because of his weak position in Congress, Macri needs to consolidate a working majority for the remainder of his administration. Failure to so do would question his ability to push ahead with much needed reforms.

Argentina	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	2,179	2,638	3,348	4,579	5,843	7,899	9,680	11,422
GDP, USD bn	527	580	598	616	585	583	575	601
GDP per capita, USD	12,761	13,887	14,168	14,434	13,561	13,381	13,054	13,494
Real GDP growth, %	6.0	-1.0	2.4	-2.5	2.5	-1.8	3.0	3.0
Private consumption, % y/y	9.4	1.1	3.6	-4.4	3.6	-1.5	3.4	3.0
Government consumption, % y/y	4.6	3.0	5.3	2.9	6.6	1.2	1.6	1.0
Gross Fixed Capital formation, % y/y	17.4	-7.1	2.3	-6.8	4.2	0.0	9.0	8.5
Exports, % y/y	4.1	-4.1	-3.5	-7.0	-0.6	6.8	9.0	5.0
Imports, % y/y	22.0	-4.7	3.9	-11.5	5.6	9.0	12.2	7.5
Unemployment rate, %	7.2	7.2	7.1	7.3	7.1	9.2	8.5	8.1
Industrial Production (%)	6.6	-7.8	0.0	-1.8	-0.6	-2.5	3.0	3.4
Prices, interest rates and money								
CPI inflation, % y/y (average)	9.8	10.0	10.6	17.8	25.6	32.6	26.9	17.1
CPI inflation, % y/y (year-end)	9.5	10.8	10.9	23.9	27.0	37.0	19.5	15.0
Broad money M2, % y/y (end-year)	28.9	40.1	27.1	29.8	37.0	21.0	19.5	16.5
Domestic private credit, % y/y	44.3	31.3	31.2	21.3	36.0	32.2	34.0	30.9
Domestic bank credit/GDP	20.9	21.9	21.9	22.0	23.2	22.7	24.8	27.6
Policy rate, % (end-year) 1/	13.3	13.8	16.9	22.6	21.5	23.5	18.1	14.5
10 year bond yield, % (year-end) 3/	11.1	12.5	11.2	9.6	7.0	6.3		
USD/ARS (year-end)	4.29	4.88	6.32	8.55	11.43	15.65	18.00	20.00
EUR/ARS (year-end)	5.57	5.45	8.68	10.46	12.48	18.15	20.34	23.40
Fiscal accounts								
General government budget balance, % GDP	1.0	0.2	0.8	0.5	-1.1	-7.2	-6.9	-6.0
Revenue, % GDP	20.0	20.9	21.4	22.3	22.6	18.0	18.7	20.6
Expenditure, % GDP	18.9	20.6	20.7	21.9	23.8	25.2	25.7	26.7
of which interest expenditure, % GDP	1.6	1.9	1.3	1.6	2.1	2.4	2.6	2.6
Primary balance, % GDP	2.7	2.2	2.0	2.0	1.0	-4.8	-4.3	-3.4
Public sector debt (gross),% GDP 2/	34.0	34.1	33.9	36.0	41.1	45.1	52.1	56.6
of which domestic public debt, % GDP	19.3	21.0	21.5	22.9	29.1	27.9	32.1	34.9
of which external public debt,% GDP	14.7	13.0	12.4	13.1	12.0	17.2	20.0	21.7
% domestic public debt held by non-residents								
Public debt held by the central bank, % GDP	9.5	12.6	14.9	16.2	20.7	13.1	10.7	9.1
Balance of payments								
Trade balance, USD bn	9.0	12.0	1.5	3.2	-3.0	1.6	-0.5	-2.0
Exports, USD bn	83.0	80.0	76.0	68.4	56.8	57.6	63.5	64.5
Imports, USD bn	74.0	68.0	74.4	65.2	59.8	56.0	64.0	66.5
Current account balance, USD bn	-4.5	-1.4	-12.1	-8.0	-15.9	-12.5	-17.1	-19.0
as % of GDP	-0.8	-0.2	-2.0	-1.3	-2.7	-2.1	-3.0	-3.2
Foreign direct investment (net), USD bn	9.4	14.3	8.9	3.1	11.1	3.0	7.5	10.0
Total FX reserves, USD bn	46.4	43.3	30.6	31.4	25.6	40.0	43.0	46.0
Foreign exchange reserves excl gold, USD bn	43.2	39.9	28.1	29.0	23.4	37.6	40.4	43.2
Total FX reserves, % GDP	8.8	7.5	5.1	5.1	4.4	6.8	7.5	7.6
Total external debt, % GDP	31.3	27.7	25.8	23.5	26.1	31.7	35.3	36.1
Net International Investment Position, % GDP	6.1	6.9	8.0	9.1	7.5	7.5	7.6	7.3
Credit ratings								
Moody's	B3	B3	Ca	Ca	Ca			
S&P	B	B-	CCC+	Sdu	Sdu			
Fitch	B	CC	CC	RD	RD			

Source: UBS. 1/ Badlar 30d deposito rate. 2/ National public sector. 3/ Eurobond yield.

Chile

- **Ex-mining, the economy is performing, but is held back by low confidence**
- **We see the CB starting a 50bp easing cycle soon**

Ex-mining, the Chilean economy is performing relatively well

The Chilean economy is still digesting the downturn in copper prices and the impact it has had on mining production and investment. The economy is expected to expand at a rate shy of 2% this year, below that of its trading partners and of measures of potential, but more in line with the deterioration in the terms of trade. Ex-mining, however, the picture is more constructive, with this sector expanding at a rate closer to 3%, supported by household consumption and its demand for services. Indeed, this part of the economy is growing at rate equal or superior to that of Peru, a country that enjoys greater investor interest at present.

Hard to see the makings of a large recovery in growth in 2017

Although Chile has managed to reduce its external imbalances and has seen more stability in copper prices and in the growth rate of some of its trading partners (China) recently, we think it is unlikely that it will see a sharp improvement in economic growth in coming quarters. For one thing, fiscal policy will turn more restrictive. With the structural parameters for both growth and copper prices having been recently ratcheted down for 2017 (to 3.0% and USD2.56/lb, respectively) and with the government committed to reducing the structural deficit by 0.25% of GDP each year (from 1.6% of GDP currently), the rate of growth of spending will have to be lower going forward, as the proposed 2017 budget attests to (it calls for a 2.7% increase in spending, down from the 7% it has averaged in the past decade). Moreover, wage mass growth is slowing, with the unemployment rate rising and the quality of jobs being created falling. Add to this low appetite for credit, a slump in construction, and lowly levels of both consumer and business confidence, and growth next year should remain subdued at 2.2%.

Inflation should undershoot the CB's target this year and next

On a brighter note, inflation is finally converging to target, having broken back into the Central Bank's 3% +/- 1% target range and accelerated all the way to 2.9% at present. Lower food prices, a stronger FX rate, and a labour market that is softening are contributing to the decline in inflation. Moreover, indexation cuts both ways in Chile and should help push inflation lower in coming months.

We see the CB delivering 50bps of cuts in H1'17

With inflation falling and likely to undershoot the CB's target in early 2017, and with the economy operating below potential, the authorities could start shifting their policy stance from one of neutrality to an easing bias in coming meetings. This process could be accelerated with the arrival of a new CB President, Mario Marcel, in December. Outgoing President Rodrigo Vergara has argued that, just as the CB did not rush to hike interest rates when inflation broke above the top of the CB's band largely on account of FX weakness, then it should not be in a hurry to cut now that the peso has strengthened beyond what the authorities deem to be fair value. It is not clear that Marcel subscribes to this view. With inflation surprising to the downside, we now see the CB delivering 50bps of cuts in H1'17.

In order for investment and growth to pick up, business confidence will need to be rebuilt

We think these cuts will ultimately have to be rolled-off in 2018, mainly because we see the economy picking up momentum and growing by 2.6% that year. The single biggest drag on economic activity at present is investment. While one can find good reason why sectors such as mining and construction are under-investing, the private sector appears to be held back by policy uncertainty related to the current administration's policy agenda, which has included large tax and labour reforms. If the presidential election scheduled for November next year results in the arrival of a more pro-business administration, investment could get off the ground.

Chile	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	121,319	129,028	137,230	147,568	157,511	164,654	172,471	182,480
GDP, USD bn	251	265	277	259	241	244	260	273
GDP per capita, USD	14,536	15,203	15,714	14,519	13,249	13,149	13,724	14,130
Real GDP growth, %	5.8	5.5	4.0	1.9	2.3	1.8	2.2	2.6
Private consumption, % y/y	8.9	6.1	5.5	2.4	1.9	2.1	2.4	2.8
Government consumption, % y/y	2.5	3.5	3.5	5.1	5.8	4.5	3.0	3.4
Gross Fixed Capital formation, % y/y	15.0	11.6	2.2	-4.2	-1.5	0.9	1.0	4.0
Exports, % y/y	5.5	0.1	3.3	1.1	-1.9	-0.3	1.1	2.4
Imports, % y/y	16.0	4.8	2.1	-5.7	-2.8	0.4	2.5	4.0
Unemployment rate, %	7.1	6.4	5.9	6.4	6.2	6.7	7.4	7.5
Industrial Production (%)	3.6	2.9	3.9	0.3	-0.3	-1.6	1.6	1.8
Prices, interest rates and money								
CPI inflation, % y/y (average)	3.3	3.0	1.9	4.4	4.3	3.8	2.2	2.9
CPI inflation, % y/y (year-end)	4.4	1.5	2.8	4.6	4.4	2.7	2.5	3.1
Broad money M2, % y/y (end-year)	12.4	16.0	10.9	8.7	9.8	9.1	9.5	11.6
Domestic private credit, % y/y	13.3	15.2	11.1	9.6	9.8	10.0	10.0	12.0
Domestic bank credit/GDP	76.1	80.4	83.3	85.0	87.9	91.8	96.1	102.8
Policy rate, % (end-year) 1/	5.25	5.00	4.50	3.00	3.50	3.50	3.00	3.50
10 year bond yield, % (year-end) 3/	5.5	5.2	4.0	4.7	4.2	4.3	4.0	4.5
USD/CLP (year-end)	521.5	478.6	523.8	607.4	707.3	660.0	670.0	670.0
EUR/CLP (year-end)	707.0	614.4	706.6	757.6	758.8	765.6	757.1	783.9
Fiscal accounts								
General government budget balance, % GDP	1.5	0.6	-0.6	-1.7	-2.2	-2.1	-1.8	-1.7
Revenue, % GDP	22.1	22.2	20.9	20.6	21.2	22.2	22.7	23.2
Expenditure, % GDP	20.7	21.6	21.5	22.3	23.4	24.3	24.5	24.9
of which interest expenditure, % GDP	0.4	0.6	0.6	0.6	0.7	0.8	0.8	0.9
Primary balance, % GDP	1.9	1.2	0.0	-1.0	-1.5	-1.3	-1.0	-0.8
Public sector debt (gross),% GDP 2/	11.1	12.0	12.8	15.1	17.5	20.0	21.0	22.1
of which domestic public debt, % GDP	9.2	10.5	11.1	12.7	14.3	16.0	16.8	17.6
of which external public debt,% GDP	1.9	1.5	1.7	2.4	3.2	4.0	4.2	4.4
% domestic public debt held by non-residents	16.7	15.9	17.8	15.7	20.4	20.0	20.0	20.0
Public debt held by the central bank, % GDP	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Balance of payments								
Trade balance, USD bn	11.0	2.3	1.7	6.3	3.5	3.4	3.6	5.7
Exports, USD bn	81.4	77.8	76.4	74.9	62.2	58.8	62.6	67.8
Imports, USD bn	70.4	75.5	74.7	68.6	58.7	55.4	59.0	62.1
Current account balance, USD bn	-3.1	-9.4	-10.3	-3.3	-4.8	-4.9	-5.6	-4.8
as % of GDP	-1.2	-3.5	-3.7	-1.3	-2.0	-2.0	-2.2	-1.8
Foreign direct investment (net), USD bn	3.1	7.9	9.5	9.4	4.7	5.4	6.2	7.1
Total FX reserves, USD bn	42.0	41.6	41.1	40.4	38.6	37.7	36.8	37.6
Foreign exchange reserves excl gold, USD bn	42.0	41.6	41.1	40.4	38.6	37.7	36.8	37.6
Total FX reserves, % GDP	16.7	15.7	14.8	15.6	16.0	15.5	14.2	13.8
Total external debt, % GDP	39.6	45.4	48.6	57.8	64.6	70.2	72.6	76.0
Net International Investment Position, % GDP	-12.6	-15.9	-13.7	-14.0	-18.7	-20.7	-20.1	-18.8
Credit ratings								
Moody's	Aa3	Aa3	Aa3	Aa3	Aa3			
S&P	A+	AA-	AA-	AA-	AA-			
Fitch	A	A	A+	A+	A+			

Source: UBS

Colombia

- **The tax reform, even if approved, may not address mid-term fiscal imbalances**
- **Rejection of the peace agreement raises uncertainty and narrows the government's room for manoeuvre**

Resizing the economy to better match demand with productive capabilities has meant lower growth

The economy is undergoing a marked slowdown, a necessary condition to bring its spending more in line with its productive capacity following a negative terms-of-trade shock – a need best expressed by the large size of Colombia's current account deficit. All components of domestic demand are slowing. Even private consumption – despite its initial resilience – has suffered from higher inflation and interest rates, weaker labour market conditions and lower consumer confidence. We foresee a marked deceleration for 2016, with GDP posting 2.2% growth, well below last year's 3.1%. In 2017, we forecast a modest improvement to 2.4%, with the economy only picking up momentum in 2018.

Even if it is approved without changes, the proposed fiscal reform falls short of the adjustment needed

Fiscal adjustment is also part of this process of resizing the economy. In 2013, the central government's oil revenues represented 3.3% of GDP; this year they should be virtually zero. The government has responded by cutting expenses by 0.6% of GDP in 2016, but this falls well short of what is needed. The tax reform currently being considered by Congress is therefore vital, but it should add only a modest 0.8% of GDP in tax revenues in 2017, rising gradually to 2.1% of GDP by 2020. Compliance with the fiscal rule requires not just that Congress approve the tax reform without major changes, but also that public investment be cut further. Neither of these assumptions is fully certain. Our optimistic base-case scenario foresees fiscal deficits of 3.4% and 3.0% of GDP in 2017 and 2018, respectively. This scenario does not incorporate the estimated 0.5% of GDP per annum that a final peace agreement with guerrilla groups may cost. Certainly, the tax reform fails to address the medium-term fiscal imbalances.

The CB should have room to cut interest rates in 2017

The fiscal outlook is not only a major concern for the rating agencies, it has also impacted the Central Bank's monetary response. Earlier this year, inflation reached a historical high of almost 9% on a 12m basis, due to supply-side shocks affecting food and energy prices, together with the pass-through from a weaker COP. Despite the transitory nature of these shocks, indexation, the contamination of inflation expectations, and the absence of an adequate fiscal response led the CB to raise its reference rate by 325bps to 7.75%. Despite some inflation pressures from the proposed tax hikes (including a 3% increase in VAT), we project the beginning of the easing cycle in early 2017, continuing through 2018, on the back of the reversal in supply-side shocks affecting prices, a lower pass-through from the COP, a narrowing current account deficit, and the need for boosting growth. In our base case of improving oil prices and an approved tax reform, we forecast a gradual appreciation of the COP.

The failure of the peace process has weakened the government

Lastly, a word on politics. The rejection of the peace agreement in the October plebiscite has increased uncertainty. From a strictly economic perspective, it reduces the government's strength in negotiating its tax reform in Congress. From a political perspective, it has strengthened former president Uribe's Centro Democrático party (which, on the issue of fiscal adjustment, appears more inclined to cut expenses rather than hike taxes). With presidential elections scheduled for April 2018, President Santos could have difficulties in his remaining time in office redirecting the peace process and addressing the fiscal imbalances.

Colombia	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	619,894	664,240	710,497	757,506	800,849	866,788	922,079	984,536
GDP, USD bn	335	369	380	379	292	282	310	335
GDP per capita, USD	7,285	7,931	8,068	7,942	6,060	5,782	6,285	6,724
Real GDP growth, %	6.6	4.0	4.9	4.4	3.1	2.2	2.4	3.2
Private consumption, % y/y	6.0	4.4	3.4	4.2	3.9	2.6	2.6	3.2
Government consumption, % y/y	3.6	6.3	9.2	4.7	2.8	2.0	1.2	2.0
Gross Fixed Capital formation, % y/y	18.9	4.3	6.3	11.6	2.6	-1.6	2.5	3.2
Exports, % y/y	11.8	6.0	5.2	-1.3	-0.7	5.0	1.6	3.5
Imports, % y/y	21.5	9.1	6.0	7.8	3.9	0.3	1.7	2.6
Unemployment rate, %	10.8	10.4	9.7	9.1	8.9	9.1	9.4	9.3
Industrial Production (%)	4.9	-0.3	-1.3	1.5	1.4	5.0	3.8	3.5
Prices, interest rates and money								
CPI inflation, % y/y (average)	3.4	3.2	2.0	2.9	5.0	6.4	5.0	3.8
CPI inflation, % y/y (year-end)	3.7	2.4	1.9	3.7	6.8	6.0	4.0	3.6
Broad money M2, % y/y (end-year)	18.9	16.5	14.7	9.1	12.5	10.0	10.0	10.0
Domestic private credit, % y/y	22.3	18.1	14.2	12.5	19.1	9.7	9.7	9.5
Domestic bank credit/GDP	36.6	39.5	42.1	44.4	48.7	49.3	50.9	52.2
Policy rate, % (end-year)	4.75	4.25	3.25	4.50	5.75	7.75	6.25	5.50
10 year bond yield, % (year-end)	7.8	5.7	7.1	7.5	8.9	7.5	7.3	7.2
USD/COP (year-end)	1,943	1,768	1,927	2,392	3,149	3,000	2,950	2,920
EUR/COP (year-end)	2,524	2,338	2,646	2,926	3,440	3,480	3,334	3,416
Fiscal accounts								
General government budget balance, % GDP 1/	-2.0	-1.9	-2.2	-2.6	-3.1	-4.1	-3.4	-3.0
Revenue, % GDP	15.2	16.1	16.9	16.6	16.2	15.0	14.8	15.5
Expenditure, % GDP	17.2	18.0	19.1	19.2	19.2	19.1	18.2	18.5
of which interest expenditure, % GDP	2.5	2.4	2.2	2.2	2.4	3.2	3.2	3.2
Primary balance, % GDP	0.5	0.6	0.0	-0.4	-0.7	-0.9	-0.2	0.2
Public sector debt (gross),% GDP 1/	36.5	34.6	37.2	40.0	43.9	49.0	53.3	57.1
of which domestic public debt, % GDP	26.2	25.7	27.5	28.1	27.7	27.1	26.7	26.3
of which external public debt,% GDP	10.3	9.0	9.7	11.9	16.2	21.9	26.6	30.8
% domestic public debt held by non-residents	3.1	3.7	6.5	15.4	18.3	23.2	26.5	29.0
Public debt held by the central bank, % GDP	0.2	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Balance of payments								
Trade balance, USD bn	6.1	5.0	3.2	-4.6	-13.9	-14.0	-12.0	-11.0
Exports, USD bn	58.3	61.6	60.3	56.9	38.1	28.0	35.0	38.0
Imports, USD bn	52.1	56.6	57.1	61.5	52.1	42.0	47.0	49.0
Current account balance, USD bn	-9.7	-11.2	-12.1	-19.5	-18.9	-13.6	-13.6	-14.0
as % of GDP	-2.9	-3.0	-3.2	-5.1	-6.5	-4.8	-4.4	-4.2
Foreign direct investment (net), USD bn	6.2	15.6	8.6	12.4	7.5	9.0	8.5	9.5
Total FX reserves, USD bn	32.3	37.5	43.6	47.3	46.7	46.5	46.9	46.9
Foreign exchange reserves excl gold, USD bn	31.9	37.1	43.3	46.9	46.6	46.0	46.4	46.4
Total FX reserves, % GDP	9.6	10.1	11.5	12.5	16.0	16.5	15.1	14.0
Total external debt, % GDP	22.5	21.3	24.2	26.8	38.1	42.7	41.3	38.8
Net International Investment Position, % GDP	-23.3	-24.7	-26.9	-30.8	-43.8	-40.7	-32.5	-25.8
Credit ratings								
Moody's	Baa3	Baa3	Baa3	Baa2	Baa2			
S&P	BBB-	BBB-	BBB	BBB	BBB			
Fitch	BBB-	BBB-	BBB	BBB	BBB			

Source: UBS. 1 and 2/ refer to Central Govt.

Peru

Main challenge is to advance with a reform agenda and get investment rolling

Risks of not reaching the 2%-of-GDP structural deficit target by 2019

With mining investment due to slow, Kuczynski has to push reforms that widen the scope of growth in Peru

Peru has been the best performing economy in the region in the last two years, buoyed by a competitive mining sector that has attracted investment despite the fall in mineral prices. However, mining investment is due to mature in 2017-18, with the pipeline of projects dropping off after that. Unless Peru advances seriously with an agenda of structural reforms, it could become an example of a tidily-managed economy delivering growth well below its potential. In our view, this is precisely the starting point and the key challenge facing President Pedro Kuczynski over the coming five years. The first step was already taken: the Executive obtained from Congress special legislative faculties until year-end to advance on key areas such as economic activity, security, anti-corruption, water and health, and the reorganization of PetroPeru.

Nevertheless, Peru will remain the best performing economy in our sample

The presidential victory of a business-friendly, well-experienced economist has translated into improving business and consumer expectations, which should support activity over the coming quarters, especially if the former materialize into investment projects, thus reversing the three-year stagnation in private investment. Risk factors preventing a speedy recovery could be falling investment in mining, a delay in key infrastructure projects, the usual fall in public-sector investment following the change in authorities, spare capacity in diverse manufacturing sectors, and mixed signs coming from the labour market. Still, we think the new authorities are proactively tackling these issues. In this context, we foresee GDP growth closing 2016 at 3.8%, and accelerating to 4.4% in 2017.

Inflation is well-contained and the sol should remain well-supported

Inflation should continue to converge towards the 2% ±1% target range, mainly driven by receding pressure from food and a lower pass-through from the PEN. We foresee year-end inflation at 2.9%, well below the 4.6% peak hit in January. In end 2017 and 2018, we forecast inflation at 2.7% and 2.6%. With inflation expectations re-anchored and relatively low concerns with respect to activity, we see the CB keeping its rate unchanged at 4.25% over the coming months. The monetary authority has not given any indication that it will alter its discreet FX-intervention policy aimed at smoothing out PEN movements. Yet, the prospects for reduced FX volatility make us believe that the CB will be less active. Indeed, given the global appetite for yield plus the financing flows expected for key infrastructure projects, we see the PEN remaining well-supported over our forecast period. Our PEN/USD forecasts for end of 2017 and 2018 stand at 3.30 and 3.25.

Some risk of fiscal slippage, but perhaps a price worth paying if investment is boosted

The legacy of a higher-than-expected fiscal deficit, coupled with an increase in planned expenditures, have led the government to loosen its fiscal deficit goals. Despite the narrowing in the overall deficit we envision for 2017 to 2.3% of GDP, we do not see scope for further reductions, meaning that the government risks not reaching the 2%-of-GDP deficit target for 2019 recently agreed with Congress. Future changes in the fiscal responsibility law could ensue. Provided increases in spending are focused on investment, Peru's credit-worthiness should not suffer.

All things considered, both the external and fiscal imbalances remain manageable. The key challenge facing Peru is whether a President with a minority party presence in Congress can continue to sway policy in the direction of reforms.

Peru	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	470	508	546	576	612	653	700	748
GDP, USD bn	171	192	202	203	192	193	209	229
GDP per capita, USD	5,724	6,385	6,627	6,584	6,167	6,115	6,554	7,088
Real GDP growth, %	6.5	6.0	5.8	2.4	3.3	3.8	4.4	4.3
Private consumption, % y/y	6.0	6.1	5.3	4.1	3.4	3.4	3.6	4.4
Government consumption, % y/y	4.8	8.1	6.7	10.1	9.5	5.5	4.0	3.5
Gross Fixed Capital formation, % y/y	12.9	9.4	11.6	-4.6	-0.9	-3.1	4.5	5.2
Exports, % y/y	6.9	5.8	-1.3	-0.8	3.5	6.5	7.0	4.2
Imports, % y/y	11.6	10.5	3.9	-1.2	2.1	-1.0	4.8	4.8
Unemployment rate, %	7.7	6.8	5.9	5.9	6.5	6.5	6.2	6.0
Industrial Production (%)	5.7	-0.9	4.9	-3.7	-1.7	-1.5	2.5	3.0
Prices, interest rates and money								
CPI inflation, % y/y (average)	3.4	3.7	2.8	3.2	3.5	3.3	2.8	2.6
CPI inflation, % y/y (year-end)	4.7	2.6	2.9	3.2	4.4	2.9	2.7	2.6
Broad money M2, % y/y (end-year)	11.9	14.4	17.6	5.3	13.0	9.0	10.0	10.0
Domestic private credit, % y/y	19.9	14.0	16.9	14.0	15.0	8.1	12.3	12.9
Domestic bank credit/GDP	27.2	28.2	31.5	33.9	36.8	37.3	39.1	41.3
Policy rate, % (end-year)	4.25	4.25	4.00	3.50	3.75	4.25	4.25	4.25
10 year bond yield, % (year-end)	6.8	4.1	5.6	5.4	7.3	5.8	6.0	6.3
USD/PEN (year-end)	2.70	2.57	2.79	2.96	3.38	3.40	3.30	3.25
EUR/PEN (year-end)	3.51	3.40	3.83	3.62	3.69	3.94	3.73	3.80
Fiscal accounts								
General government budget balance, % GDP	1.0	1.3	0.5	-0.5	-2.9	-3.0	-2.3	-2.3
Revenue, % GDP	18.8	19.2	19.1	19.1	16.7	18.9	19.4	19.5
Expenditure, % GDP	17.8	17.9	18.6	19.6	19.6	21.9	21.7	21.8
of which interest expenditure, % GDP	1.1	1.0	1.0	1.0	1.0	1.2	1.2	1.3
Primary balance, % GDP	2.1	2.4	1.5	0.5	-1.9	-1.8	-1.1	-1.0
Public sector debt (gross),% GDP 1/	22.1	20.4	19.6	20.0	23.3	25.6	25.9	27.5
of which domestic public debt, % GDP	10.7	10.6	10.8	11.3	12.2	14.1	14.4	16.0
of which external public debt,% GDP	11.4	9.8	8.8	8.7	11.1	11.5	11.5	11.5
% domestic public debt held by non-residents	44.8	55.4	51.1	37.8	35.4	33.0	32.0	31.0
Public debt held by the central bank, % GDP	0.0	0.0	0.0	0.0	0.0	0.2	0.1	0.1
Balance of payments								
Trade balance, USD bn	9.2	6.4	0.5	-1.5	-3.1	-1.4	-0.1	2.0
Exports, USD bn	46.4	47.4	42.9	39.5	34.2	34.7	38.0	42.0
Imports, USD bn	37.2	41.0	42.4	41.0	37.4	36.1	38.1	40.0
Current account balance, USD bn	-3.2	-5.1	-8.6	-8.2	-9.2	-7.2	-6.6	-6.8
as % of GDP	-1.9	-2.7	-4.2	-4.0	-4.8	-3.7	-3.2	-3.0
Foreign direct investment (net), USD bn	7.5	11.8	9.2	6.2	6.0	4.9	5.1	6.5
Total FX reserves, USD bn	48.9	64.0	65.7	62.4	61.5	60.6	60.0	63.0
Foreign exchange reserves excl gold, USD bn	47.1	62.2	64.4	61.0	60.4	59.4	58.8	61.7
Total FX reserves, % GDP	28.6	33.3	32.5	30.7	32.0	31.5	28.7	27.6
Total external debt, % GDP	28.2	30.9	30.1	31.8	35.5	36.5	35.7	34.4
Net International Investment Position, % GDP	-23.8	-23.8	-26.1	-29.6	-34.0	-30.7	-25.4	-18.9
Credit ratings								
Moody's	Baa3	Baa2	Baa2	A3	A3			
S&P	BBB	BBB	BBB+	BBB+	BBB+			
Fitch	BBB	BBB	BBB+	BBB+	BBB+			

Source: UBS. 1/ Refers to CG.

Venezuela

Deep macroeconomic imbalance remains unaddressed over the forecast period

A default scenario in 2017 cannot be ruled out

Despite increased political uncertainty, our working assumption is of no major political breakthrough

Throughout this year, President Maduro has applied delaying tactics to deal with the country's deepening political and economic crisis. On the political front, the National Electoral Council (CNE) recently decided to postpone governors' elections from the end of 2016 to end of 1H17, while municipal elections have been delayed until 2H17. However, the government's stalling tactics are particularly visible in the treatment of the recall referendum seeking to oust President Maduro from office. The CNE first simply delayed its decisions, then imposed stricter procedural conditions, and finally temporarily suspended the collection of signatures leading to the recall referendum. At this stage, it looks almost impossible to have the referendum held this year. The timing matters, because a recall referendum held after 10 January 2017 that met with success would not trigger new presidential elections but rather would see the current Vice-President, Aristóbulo Istúriz, serve out the remainder of the presidential term until 2019.

In this scenario, Venezuela would continue to drift towards hyperinflation amidst a deep recession, even with oil prices rising

Against this background, our base case is one where President Maduro stays in office, but with a narrower margin of manoeuvre and amidst increasing social discontent on account of the depth of the recession, the drift to hyperinflation, and the shortage of goods in the stores. In the absence of major political renewal, we see little scope for economic policy change. Thus, we project Venezuela remaining mired in stagflation. We foresee a GDP contraction in 2016 of 10%, decelerating to -5% and -3% in 2017 and 2018, respectively. The prospects of recovering oil prices should bring some relief to imports and, thus, consumption after the severe rationing in FX and goods witnessed in H1'16. Inflation should persist unabated, ending 2016 above 700%. Over our forecast horizon, we foresee inflation spiralling further on account of monetization of the fiscal deficit and inconsistent income and wage policies.

Despite the recent PDVSA bond swap, the likelihood of a default in our forecast period remains high

The recent debt swap launched by PDVSA to ease its short-term FX maturity obligations, without a wider plan to tackle the country's macroeconomic imbalances (the discussion to increase gasoline prices or to correct the highly distorted FX regime appears to be shelved for now), is further evidence that the government is trying to muddle through an environment of mounting social and economic pressure. While the economy's external funding hole of approximately USD 21bn FX will be financed (thanks to the recent PDVSA bond swap, an extension of China repayment schedules, and the sale of reserve and non-reserve assets), questions remain about the possibility of a default in 2017 in view of the USD 7.0–9.5 bn external funding shortfall we estimate even in a more benign oil scenario. Avoiding default would basically entail depleting reserves at the Central Bank, as non-reserve assets – always difficult to measure – appear to have been completely run down.

In brief, Venezuela is likely to continue to face sharply contracting output, escalating inflation, severe balance of payment pressure and further declining external assets. As such, the risk of default remains material.

Venezuela	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	1,357	1,635	2,246	3,031	14,447	49,387	221,344	1,932,921
GDP, USD bn	316	380	356	481	160	156	154	153
GDP per capita, USD	10,859	12,888	11,904	16,047	5,264	5,037	4,906	4,815
Real GDP growth, %	4.2	5.6	1.3	-3.9	-5.7	-10.0	-5.0	-3.0
Private consumption, % y/y	4.0	7.0	4.7	-3.4				
Government consumption, % y/y	5.9	6.3	3.3	0.6				
Gross Fixed Capital formation, % y/y	4.4	23.3	-9.0	-16.9				
Exports, % y/y	4.7	1.6	-6.2	-4.7				
Imports, % y/y	15.4	24.4	-9.7	-18.5				
Unemployment rate, %	8.2	7.8	7.5	7.0	6.8	16.0	18.0	20.0
Industrial Production (%)	1.8	1.9	0.2	-7.0	-11.0	-8.0	-3.0	0.0
Prices, interest rates and money								
CPI inflation, % y/y (average)	26.1	21.1	40.6	62.2	121.7	450.4	1,460.0	2,600.0
CPI inflation, % y/y (year-end)	27.6	20.1	56.2	68.5	180.9	720.0	2,200.0	3,000.0
Broad money M2, % y/y (end-year)	50.6	61.0	69.7	64.0	100.7	120.0	150.0	170.0
Domestic private credit, % y/y	33.9	53.1	52.8	72.1	98.6	116.4	120.0	150.0
Domestic bank credit/GDP	17.9	21.7	25.6	32.4	24.5	14.4	13.4	2.1
Policy rate, % (end-year) 1/	14.5	14.5	14.5	14.6	14.7	15.0	17.0	18.0
10 year bond yield, % (year-end) 2/	12.9	9.6	14.0	22.7	25.3	23.4		
USD/VEF (year-end) 3/	4.3	4.3	6.3	6.3	139	439	2,504	22,739
EUR/VEF (year-end)	5.6	5.7	8.7	7.7	152	510	2,830	26,604
Fiscal accounts								
General government budget balance, % GDP	-11.6	-16.5	-14.6	-14.8	-19.9	-25.0	-25.0	-22.0
Revenue, % GDP	27.9	23.5	23.4	28.8	22.6	15.5	13.0	16.5
Expenditure, % GDP	39.5	40.0	38.0	43.6	42.6	40.5	38.0	38.5
of which interest expenditure, % GDP	2.2	2.7	3.0	3.8	3.1	2.0	1.0	2.0
Primary balance, % GDP	-9.4	-13.8	-11.6	-10.9	-16.8	-23.0	-24.0	-20.0
Public sector debt (gross),% GDP	25.1	27.6	32.3	53.4	60.2	62.7	64.7	66.5
of which domestic public debt, % GDP	11.4	15.6	19.8	19.5	11.9	13.1	14.1	15.0
of which external public debt,% GDP	13.8	11.9	12.6	33.9	48.3	49.6	50.6	51.5
% domestic public debt held by non-residents								
Public debt held by the central bank, % GDP	5.8	10.5	12.8	14.4	5.2	2.4	1.3	0.6
Balance of payments								
Trade balance, USD bn	41.2	31.9	31.6	27.2	-0.7	11.1	15.5	7.8
Exports, USD bn	93.7	97.9	88.8	74.7	39.5	29.2	36.0	37.9
Imports, USD bn	52.6	66.0	57.2	47.5	40.1	18.1	20.5	30.0
Current account balance, USD bn	16.3	2.6	4.6	3.6	-19.9	-10.9	-2.5	1.5
as % of GDP	5.2	0.7	1.3	0.7	-12.4	-7.0	-1.6	1.0
Foreign direct investment (net), USD bn	6.1	1.7	1.9	-0.7	1.0	0.5	0.1	0.1
Total FX reserves, USD bn	29.9	29.9	21.5	22.1	16.4	9.0	7.0	5.0
Foreign exchange reserves excl gold, USD bn	9.9	9.9	6.0	7.5	6.3	3.2	2.5	1.8
Total FX reserves, % GDP	9.5	7.9	6.0	4.6	10.2	5.8	4.6	3.3
Total external debt, % GDP	35.1	31.3	35.8	27.6	90.5	92.8	97.5	101.1
Net International Investment Position, % GDP	45.9	36.4	41.8	34.2	93.0	91.9	89.2	85.9
Credit ratings								
Moody's	B2	B2	Caa1	Caa1	Caa3			
S&P	B+	B+	B	CCC+	CCC			
Fitch	B+	B+	B+	CCC	CCC			

Source: UBS. 1/ 30 day deposit rate. 2/ Eurobond yield. 3/ Blended weighted average of several available FX rates

Reinhard Cluse
Economist
reinhard.cluse@ubs.com
+44-20-7568-6722

Felix Huefner
Economist
felix.huefner@ubs.com
+49-69-1369-8280

John Wraith
Strategist
john.wraith@ubs.com
+44-20-7568-8286

Jennifer Aslin
Associate Economist
jennifer.aslin@ubs.com
+44-20-7568-6585

Western Europe

UBS Research THESIS MAP

2017-18 Outlook: Growth to slow a bit, inflation to rise, temporary extension on QE

PIVOTAL QUESTIONS

Q: What is the Eurozone growth outlook for 2017/18?

We expect a deceleration in GDP growth from 1.6% in 2016 to 1.3% in 2017 and 1.2% in 2018. Key will be the softening in domestic demand caused by recovering oil prices and higher inflation.

Q: Will Eurozone inflation recover?

Yes, but mainly driven by base effects related to oil prices. We expect headline inflation to accelerate from an average 0.2% y/y in 2016 to 1.4% in 2017, and 1.8% in 2018. Core inflation is likely to pick up more moderately, from 0.9% y/y in 2016 to 1.3% in 2018.

Q: How will the ECB react?

We expect the ECB to extend QE by six months beyond March 2017 in its current form (€80bn monthly), but to start tapering after September 2017 over the course of one year. We do not think ECB policy rates will be reduced further; rate hikes are unlikely before 2019.

UBS VIEW

While we remain constructive on the Eurozone's resilience over the coming months, we expect **domestic demand** – so far the driver of growth – **to decelerate in 2017/18**. We think Eurozone growth is still not self-sustaining, and is subject to downside risks, both domestic and external.

EVIDENCE

While Eurozone PMIs have held up well after the UK referendum, **the likely pick-up in oil prices and inflation should cut into household purchasing power**. The external environment, while a bit better, is unlikely to pick up substantially. Game-changing fiscal initiatives in Europe appear unlikely.

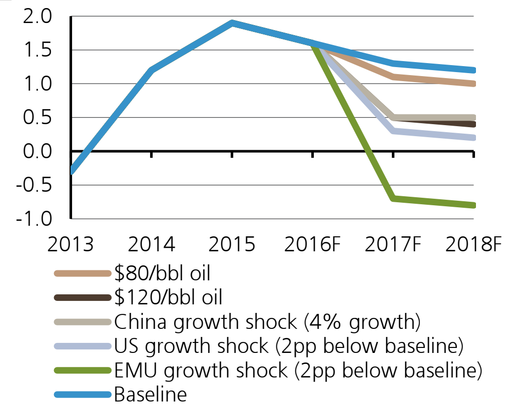
WHAT'S PRICED IN?

There is not yet a strong analyst consensus for Eurozone growth in 2018, but the **2018 projections by the ECB (1.6%), the European Commission (1.7%) and the IMF (1.6%) appear too high to us.**

UPSIDE/DOWNSIDE RISKS:

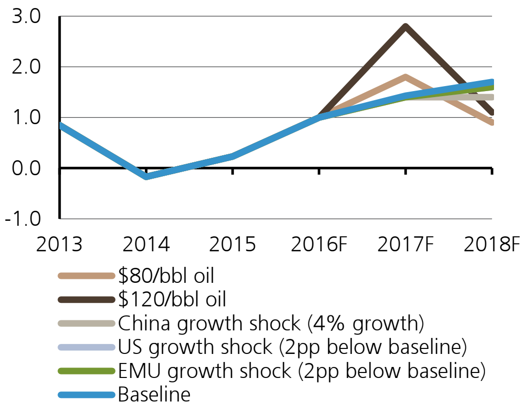
Key **downside risks** would be: a negative Chinese growth shock, indirect consequences of changes in US politics, disruptive Fed tightening, a sharp rise in oil prices, severe disruptions around the UK's EU exit process, disruptive ECB tapering, or new Eurozone shocks. **Positive risks** could come from an acceleration in Eurozone structural reforms, a big fiscal initiative in the US and/or Europe, or simply from a swift reduction in uncertainty.

Figure 104: Eurozone GDP growth scenarios



Source: Haver, UBS

Figure 105: Eurozone inflation scenarios



Source: Haver, UBS

Euro Area

- **GDP growth to slow from 1.6% 2016 to 1.3% in 2017 and 1.2% in 2018 as support for domestic demand starts to soften**
- **ECB to extend QE by six months beyond March 2017 in its current form, but start tapering after Sep-17 as inflation moves closer to target**
- **Fiscal policy to remain accommodative, but no game-changer**

Eurozone has been resilient due to robust domestic demand

The Eurozone economy has shown a respectable degree of resilience in recent quarters, not least since the UK voted to leave the EU on 23 June. The key explanation is robust domestic demand, which has supported growth at a time when the external side was exposed to headwinds. Domestic demand benefited from a number of factors, including:

- the ECB's easy monetary policy;
- low oil and commodity prices;
- improving labour markets and solid real wage growth;
- moderately supportive fiscal policy; and
- the gradual recovery in credit.

Eurozone growth expected to slow from 1.6% in 2016 to 1.3% in 2017

According to our latest assessment, the Eurozone should grow by 1.6% in 2016 – or by 10bps more than we anticipated previously. For 2017, we continue to expect a slowdown to 1.3%. A key reason for the deceleration lies in the negative impact that the UK referendum is likely to have on Eurozone corporate fixed investment. Another reason is that the big fiscal stimulus that the German government unleashed in 2015/2016 to accommodate a large influx of refugees is unlikely to be repeated in the same way in 2017/18.

Support for domestic demand is likely to soften over time

We expect domestic demand (rather than foreign trade) to remain the key force behind GDP growth over the coming years. Yet some of the above-mentioned drivers of domestic demand are likely to lose steam in 2017, and more so in 2018.

Less support from oil prices, real wage growth, monetary conditions

First of all, **oil** is trading around US$45/bbl, up more than 60% from the lows in early 2016. Should oil prices continue to trade up in line with UBS forecasts ($52 for Q4-16), that would imply that the tailwind to household purchasing power will eventually turn into a (moderate) headwind. Second, the pick-up in headline **inflation** that is now under way is likely to lead to a deceleration in **real wage growth** in many Eurozone countries where labour-market conditions are not yet tight (exception: Germany). Also, **monetary conditions** might start to tighten once yields rise more visibly (as we expect), which could easily happen when the ECB signals a reduction in asset purchases from current levels (tapering) – a step we expect the ECB to take later in 2017.

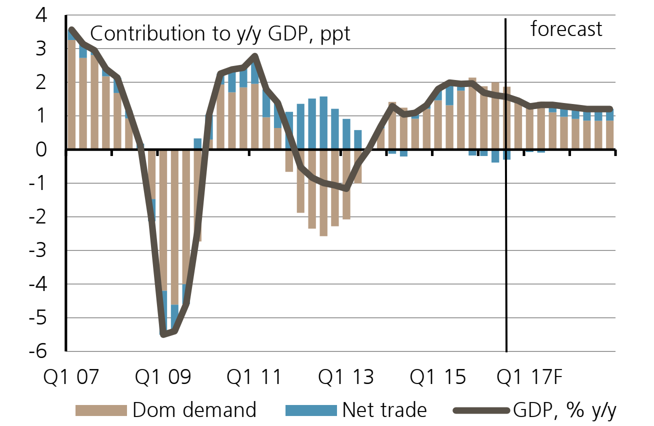
Net exports to deliver only modest support to growth

Taking all these factors together, we expect **domestic demand to decelerate in 2017/18**, and hence to provide a smaller contribution to headline GDP growth than previously. **Net exports** are unlikely to compensate for this: it is true that parts of the EM universe should do a bit better as oil and commodity prices recover. However, while we acknowledge the potential upside risk from stronger US fiscal policy, we expect the US business cycle to enter its mature stage in 2017/18 and the structural deceleration of the Chinese economy to continue. As a result, we expect net exports to provide only a moderate contribution to Eurozone GDP growth.

All combined, we expect Eurozone GDP growth to decelerate from 1.3% in 2017 to 1.2% in 2018. As such, we do not share the more constructive growth forecasts that have been presented by the ECB (1.6% for 2017 and 2018), the European Commission (1.5%/1.7% for 2017/18) or the IMF (1.5%/1.6% for 2017/18). **Nominal GDP growth**, meanwhile, should accelerate from 2.4% in 2016 to 3% in 2017 and 2018.

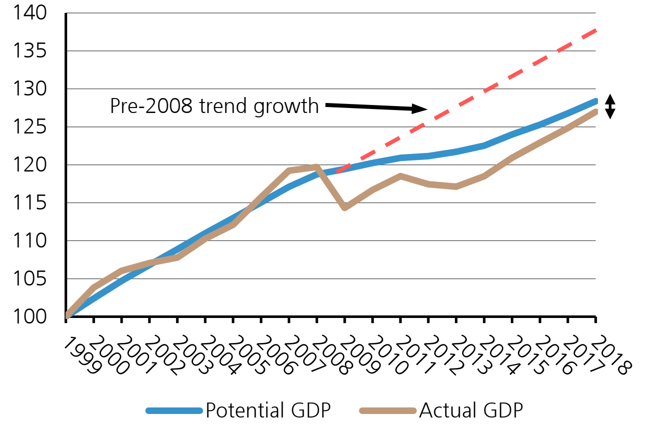
Real GDP growth to decelerate to just 1.2% in 2018

Figure 106: Eurozone real GDP and contributions in ppt



Source: Haver, UBS estimates

Figure 107: Eurozone actual and potential GDP growth



Source: Haver, Markit, UBS

We would stress, though, that even at the reduced rates we project for 2017 and 2018, the Eurozone would still be growing above its potential of perhaps 1% – implying continued improvements in labour markets (albeit at a reduced pace) and a further narrowing of the **output gap.** According to European Commission forecasts, the Eurozone output gap should shrink towards -0.7% in 2017 and -0.2% in 2018. However, there is no such thing as "the" Eurozone output gap. Instead, output gaps will differ substantially among individual countries. For example, we think the output gap in Germany is closed already, while output gaps in many other Eurozone countries are still substantial.

Eurozone output to narrow, but with large country-specific differences

Figure 108: New, old and consensus GDP growth forecasts, % y/y

	New forecasts			Old forecasts		Consensus		New vs Old forecasts		UBS vs Consensus	
	2016F	2017F	2018F	2016F	2017F	2016F	2017F	2016F	2017F	2016F	2017F
Eurozone	**1.6**	**1.3**	**1.2**	**1.5**	**1.3**	**1.6**	**1.3**	**0.1**	**0.0**	**0.0**	**0.0**
Germany	1.8	1.3	1.3	1.4	1.1	1.8	1.3	0.4	0.2	0.0	0.0
France	1.3	1.3	1.4	1.4	1.4	1.3	1.2	-0.1	-0.1	0.0	0.1
Italy	0.7	0.8	0.8	0.9	0.9	0.8	0.7	-0.2	-0.1	-0.1	0.1
Spain	3.2	2.3	1.9	2.8	1.9	3.1	2.1	0.4	0.4	0.1	0.2
Greece	0.0	2.0	2.6	-0.9	1.5	-0.6	1.1	0.9	0.5	0.6	0.9
UK	2.0	1.0	0.7	1.9	0.7	1.9	0.9	0.1	0.3	0.1	0.1
Switzerland	1.5	1.3	1.6	1.4	1.3	1.5	1.4	0.1	0.0	0.0	-0.1

Source: UBS estimates, 'Consensus Forecasts', Consensus Economics 10 October 2016.

Potential impact of changes in US politics on the European outlook

Overall, it seems too early in our view to draw strong conclusions on the impact of the Trump victory on the European growth outlook as too few details are known yet. We would list a number of potential implications, however, which could influence the risk profile around our baseline scenario.

First, a large fiscal boost in the US would likely spill over to Europe and present cyclical upside risk. Second, higher US bond yields might lead to higher European bond yields, prompting an unwelcome tightening in financial conditions, which might have implications for ECB monetary policy. Third, restrictions on global trade could have an adverse impact on European exports. More broadly, as the policies of the new US administration become clearer, financial-market and private-sector confidence might be affected. Last but not least, upcoming political events in Europe might be scrutinized even more thoroughly – potentially leading some observers to fear adverse outcomes more than before.

Big fiscal expansion? Don't hold your breath!

Sluggish Eurozone growth, together with the perception that monetary policy is "maxed out", has led to growing demands that **fiscal policy** should "take over". Following the Trump victory in the US, the expectations on fiscal policy seem to have risen very sharply. However, we do not count on a new major fiscal initiative in the Eurozone that would be able to change the big picture. It should be noted that, relative to past years, policy is already expansionary, so governments would have to spend even more to make an additional growth impact.

Fiscal policy is likely to become more accommodative…

It is true that the signs are for fiscal policy to stay expansionary. First, the period of aggressive fiscal tightening under the pressure of IMF/EU adjustment programmes (2012-14) is now behind us. Second, the ECB's QE policy has important fiscal side-effects as declining government bond yields grant governments some fiscal breathing space. Third, the election cycle – with elections/referendums looming in Italy, the Netherlands, France and Germany – would have implied stronger public spending in any event. And last but not least, following a slow start, the deployment of funds related to the €315bn Juncker Plan is now under way.

… but a *major* fiscal boost is unlikely

Nevertheless, we think of fiscal policy more as a source of incremental support than a major game-changer. Crucially, few governments have fiscal space. France, Spain and Portugal (as well as Greece, Croatia and the UK) are still in the EU's Excessive Deficit Procedure. Italy's debt stock is uncomfortably high, at 133% of GDP. Of the bigger Eurozone countries, only Germany has fiscal space (public debt below 70% of GDP and falling; balanced budget), but the government is hesitant to deploy it. (We would only expect this relatively conservative stance to change if the German economy were to suffer a marked slowdown.)

European Commission President Jean-Claude Juncker proposed that the "European fund for strategic investments" that carries his name should be doubled to €630bn. But even if this were to happen, the resulting stimulus to growth would likely unfold only slowly, as has been the case with the original Juncker Plan.

Last but not least, ultra-unorthodox concepts such as "helicopter money", where the ECB would directly fund expansionary fiscal policy, appear unlikely, given tight legal limits and strong political resistance. Overall, then, we think fiscal policy is likely to contribute moderately to Eurozone growth in 2017/18, but not more than 0.2-0.3pp per year.

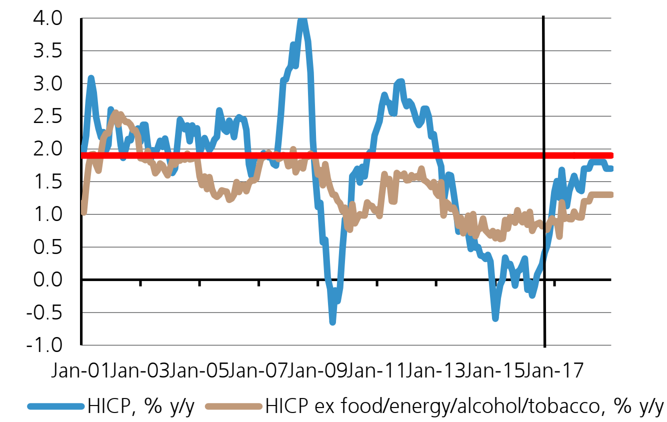
Of course, should the US stage a major fiscal stimulus under President Trump and thus lift US GDP growth, this should have positive growth implications for Europe as well: we estimate that European growth would rise by roughly 0.5pp for each 1pp rise in US growth.

Inflation rising, driven by base effects related to oil prices

Inflation has been very low in recent quarters, but is now on its way up. Following a rate of 0.5% y/y in October, we project headline inflation (HICP) to rise to 1.0% y/y by end-2016, 1.3% by the end of Q1 2017, 1.4% by end-2017, and 1.7% y/y by end-2018. This would correspond to annual averages of 0.2% in 2016, 1.4% in 2017 and 1.8% in 2018. As such, inflation should come a lot closer to the ECB's target of "close to, but below, 2%" in 2017/2018. However, rising headline inflation is largely due to energy-related base effects, with food prices contributing moderately as well. In other words, HICP should be driven up mainly by non-core inflation. Core inflation, in contrast, should move up much more slowly, from an annual average of 0.9% in 2016 to 1.3% in 2018, driven by spillovers from non-core inflation and the gradual closing of the output gap.

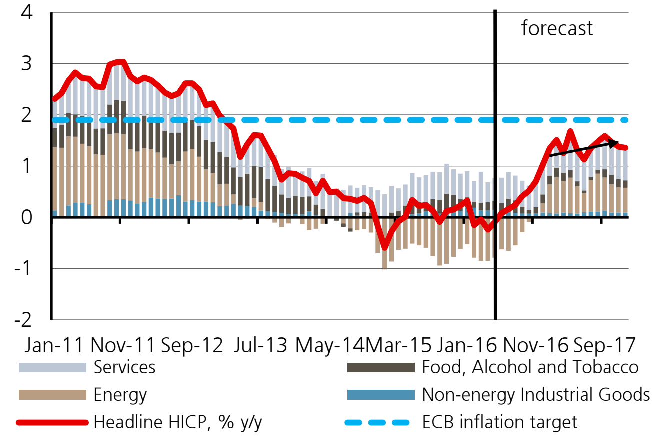
Inflation rising on the back of base effects related to energy prices

Figure 109: Eurozone headline and core HICP, % y/y



Source: Haver, UBS

Figure 110: Contributions to Eurozone HICP inflation, ppt



Source: Haver, UBS estimates

Monetary policy: QE extension in Dec, but tapering should start later in 2017

According to our base-case scenario, the ECB will, on 8 December, announce a six-month extension of QE beyond March 2017, with ongoing purchases of €80bn per month. We believe the ECB will also announce technical changes to the QE programme in order to widen the available pool of assets and hence give the QE extension credibility (although the recent rise in yields might have reduced the urgency of very aggressive technical changes).

We expect the QE programme to be extended by six months beyond March 2017

The ECB's new staff macroeconomic forecasts for 2017-19 – and the inflation forecast for 2018/19 in particular – will form an important basis for the decision. Within this context, the ECB will have to judge whether the recovery in inflation (towards the target of "close to but below 2%") is "sustainable" and hence more than just driven by volatile oil prices.

However, we think the members of the ECB Governing Council (GC) will have to take an even more comprehensive view, evaluate the broader balance of risks, and ask themselves whether the time is ripe for a reduction in monetary stimulus. They might also be forced to consider the implications of political events, such as the US elections or the Italian referendum on 4 December. Within this context, we would argue that the recent rise in European bond yields constitutes an unwelcome tightening in Eurozone financial conditions. Overall, we believe a majority of ECB GC members will lean towards the side of caution and vote to extend QE in its current form by another six months, to the end of September 2017.

The ECB Governing Council will likely take a broad view

After September 2017, however, we think the time will have come for the ECB to start scaling back the QE programme. We think the decision might potentially be taken by the ECB as early as **8 June 2017**, along with an updated set of macro forecasts for 2017-19. Tapering" could take various forms, with different speeds, degrees of flexibility, and strength of forward guidance – and hence hawkishness.

We expect tapering to start after September 2017

We believe how exactly the ECB manages the tapering process will depend crucially on how growth and inflation dynamics and the overall balance of risks are being evaluated when the decision comes close. Our base-case assumption is that the ECB would wind down the QE programme over the course of one year, from October 2017 to the fall of 2018. **If and when the tapering process starts, we think the ECB will have to take great care not to create a major "tantrum" in the financial markets**, with significant rises in bonds yields and losses in risk assets. Hence, we think the ECB will likely adopt a *flexible* framework where it does not commit too strongly to a pre-determined pattern of winding down QE.

Will the ECB be able to avoid a "taper tantrum"?

No more rate cuts, but no quick rate hikes either

How about ECB interest rates? Our base-case scenario implies that ECB policy rates have bottomed out, with the depo rate at -0.4%, the refi rate at zero, and the marginal lending rate at 0.25%. It's true that we cannot categorically rule out the risk scenario of a further depo cut – particularly if the EUR appreciated sharply – but we think that the resistance against further rate cuts is now very high. After all, the ECB is well aware of the negative side-effects that low rates generally and the negative deposit rate in particular inflict upon the financial sector. However, the ECB has explicitly stated that rate *hikes* should only be expected once the QE programme has come to an end. Assuming that QE will run until the fall of 2018, we think that ECB policy rates will remain at current levels until (at least) 2019.

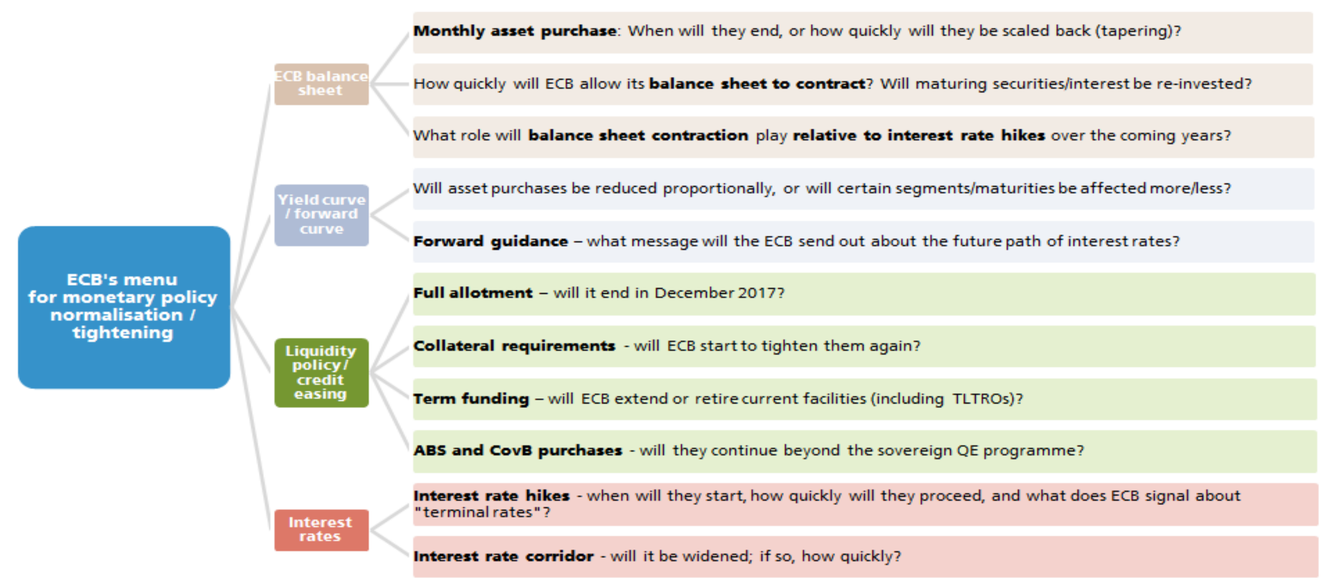
ECB policy rates unlikely to rise before 2019

ECB's options for eventual monetary policy normalisation

When it comes to the eventual monetary policy normalisation, the ECB will have access to a nuanced menu of choices of balance-sheet measures; ways to influence the yield/forward curve; liquidity and credit policy; and interest rates.

A broad menu for eventual policy normalisation/tightening

Figure 111: ECB's menu for monetary policy normalisation/tightening



Source: UBS

EUROZONE	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	9795	9836	9937	10140	10452	10707	11026	11372
GDP, USD bn	13631	12646	13198	13472	11597	11985	12598	13435
GDP per capita, USD	40605	37574	39140	39869	34226	35248	36954	39293
Real GDP growth, %	1.5	-0.9	-0.3	1.2	1.9	1.6	1.3	1.2
Private consumption, % y/y	-0.1	-1.2	-0.5	0.8	1.8	1.6	1.3	1.1
Government consumption, % y/y	-0.1	-0.3	0.3	0.6	1.4	1.8	1.4	1.0
Gross Fixed Capital formation, % y/y	1.7	-3.3	-2.5	1.4	2.9	3.1	1.4	1.8
Exports, % y/y	6.7	2.9	2.2	4.4	6.2	2.4	2.7	2.8
Imports, % y/y	4.6	-0.6	1.4	4.9	6.2	3.1	3.0	2.6
Unemployment rate, %	10.3	11.5	12.0	11.5	10.8	10.3	10.0	9.8
Industrial Production (%)	2.4	-3.0	-0.9	0.7	0.6	1.3	1.2	1.3
Prices, interest rates and money								
HICP inflation, % y/y (average)	2.7	2.5	1.4	0.4	0.0	0.2	1.4	1.8
HICP inflation, % y/y (year-end)	2.8	2.2	0.8	-0.2	0.2	1.0	1.4	1.7
Broad money M2, % y/y (end-year)	2.2	4.5	2.4	5.3	5.3	5.0	5.8	6.5
Domestic private credit, % y/y	1.3	-1.8	-2.2	-0.8	0.8	1.2	1.8	2.1
Domestic bank credit/GDP	113.6	111.2	107.3	104.7	102.1	101.0	100.0	99.1
Policy rate, % (end-year)	1.00	0.75	0.25	0.05	0.05	0.00	0.00	0.00
10 year bund yield, % (year-end)	2.10	1.30	1.90	0.60	0.60	0.15	0.50	0.90
EUR/USD (year-end)	1.29	1.32	1.38	1.21	1.09	1.10	1.13	1.17
Fiscal accounts								
General government budget balance, % GDP	-4.2	-3.7	-3.0	-2.6	-2.1	-2.0	-1.7	-1.5
Revenue, % GDP	44.9	46.1	46.6	46.8	46.6	46.5	46.6	46.7
Expenditure, % GDP	49.1	49.7	49.6	49.3	48.6	48.5	48.3	48.2
of which interest expenditure, % GDP	3.0	3.0	2.8	2.7	2.4	2.3	2.2	2.4
Primary balance, % GDP	-1.2	-0.6	-0.2	0.1	0.3	0.3	0.5	0.9
Public sector debt (gross),% GDP	86.7	91.3	93.4	94.4	92.9	92.5	91.5	90.7
of which domestic public debt, % GDP	-	-	-	-	-	-	-	-
of which external public debt,% GDP	-	-	-	-	-	-	-	-
% domestic public debt held by non-residents	-	-	-	-	-	-	-	-
Public debt held by the central bank, % GDP	11.8	14.6	10.2	8.3	21.2	38.9	46.1	47.1
Balance of payments								
Trade balance, EUR bn	22	123	211	242	352	370	363	340
Exports, EUR bn	1741	1885	1918	1969	2104	2085	2113	2140
Imports, EUR bn	1719	1762	1707	1726	1752	1715	1750	1800
Current account balance, EUR bn	20	122	215	244	327	343	331	318
as % of GDP	0.2	1.2	2.2	2.4	3.1	3.2	3.0	2.8
Foreign direct investment (net), EUR bn	95	45	27	63	246	54	55	57
Total FX reserves, EUR bn	667	689	542	612	644	724	715	719
Foreign exchange reserves excl gold, EUR bn	245	252	240	270	307	311	295	279
Total FX reserves, % GDP	6.8	7.0	5.5	6.0	6.2	6.8	6.5	6.3
Total external debt, % GDP	110.0	122.4	115.7	110.3	122.1	123.9	118.5	111.8
Net International Investment Position, % GDP	-15.9	-15.0	-13.9	-11.0	-10.3	-8.2	-8.1	-7.8
Credit ratings								
Moody's	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
S&P	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Fitch	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a

Source: Haver, European Commission, IMF, ECB, IMF, UBS estimates

Germany

- **GDP growth to slow from 1.8% in 2016 to 1.3% in both 2017 and 2018**
- **Domestic demand to continue as main driver, but headwinds increase**
- **Inflationary pressures increase**

GDP growth well above potential

The German economy performed exceptionally well in H1 2016 with annualized growth of around 2% – well above the potential growth rate of less than 1.5% – driving down the unemployment rate further to below 5%. We expect growth to hold up well for the remainder of 2016, as business confidence has risen and consumption has remained robust overall. We expect GDP growth of 1.8% this year – the strongest since 2011 and more than we expected right after the UK vote to leave the EU (1.4%).

Exceptionally favourable conditions for private consumption

The likely solid 2016 growth outcome reflects an exceptional combination of low oil prices, sharply increased public spending largely due to the influx of refugees, income gains from increased employment and a booming real estate market, supported by low interest rates. This combination of factors benefits consumption in particular: household consumption is set to rise by 1.5% in 2016 – well above its long-term average of less than 1% growth. At 3.6%, public spending growth this year is likely to be the strongest since 1993. Strong private and public consumption has helped the economy to more than offset a weaker external environment and to weather the uncertainty shock from the UK referendum result.

Some moderation of growth is in store and current account surplus should remain at high levels

Going forward, we expect some moderation in growth as the tailwind from low oil prices fades and public spending growth ebbs due to the decline in refugee inflows. A further tightening in the labour market (accompanied by stronger wage growth) and some income tax cuts ahead of the general election in September 2017 are likely to support household consumption, but may not fully offset those headwinds. Business investment may pick up somewhat from its fairly subdued levels, but we also expect it to suffer from political uncertainty (more so than consumption) in the run-up to the general election and also from uncertainty regarding the negotiations on the UK's departure from the EU. Adding uninspiring growth in export markets to the mix implies that German growth is set to moderate from here on, in our view. The current account surplus – already the world’s largest in nominal terms – is set to moderate only slightly as higher oil prices boost imports. Overall, we project the surplus to remain at relatively high levels of around 8% of GDP, unless corporate (and public) investment increases much more forcefully going forward, which we do not anticipate.

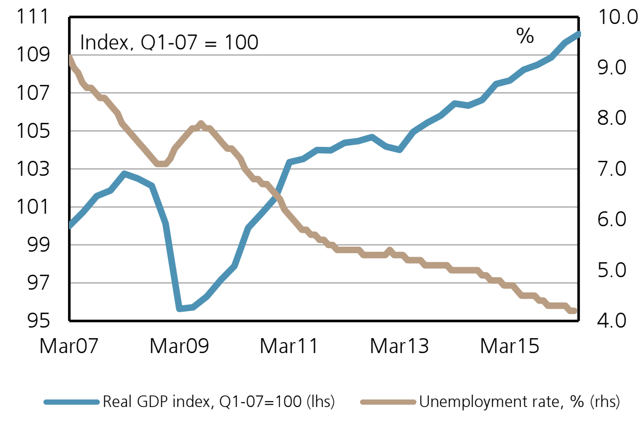
Growth in line with potential in 2017/18, wages to accelerate

We project GDP growth of 1.3% in both 2017 and 2018 – broadly in line with Germany’s potential growth rate. We expect the decline in unemployment to moderate – not least reflecting inflows of unemployed refugees. Given the tightness of the labour market, we project wage growth to accelerate, helped by a 4% increase in the statutory minimum wage in 2017. This should also drive up the inflation rate, which has thus far remained only just above the Eurozone average.

Political uncertainty and external factors are downside risks; increased corporate and public investment is an upside risk

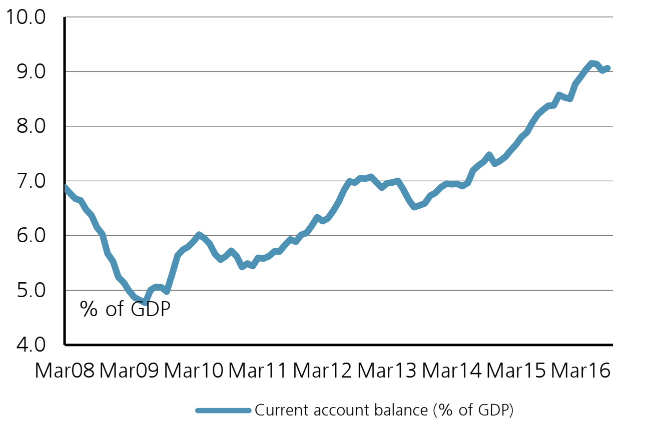
Risks remain tilted to the downside: apart from domestic political uncertainty, the external environment could become more of a headwind than otherwise assumed – including the impact of the EU/UK negotiations and indirect consequences to changes to US politics. A more forceful upswing in corporate investment and a substantial increase in public spending on infrastructure are sources of upside risk to our forecasts.

Figure 112: Growth and the labour market



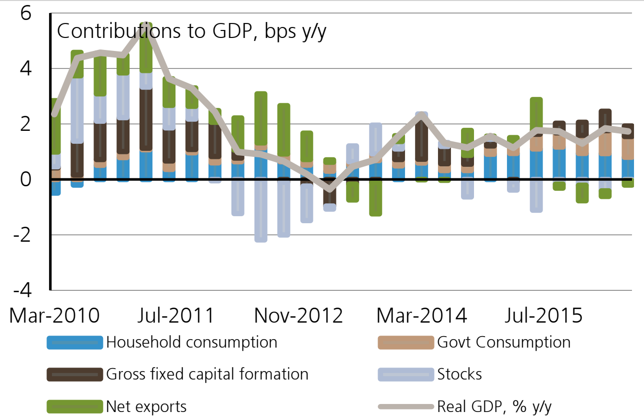
Source: Haver, UBS

Figure 113: Current account balance



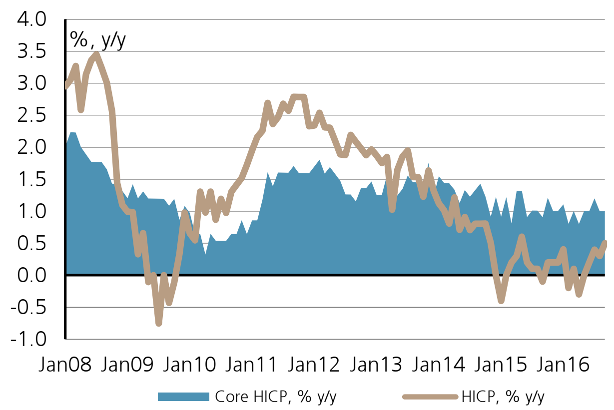
Source: Haver, UBS

Figure 114: GDP growth components



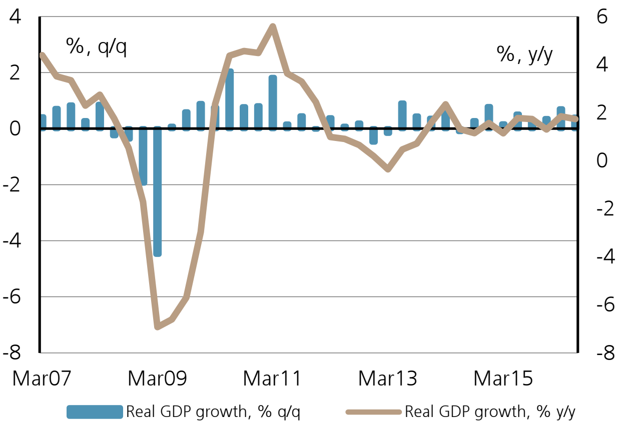
Source: Haver, UBS

Figure 115: Inflation



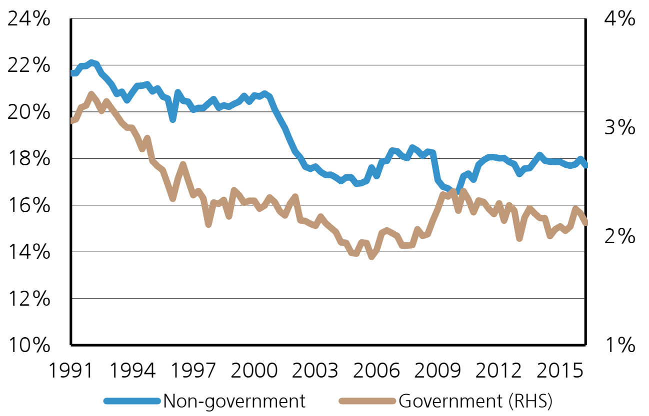
Source: Haver, UBS

Figure 116: Real GDP growth



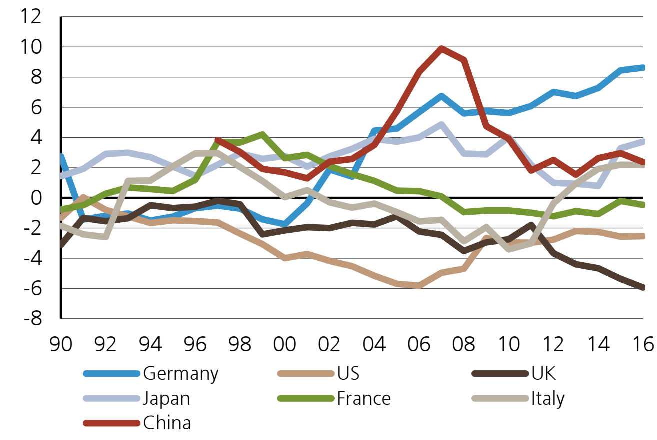
Source: Haver, UBS

Figure 117: Investment ratio



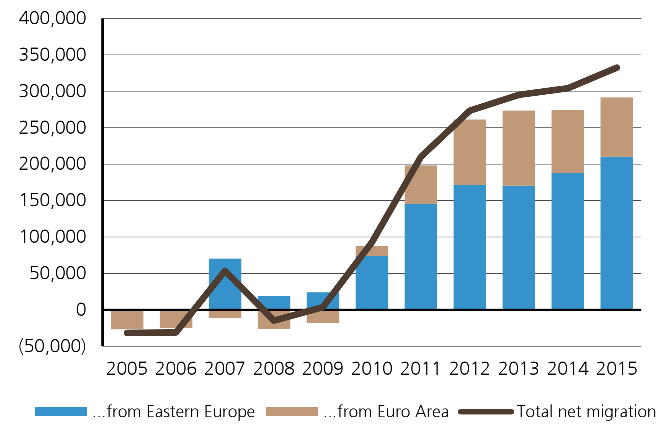
Source: Haver, UBS

Figure 118: Current account balance, % of GDP



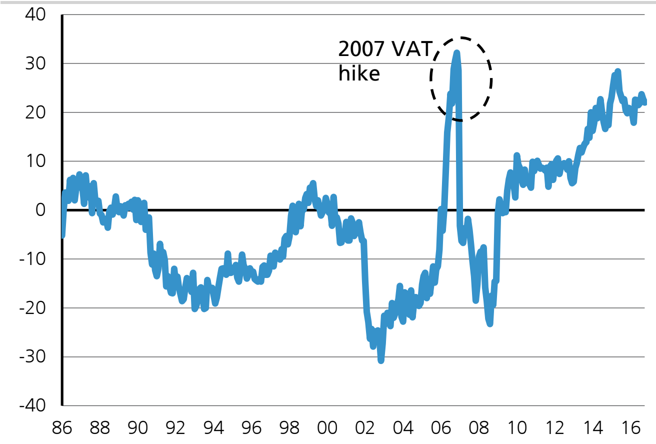
Source: Haver, UBS

Figure 119: Immigration from other EU countries



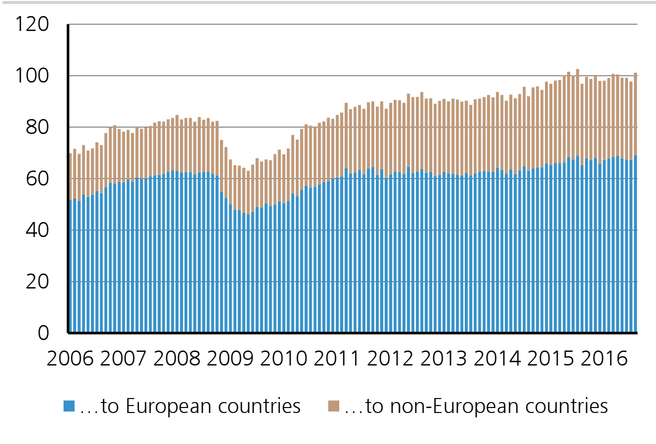
Source: Destatis, UBS

Figure 120: Consumer confidence – propensity to make major purchases



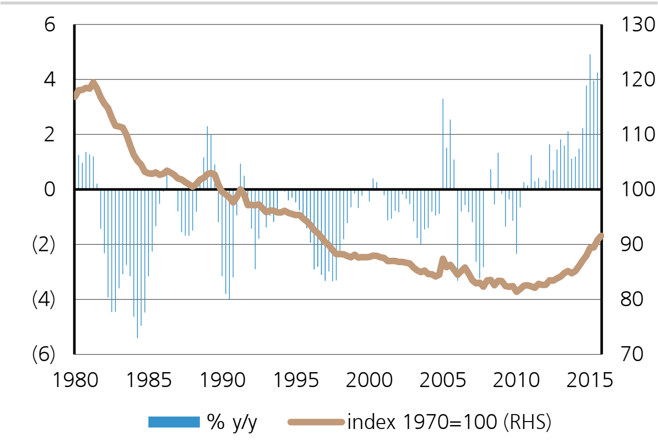
Source: Haver, UBS

Figure 121: German exports (billion Euros)



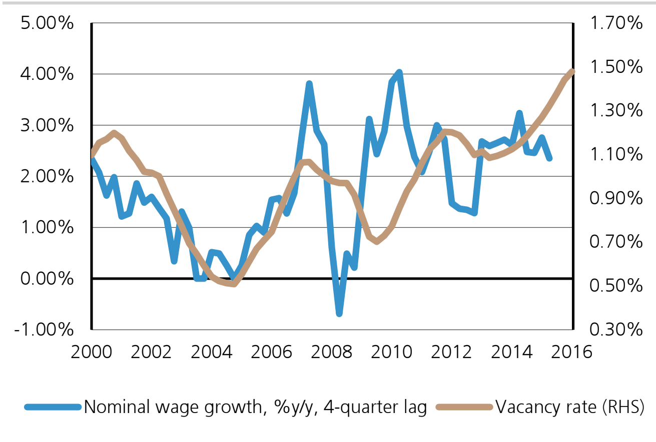
Source: Haver, UBS

Figure 122: Germany - real house prices



Source: BIS, UBS

Figure 123: Wage growth and vacancies



Source: Haver, UBS

GERMANY	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	2699	2759	2831	2928	3030	3132	3220	3320
GDP, USD bn	3756	3547	3760	3890	3362	3506	3679	3922
GDP per capita, USD	46794	44107	46623	48036	41220	42604	44584	47383
Real GDP growth, %	3.7	0.7	0.6	1.6	1.5	1.8	1.3	1.3
Private consumption, % y/y	1.3	1.3	0.9	1.0	1.9	1.5	1.4	1.2
Government consumption, % y/y	0.9	1.0	1.2	1.2	2.8	3.6	1.7	1.1
Gross Fixed Capital formation, % y/y	7.3	-0.1	-1.1	3.4	1.1	2.1	1.5	2.5
Exports, % y/y	8.4	3.5	2.0	4.0	4.6	2.8	2.3	2.5
Imports, % y/y	7.2	0.4	3.2	4.0	5.0	2.9	2.5	2.7
Unemployment rate, %	5.9	5.4	5.2	5.0	4.6	4.3	4.3	4.4
Industrial Production (%)	7.4	-0.4	0.1	1.5	0.5	1.1	0.9	0.8
Prices, interest rates and money								
HICP inflation, % y/y (average)	2.5	2.1	1.6	0.8	0.1	0.4	1.3	1.8
HICP inflation, % y/y (year-end)	2.3	2.0	1.3	0.0	0.2	1.3	1.3	1.8
Broad money M2, % y/y (end-year)	6.8	7.6	2.9	5.0	8.6	4.0	5.0	5.0
Domestic private credit, % y/y	1.1	0.8	0.2	0.6	2.3	2.7	2.3	2.2
Domestic bank credit/GDP	101.3	99.4	96.6	93.6	92.0	91.5	91.1	90.7
Policy rate, % (end-year)	1.00	0.75	0.25	0.05	0.05	0.00	0.00	0.00
10 year bond yield, % (year-end)	1.74	1.29	1.92	0.50	0.59	0.15	0.50	0.90
USD/EUR (year-end)	1.29	1.32	1.38	1.21	1.09	1.10	1.13	1.17
Fiscal accounts								
General government budget balance, % GDP	-1.0	-0.1	-0.1	0.3	0.7	0.2	0.1	0.2
Revenue, % GDP	43.8	44.4	44.4	44.6	44.6	44.5	44.6	44.5
Expenditure, % GDP	44.7	44.5	44.5	44.3	43.9	44.3	44.5	44.3
of which interest expenditure, % GDP	2.5	2.3	2.0	1.8	1.6	1.4	1.3	1.2
Primary balance, % GDP	1.5	2.2	1.8	2.1	2.3	1.6	1.4	1.4
Public sector debt (gross),% GDP	78.3	79.6	77.2	74.7	71.2	68.6	66.3	63.6
of which domestic public debt, % GDP	-	-	-	-	-	-	-	-
of which external public debt,% GDP	-	-	-	-	-	-	-	-
% domestic public debt held by non-residents	51.6	61.3	61.1	61.0	58.7	n/a	n/a	n/a
Public debt held by the central bank, % GDP	-	-	-	-	-	-	-	-
Balance of payments								
Trade balance, EUR bn	161	202	214	228	261	279	279	279
Exports, EUR bn	1025	1074	1084	1118	1177	1225	1252	1280
Imports, EUR bn	865	872	870	890	916	940	966	987
Current account balance, EUR bn	163	195	192	216	258	279	271	271
as % of GDP	6.0	7.1	6.8	7.4	8.5	8.9	8.4	8.2
Foreign direct investment (net), EUR bn	7.5	26.4	21.6	79.4	56.4	21.9	22.5	23.2
Total FX reserves, EUR bn	-	-	-	-	-	-	-	-
Foreign exchange reserves excl gold, EUR bn	-	-	-	-	-	-	-	-
Total FX reserves, % GDP	-	-	-	-	-	-	-	-
Total external debt, % GDP	162.7	165.4	150.2	153.6	148.3	154.0	155.0	155.0
Net International Investment Position, % GDP	23.3	28.0	33.7	40.1	48.7	54.3	60.1	65.7
Credit ratings								
Moody's	Aaa	Aaa	Aaa	Aaa	Aaa	Aaa	n/a	n/a
S&P	AAA	AAA	AAA	AAA	AAA	AAA	n/a	n/a
Fitch	AAA	AAA	AAA	AAA	AAA	AAA	n/a	n/a

Source: Haver, Eurostat, European Commission, Reuters Eikon, IMF, UBS estimates

France

- **Moderate GDP growth of 1.3% in 2016 and 2017, 1.4% in 2018**
- **Domestic demand is key driver of growth**
- **Presidential election in May 2017 a key focus**

A continuing gradual recovery

The French economy is continuing its gradual recovery. After a solid Q1, growth stagnated in Q2 but accelerated again to 0.2% q/q in Q3 2016. As in other Eurozone countries, the UK referendum has had no visible adverse effects on the growth momentum.

Domestic demand to remain key driver

Lower oil prices and favourable financing conditions have helped domestic demand, but there is also visible improvement in the labour market. The unemployment rate looks likely to have peaked at 10.5% in 2015 and we expect it to have fallen by around half a percentage point by the end of 2016, supporting household income. Gains in employment should continue to benefit from public support aimed at lowering labour costs through the Competitiveness and Employment Tax Credit (CICE) and the Responsibility and Solidarity Pact.

A mixed outlook for corporate investment

Looking ahead, we see growth continuing at its current pace. As elsewhere, the tailwind of lower commodity prices on consumption will likely fade. However, continued employment gains and some fiscal support provide a degree of offset. The outlook for investment is more mixed: on the one hand, our UBS Evidence Lab survey of corporate investment intentions continues to show that France is lagging other Eurozone economies; on the other hand, business confidence readings have improved recently and there remains some catch-up potential for the construction sector, where investment has fallen continuously since 2008 and has hit its lowest level relative to GDP since the early 1980s. Some rebound may be in store as sentiment in the sector has improved.

Fiscal space to support growth is limited

On the fiscal side, the budget deficit has remained above the 3% of GDP threshold since 2008 and France has been in the European Commission's "Excessive Deficit Procedure" since 2009. The government's plan is to lower the deficit from 3.5% in 2015 to 2.7% in 2017, implying that fiscal scope to support growth is very limited even if interest costs decline further.

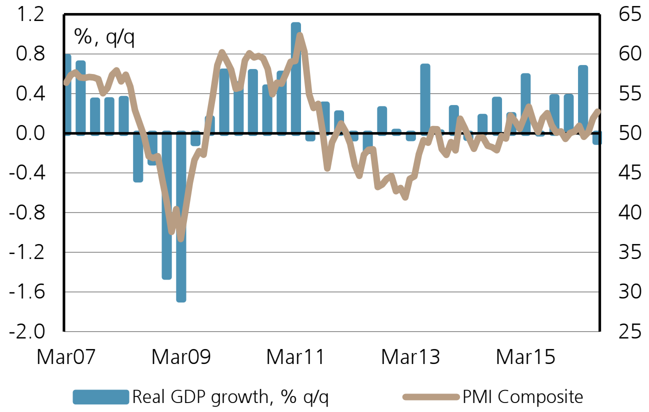
Some progress has been made in structural reforms

Our projection of resilient growth ahead is also driven by progress on structural reforms, which should support potential growth somewhat. In particular, as part of the *loi travail*, some decision-making has been shifted further to the company level and could help to better adjust working time and wage costs to local needs, thus in turn improving the economy's competitiveness. Also, it is worth pointing out that the demographic outlook is in better shape in France than in the other core Eurozone countries, which points to a higher trend growth rate.

Political uncertainty is a downside risk

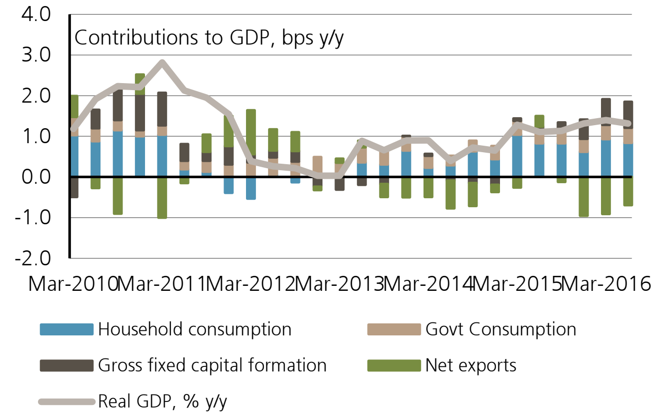
A key uncertainty is the presidential election, scheduled for May 2017. Over the coming months, primaries in the Socialist and Republican parties will be held, giving a clearer picture as to who the contenders will be; we expect the election campaign to start in earnest then. Uncertainty about the election outcome could weigh on corporate investment in the first months of 2017. At the same time, increased fiscal support may emerge ahead of the election, which would be a plus for cyclical growth prospects, notably consumption.

Figure 124: GDP growth and composite PMI



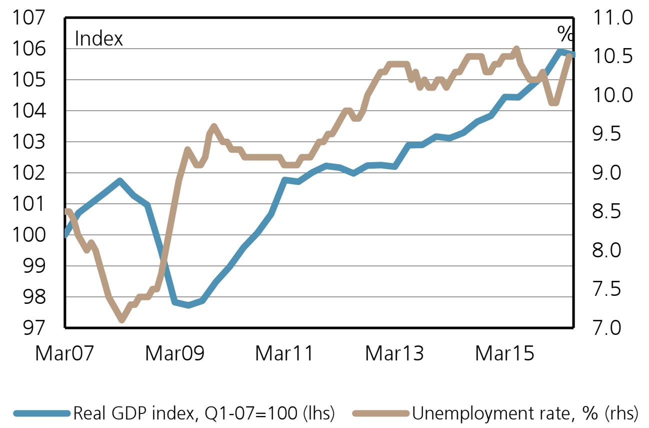
Source: Haver, UBS

Figure 125: GDP growth by components



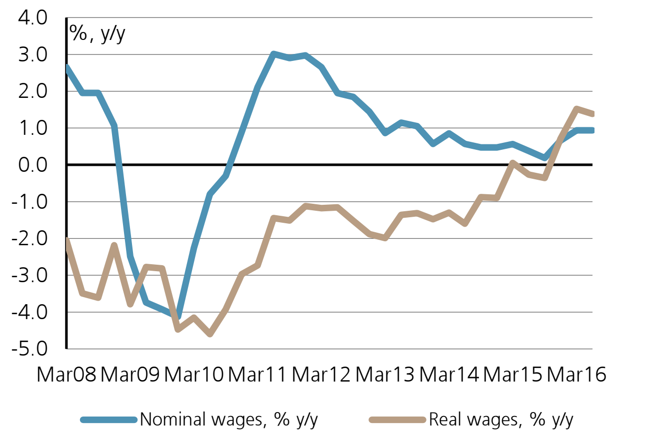
Source: Haver, UBS

Figure 126: Real GDP and unemployment



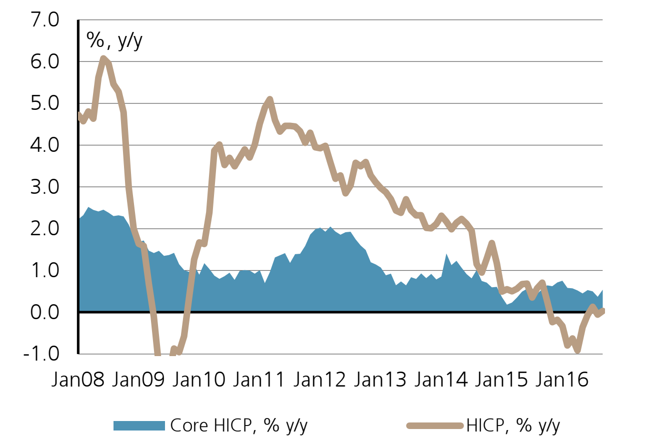
Source: Haver, UBS

Figure 127: Wage growth



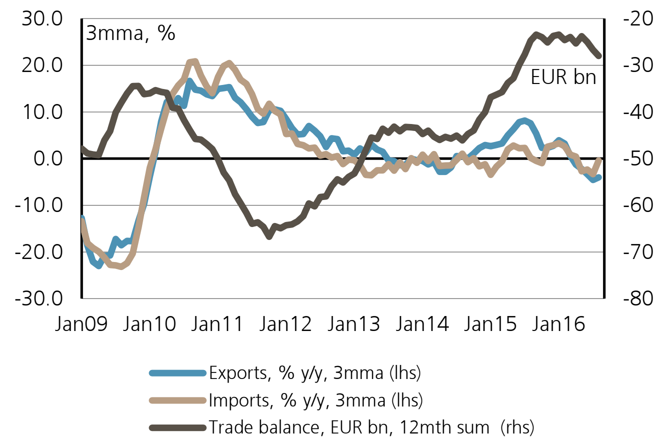
Source: Haver, UBS

Figure 128: Inflation



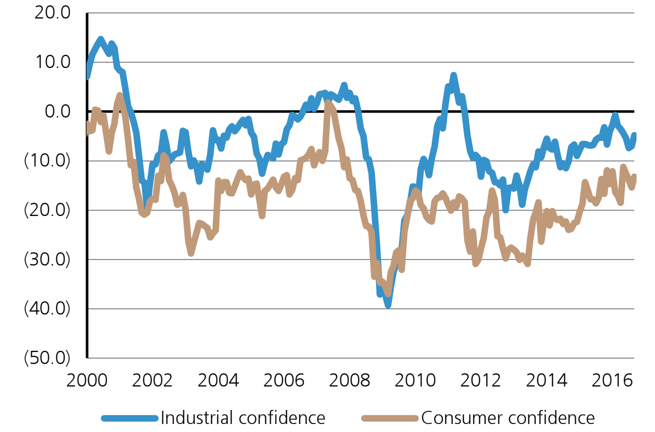
Source: Haver, UBS

Figure 129: Exports and imports



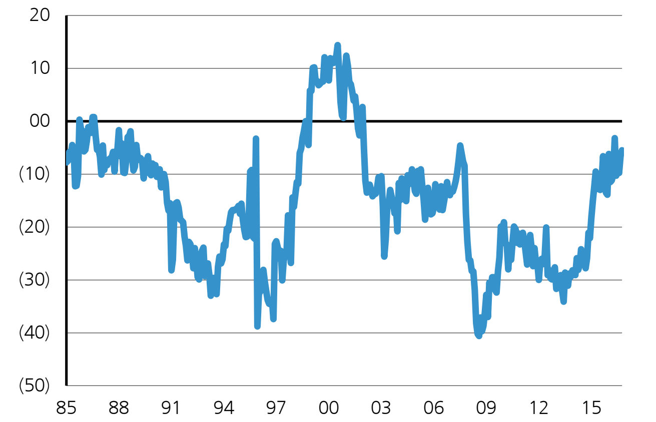
Source: Haver, UBS

Figure 130: EC sentiment indicators for France



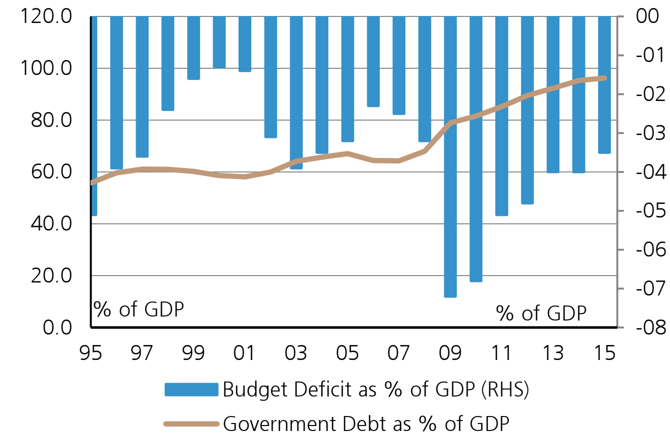
Source: Haver, UBS

Figure 131: Consumer confidence – propensity to make major purchases



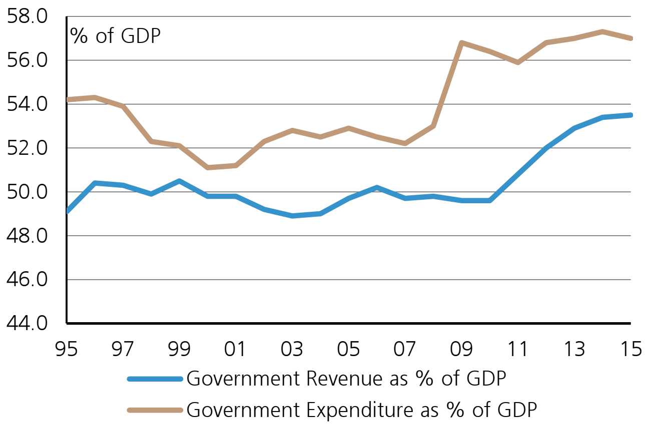
Source: Haver, UBS

Figure 132: Government finances



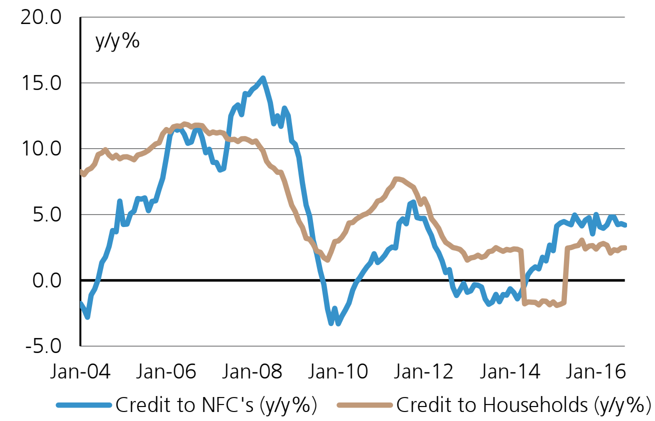
Source: Haver, UBS

Figure 133: Government revenues and expenditures



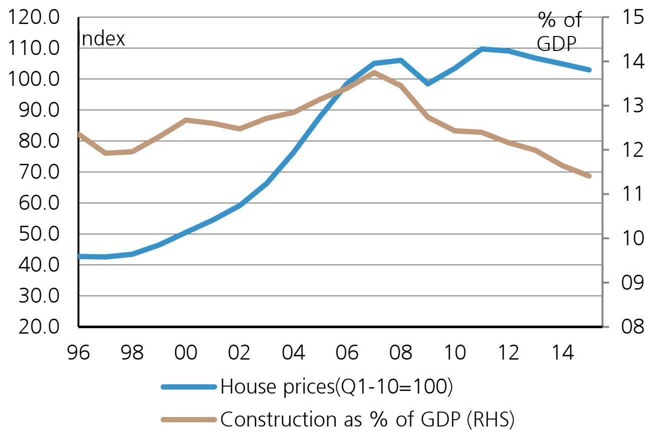
Source: Haver, UBS

Figure 134: Credit growth



Source: Haver, UBS

Figure 135: House prices and construction



Source: Haver, UBS

FRANCE	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	2058	2087	2116	2141	2181	2227	2291	2371
GDP, USD bn	2865	2683	2811	2845	2420	2493	2617	2801
GDP per capita, USD	43872	40901	42662	43000	36399	37313	39004	41537
Real GDP growth, %	2.1	0.2	0.6	0.7	1.2	1.3	1.3	1.4
Private consumption, % y/y	0.4	-0.2	0.6	0.7	1.5	1.4	1.4	1.5
Government consumption, % y/y	1.1	1.6	1.5	1.2	1.4	1.6	1.4	0.4
Gross Fixed Capital formation, % y/y	2.1	0.4	-0.7	-0.4	0.9	2.7	1.2	2.5
Exports, % y/y	7.1	2.7	1.9	3.4	6.0	1.0	3.0	3.0
Imports, % y/y	6.6	0.8	2.2	4.8	6.4	2.9	3.6	3.0
Unemployment rate, %	8.8	9.4	9.9	9.9	10.1	9.7	9.5	9.4
Industrial Production (%)	3.0	-2.3	-0.5	-0.9	1.5	0.3	1.0	1.2
Prices, interest rates and money								
HICP inflation, % y/y (average)	2.3	2.2	1.0	0.6	0.1	0.3	1.4	1.6
HICP inflation, % y/y (year-end)	2.7	1.5	0.8	0.1	0.3	0.9	1.5	1.6
Broad money M2, % y/y (end-year)	4.0	5.7	2.8	3.8	4.6	5.1	5.4	6.0
Domestic private credit, % y/y	5.3	1.0	0.8	0.1	3.0	3.5	3.9	4.3
Domestic bank credit/GDP	104.2	104.4	104.1	102.9	103.9	104.5	105.3	106.1
ECB refi rate, % (end-year)	1.00	0.75	0.25	0.05	0.05	0.00	0.00	0.00
10 year bond yield, % (year-end)	3.15	1.85	2.37	0.83	0.99	0.45	0.85	1.20
USD/EUR (year-end)	1.29	1.32	1.38	1.21	1.09	1.10	1.13	1.17
Fiscal accounts								
General government budget balance, % GDP	-5.1	-4.8	-4.0	-4.0	-3.5	-3.4	-3.1	-2.7
Revenue, % GDP	50.8	52.0	52.9	53.4	53.2	52.8	52.6	53.1
Expenditure, % GDP	55.9	56.8	57.0	57.3	56.8	56.2	55.7	55.8
of which interest expenditure, % GDP	2.6	2.6	2.3	2.2	2.0	1.9	1.7	1.5
Primary balance, % GDP	-2.5	-2.2	-1.8	-1.8	-1.5	-1.5	-1.4	-1.2
Public sector debt (gross),% GDP	85.2	89.6	92.4	95.4	95.8	96.4	97.0	98.0
of which domestic public debt, % GDP	-	-	-	-	-	-	-	-
of which external public debt,% GDP	-	-	-	-	-	-	-	-
% domestic public debt held by non-residents	59.0	63.5	63.8	61.2	61.9	n/a	n/a	n/a
Public debt held by the central bank, % GDP	-	-	-	-	-	-	-	-
Balance of payments								
Trade balance, EUR bn	-65	-54	-43	-40	-24	-24	-31	-36
Exports, EUR bn	422	436	438	438	461	465	479	493
Imports, EUR bn	487	491	481	478	485	497	521	539
Current account balance, EUR bn	-20.4	-25.5	-18.5	-22.8	-4.4	-13.6	-8.4	-13.4
as % of GDP	-1.0	-1.2	-0.9	-1.1	-0.2	-0.6	-0.4	-0.6
Foreign direct investment (net), EUR bn	14.2	15.1	-10.5	36.0	-1.9	-4.5	1.0	4.7
Total FX reserves, EUR bn	-	-	-	-	-	-	-	-
Foreign exchange reserves excl gold, EUR bn	-	-	-	-	-	-	-	-
Total FX reserves, % GDP	-	-	-	-	-	-	-	-
Total external debt, % GDP	200.8	200.0	193.9	209.7	209.7	215.0	220.0	220.0
Net International Investment Position, % GDP	-8.7	-12.8	-16.6	-16.9	-16.4	-17.0	-17.4	-17.6
Credit ratings								
Moody's	Aaa	Aa1	Aa1	Aa1	Aa2	Aa2	n/a	n/a
S&P	AAA	AA+	AA	AA	AA	AA	n/a	n/a
Fitch	AAA	AAA	AA+	AA	AA	AA	n/a	n/a

Source: Haver, Eurostat, European Commission, Reuters Eikon, IMF, UBS estimates

Italy

- **A continued domestic-demand-driven recovery**
- **Constitutional referendum implies political uncertainty**
- **Some fiscal support in short term supports consumption**

We project continued above-potential growth

The growth recovery in Italy has continued in 2016 with a projected GDP increase of 0.7% (lower than the 0.9% we projected previously), following 0.6% in 2015. While growth in Q2 2016 ground to a halt following 0.3% q/q in Q1, available indicators suggest that momentum returned in Q3. As in other Eurozone countries, domestic demand – and in particular household consumption – is the key driver. Net exports are expected to continue detracting from growth, reflecting only moderate export growth and rising imports. Looking ahead, we expect annual GDP growth to remain at 0.8% in both 2017 and 2018 as unemployment declines and household income increases. GDP growth should thus remain significantly above its potential rate, which we estimate is slightly above 0%.

Constitutional referendum in December key to watch for sentiment

Looking ahead, political uncertainty is a key focus, notably the referendum on constitutional reform, scheduled for 4 December. The referendum is part of the government's agenda to improve decision-making by reforming the Senate (Upper House of Parliament) and follows the passing of the reform of the Lower House earlier in 2016. Progress in reforming political decision-making could, in our view, be a first prerequisite for enacting structural reforms going forward, even though its importance in this regard should not be over-emphasized at this stage. The referendum is also a potential source of political uncertainty and driver of overall sentiment, given that the Prime Minister might step down if the government's proposals are rejected: opinion polls suggest the referendum is too close to call, with the share of undecided voters being particularly high.

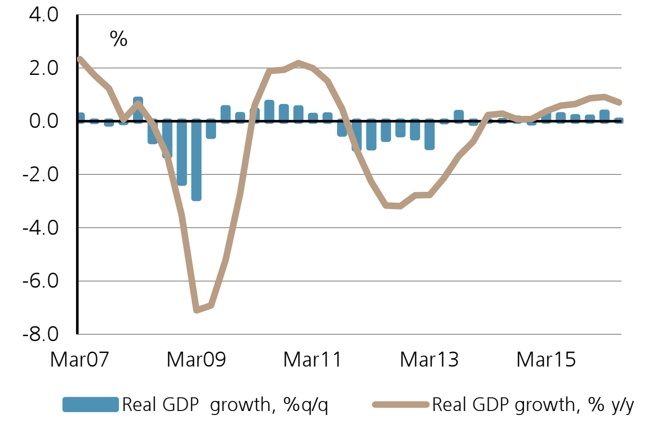
Fiscal policy to turn somewhat more expansionary

In the run-up to the referendum, more fiscal support for households is likely to be promised. Indeed, the government's 2017 budget proposal envisages a deficit of 2.3% of GDP compared to earlier plans of 1.8%, implying around 0.4% more stimulus than previously planned. This should provide some support for private consumption, such as tax relief and increases in pension benefits. A cut in Italy's corporate tax rate is also part of the budget plan. Still, we expect investment to moderate somewhat going forward, owing to political uncertainty.

Political uncertainty is there to stay until the general election in 2018

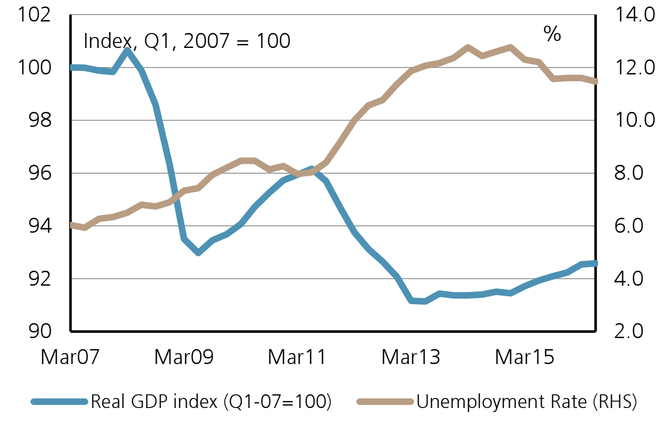
We stress, however, that pre-referendum uncertainty is unlikely to disappear altogether, even if the referendum results in a "Yes" vote, as the next general election needs to take place by May 2018 at the latest and opinion polls point to a tight race. This implies that: (1) any government will be preoccupied with the election campaign after the referendum and is unlikely to embark on substantial structural reforms; and (2) there is a risk of a non-market-friendly party being elected, which, under the new electoral law, would be guaranteed a stable majority. If uncertainty were to be lifted earlier than we assume – perhaps because of early new elections resulting in the formation of a new government with a clear mandate – growth momentum could also pick up and create upside risk to our outlook.

Figure 136: Real GDP growth



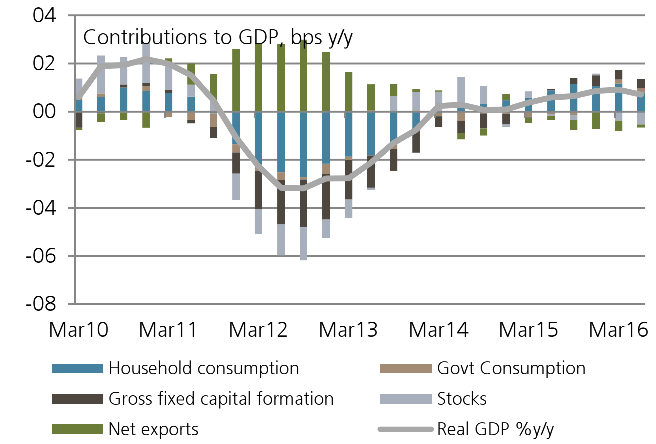
Source: Haver, UBS.

Figure 137: GDP and unemployment



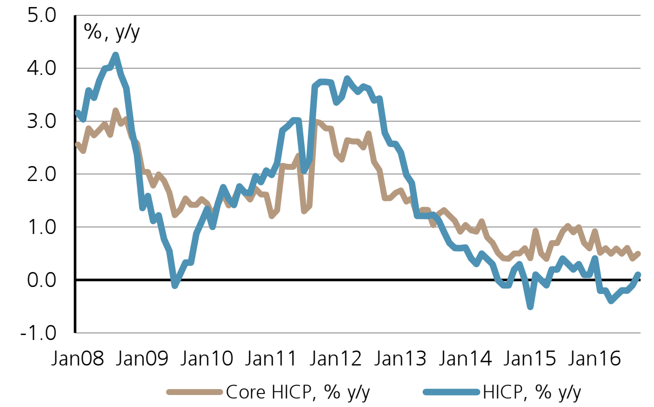
Source: Haver, UBS.

Figure 138: GDP growth contributions



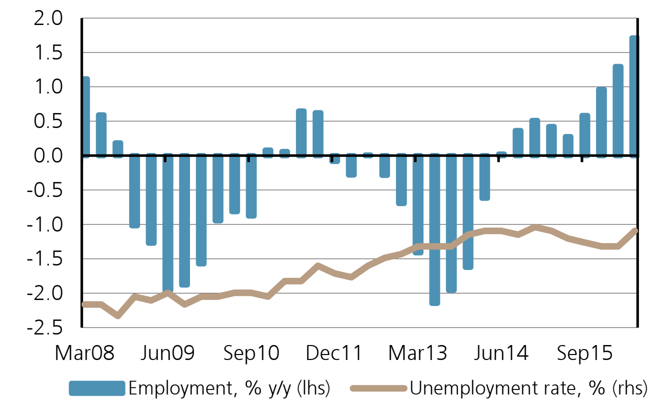
Source: Haver, UBS.

Figure 139: Inflation



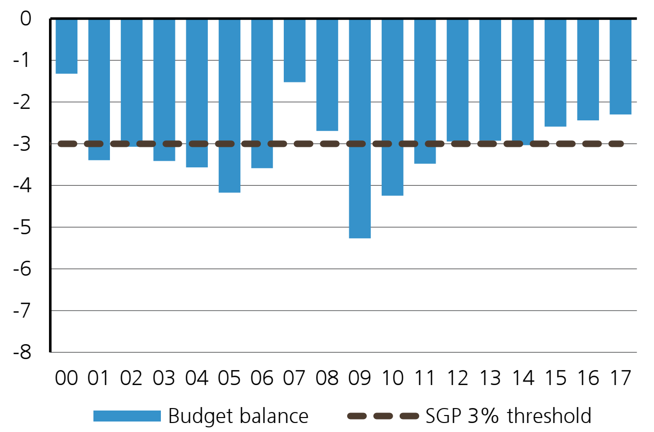
Source: Haver, UBS

Figure 140: Labour market



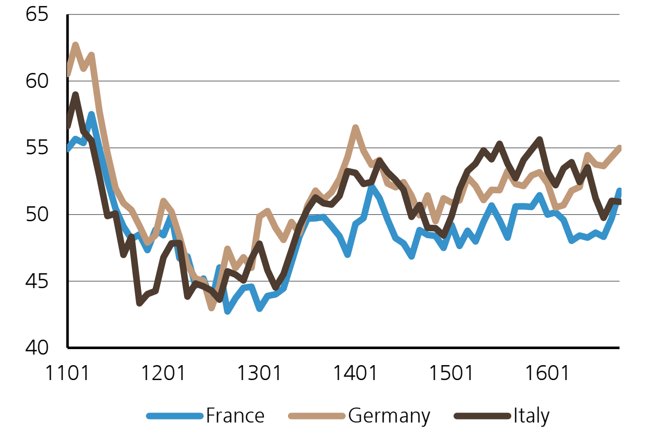
Source: Haver, UBS.

Figure 141: Budget balance



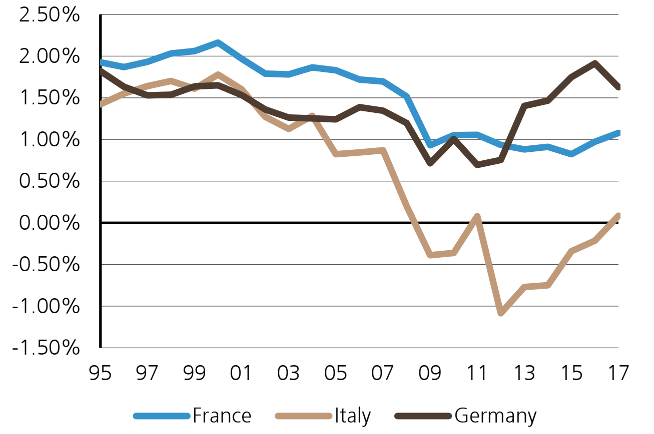
Source: Haver, UBS.

Figure 142: Manufacturing PMIs, selected countries



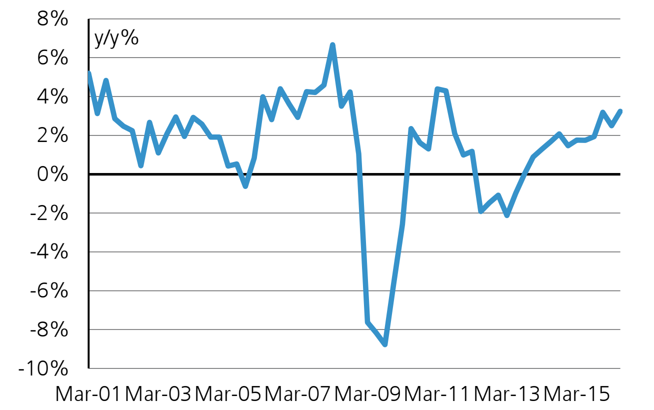
Source: Haver, UBS

Figure 143: Potential growth estimates



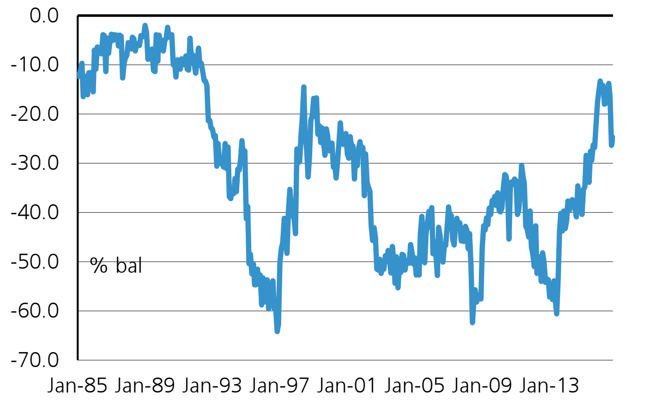
Source: Haver, European Commission, UBS

Figure 144: Nominal wage growth



Source: Haver, UBS

Figure 145: Consumer confidence – major purchases

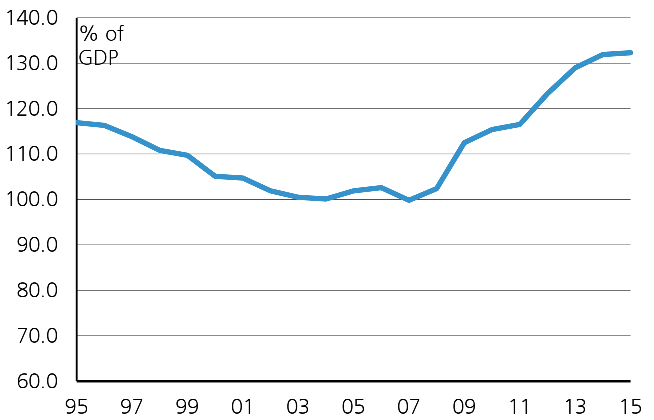


Source: Haver, UBS

Figure 146: Italian vs German government bond spread

Source: Haver, UBS

Figure 147: Government debt



Source: Haver, UBS

ITALY	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	1638	1613	1604	1621	1642	1663	1691	1731
GDP, USD bn	2280	2074	2131	2154	1821	1861	1932	2045
GDP per capita, USD	37959	34375	35136	35440	29994	30638	31718	33461
Real GDP growth, %	0.7	-2.9	-1.7	0.2	0.6	0.7	0.8	0.8
Private consumption, % y/y	0.0	-4.0	-2.4	0.4	1.5	1.3	1.4	1.0
Government consumption, % y/y	-1.8	-1.4	-0.3	-0.9	-0.6	0.6	0.2	0.2
Gross Fixed Capital formation, % y/y	-1.7	-9.4	-6.6	-2.9	1.1	1.9	0.3	0.6
Exports, % y/y	6.1	2.0	1.0	2.6	4.0	1.4	2.2	2.6
Imports, % y/y	1.2	-8.3	-2.2	3.2	5.8	2.6	3.3	2.7
Unemployment rate, %	8.4	10.7	12.2	12.7	11.9	11.5	11.2	10.8
Industrial Production (%)	1.3	-6.2	-3.0	-0.6	0.9	1.8	1.0	0.8
Prices, interest rates and money								
HICP inflation, % y/y (average)	2.9	3.3	1.2	0.2	0.1	-0.1	1.1	1.8
HICP inflation, % y/y (year-end)	3.7	2.6	0.6	0.0	0.1	0.2	1.4	1.8
Broad money M2, % y/y (end-year)	0.6	6.9	2.8	3.5	3.8	3.6	3.6	3.6
Domestic private credit, % y/y	3.5	-2.5	-4.1	-0.9	0.7	0.6	2.9	2.3
Domestic bank credit/GDP	108.8	108.7	105.2	103.8	103.2	101.8	103.0	106.0
Policy rate, % (end-year)	1.00	0.75	0.25	0.05	0.05	0.00	0.00	0.00
10 year bond yield, % (year-end)	6.98	4.53	4.17	1.92	1.62	1.75	2.00	2.20
USD/EUR (year-end)	1.29	1.32	1.38	1.21	1.09	1.10	1.13	1.17
Fiscal accounts								
General government budget balance, % GDP	-3.5	-2.9	-2.9	-3.0	-2.6	-2.4	-2.2	-1.3
Revenue, % GDP	45.7	47.8	48.1	48.2	47.9	47.2	46.0	45.8
Expenditure, % GDP	49.1	50.8	51.0	51.2	50.5	49.6	48.2	47.2
of which interest expenditure, % GDP	4.7	5.2	4.8	4.6	4.2	3.7	3.6	3.4
Primary balance, % GDP	1.2	2.2	1.9	1.6	1.6	1.3	1.4	2.1
Public sector debt (gross),% GDP	116.5	123.3	129.0	132.5	132.7	132.7	131.5	131.0
of which domestic public debt, % GDP	-	-	-	-	-	-	-	-
of which external public debt,% GDP	-	-	-	-	-	-	-	-
% domestic public debt held by non-residents	43.7	35.1	36.7	36.0	37.9	n/a	n/a	n/a
Public debt held by the central bank, % GDP	-	-	-	-	-	-	-	-
Balance of payments								
Trade balance, EUR bn	-19	17	36	47	54	56	50	47
Exports, EUR bn	364	377	379	390	405	411	420	431
Imports, EUR bn	382	361	343	342	353	354	370	384
Current account balance, EUR bn	-49.3	-5.8	15.4	30.5	26.6	33.3	28.8	29.4
as % of GDP	-3.0	-0.4	1.0	1.9	1.6	2.0	1.8	1.7
Foreign direct investment (net), EUR bn	12.4	5.3	0.6	2.3	0.9	2.0	2.0	2.0
Total FX reserves, EUR bn	-	-	-	-	-	-	-	-
Foreign exchange reserves excl gold, EUR bn	-	-	-	-	-	-	-	-
Total FX reserves, % GDP	-	-	-	-	-	-	-	-
Total external debt, % GDP	112.7	119.4	119.1	124.4	126.3	129.7	130.5	131.3
Net International Investment Position, % GDP	-19.2	-23.9	-25.3	-24.5	-23.6	-19.1	-18.3	-17.4
Credit ratings								
Moody's	A2	Baa2	Baa2	Baa2	Baa2	Baa2	n/a	n/a
S&P	A	BBB+	BBB	BBB-	BBB-	BBB-	n/a	n/a
Fitch	A+	A-	BBB+	BBB+	BBB+	BBB+	n/a	n/a

Source: Haver, Eurostat, European Commission, Reuters Eikon, IMF, UBS estimates

Spain

- **GDP growth to decelerate from 3.2% in 2016 (upgraded from 2.8%) to 2.3% in 2017 (previously 1.9%) and 1.9% in 2018**
- **Spain to remain the fastest growing of the major Eurozone countries**
- **Fiscal consolidation and labour-market reform remain key challenges**

Growth to decelerate, but remain high relative to the other big Eurozone countries

Economic momentum remains surprisingly strong thanks to an improving labour market, accommodative fiscal conditions and external trade supported by strong tourism. We have raised our GDP growth forecast from 2.8% to 3.2% for 2016 and from 1.9% to 2.3% for 2017. It is encouraging that the recent period of political uncertainty does not seem to have taken a substantial toll on growth. For 2018, we forecast a deceleration to 1.9%, driven by a number of factors. First, similar to other European countries, the pick-up in oil prices and inflation will likely create headwinds to household real income growth. Second, the improvement in labour markets is likely to lose some steam. Third, fiscal policy, which has been growth-supportive in recent years, will have to tighten. In more abstract terms, Spain has grown well above its potential output growth rate (estimated at less than 1%) in recent years. But, by definition, above-potential growth cannot be sustained forever; as such, a certain deceleration in Spanish growth seems almost inevitable – unless potential growth itself is being raised. But even then, Spain should be able to maintain the highest growth rate among the bigger Eurozone countries.

Spain has no fiscal policy margin

Fiscal policy is likely to be a headwind to growth over the coming years. Although the deadline for Spain to bring its budget deficit below 3% of GDP (and hence exit the European Commission's "Excessive Deficit Procedure") has already been postponed twice in recent years, the EC this year granted Spain another two-year extension, to 2018. Following a higher-than-targeted budget deficit of 5.1% of GDP in 2015, the Commission proposed amended budget deficit targets of 4.6% of GDP for 2016, 3.1% for 2017 and 2.2% of GDP in 2018. Consequently, the government will remain under pressure to consolidate public finances further. We think this will have to include a reduction in expenditure (relative to GDP), which has been avoided so far. In other words, Spain has no fiscal policy margin.

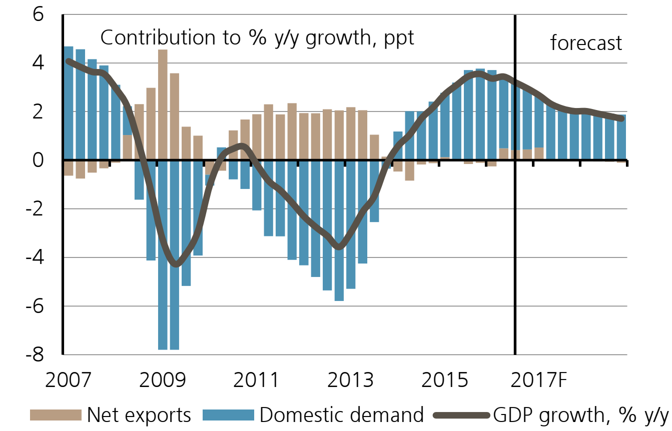
Can Spain achieve further declines in unemployment without new labour-market reforms?

A key question for economic performance going forward will be whether Spain can make further progress in reducing its very high unemployment rate. After all, labour-market trends are a major driver of household consumption, which represents 55% of GDP; obviously, this would also have a big impact on public finances. Unemployment dropped from 26% in 2013 to 19.5% in August 2016. Although the 2012 labour market reform will have contributed to this outcome, we feel that more reforms will be needed to sustain the trend of declining unemployment. According to IMF estimates, the level of *structural* unemployment in Spain is 16.5% – hence, a substantial decline in unemployment below this level cannot be achieved just by faster growth. Instead, greater flexibility in labour contracts, wage-setting and active labour-market policies will be required.

Downside risk: slow fiscal consolidation and related vulnerabilities

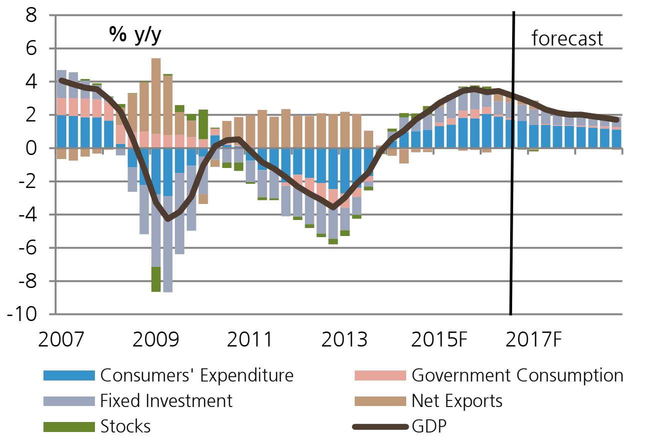
Key downside risks for the outlook, in our view, are slow progress in budget consolidation and structural reforms by a politically weak (minority) government. Given Spain's large stock of public debt (100% of GDP), this could expose Spanish markets to weakness in an environment of rising global yields. Upside risks could come from a better-than-expected external environment, for both tourism and good exports, or an ongoing, faster-than-expected decline in unemployment.

Figure 148: Real GDP (% y/y) and contributions (ppt)



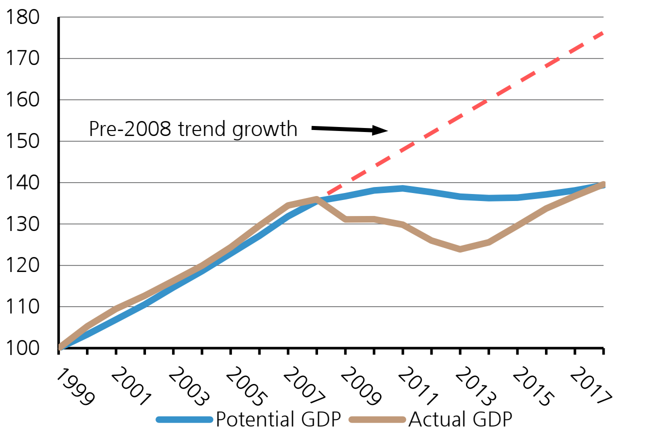
Source: Haver, UBS estimates

Figure 149: GDP (% y/y) and contributions to growth (ppt)



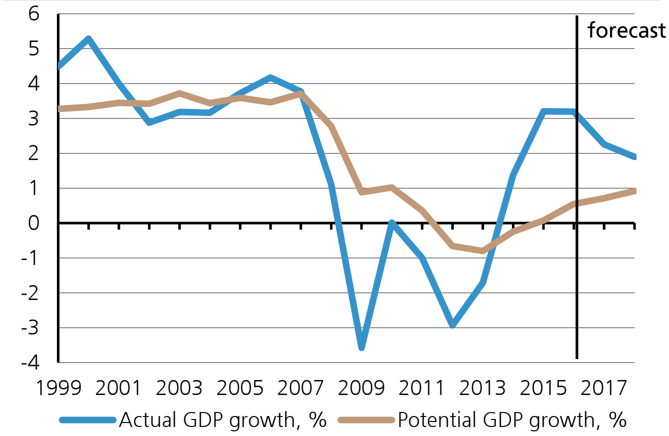
Source: Haver, UBS estimates

Figure 150: Actual and potential GDP (indexed, 1999 = 100)



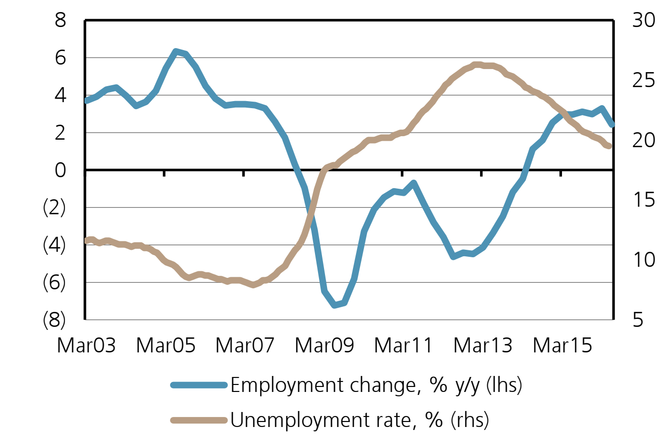
Source: European Commission estimates, Haver, UBS

Figure 151: Actual and potential real GDP growth (%)



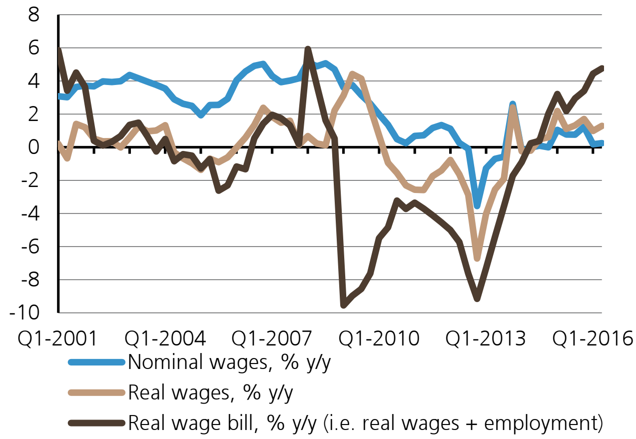
Source: European Commission estimates, Haver, UBS. UBS forecasts for actual GDP growth.

Figure 152: Employment growth and unemployment rate



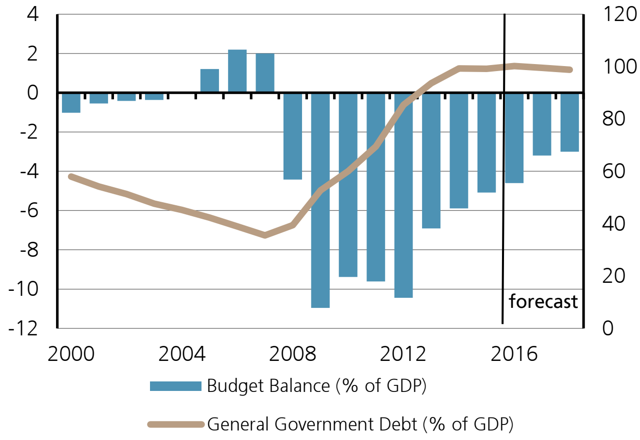
Source: Haver, UBS

Figure 153: Wage growth, nominal and real (% y/y)



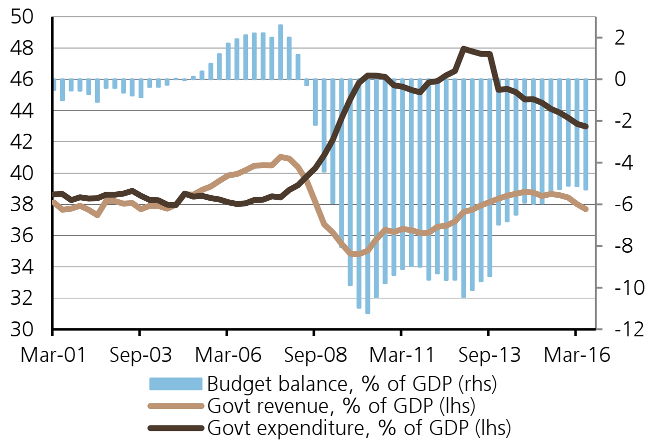
Source: Haver, UBS

Figure 154: Budget deficit and public debt



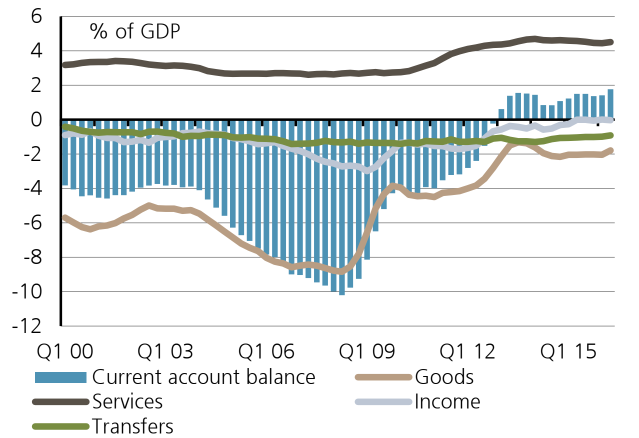
Source: Haver, UBS estimates

Figure 155: Government revenue, expenditure & balance



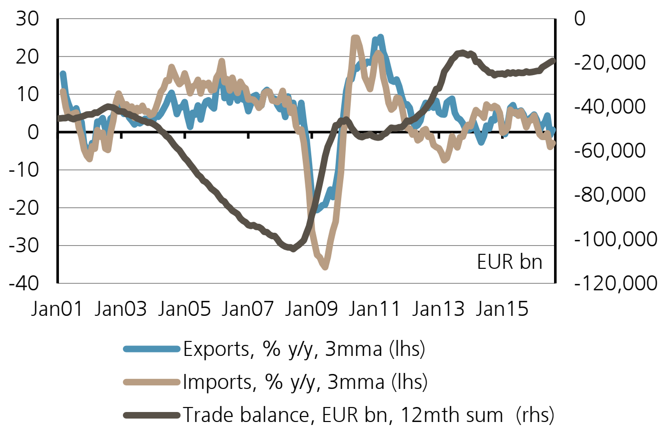
Source: Haver, UBS

Figure 156: Current account and sub-components



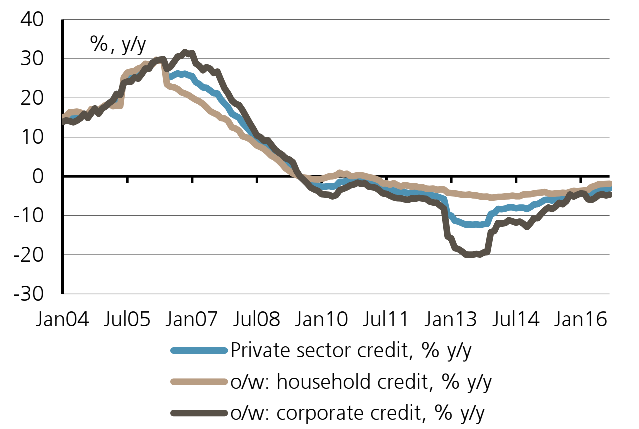
Source: Haver, UBS

Figure 157: Foreign trade



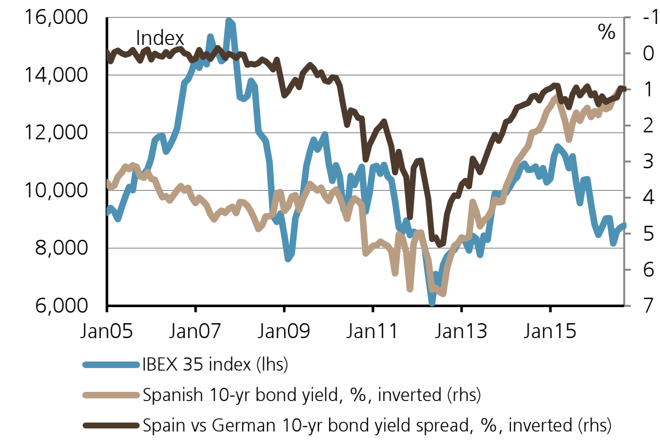
Source: European Commission estimates, UBS

Figure 158: Credit growth



Source: Haver, UBS

Figure 159: Stock market, bond yields and spreads



Source: Haver, UBS

SPAIN	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	1070	1040	1026	1037	1076	1119	1161	1206
GDP, USD bn	1490	1337	1362	1378	1193	1252	1327	1425
GDP per capita, USD	31876	28584	29236	29650	25706	27016	28655	30811
Real GDP growth, %	-1.0	-2.9	-1.7	1.4	3.2	3.2	2.3	1.9
Private consumption, % y/y	-2.4	-3.5	-3.1	1.6	2.9	3.3	2.5	2.2
Government consumption, % y/y	-0.3	-4.7	-2.1	-0.3	2.0	0.8	0.0	0.6
Gross Fixed Capital formation, % y/y	-6.9	-8.6	-3.4	3.8	6.0	4.4	3.7	2.9
Exports, % y/y	7.4	1.1	4.3	4.2	4.9	6.1	4.6	3.3
Imports, % y/y	-0.8	-6.4	-0.5	6.5	5.6	5.9	4.8	3.9
Unemployment rate, %	21.4	24.8	26.1	24.4	22.1	19.9	18.4	17.3
Industrial Production (%)	-1.7	-6.8	-1.8	1.2	3.3	1.9	2.9	2.8
Prices, interest rates and money								
HICP inflation, % y/y (average)	3.0	2.4	1.5	-0.2	-0.6	-0.4	1.6	1.7
HICP inflation, % y/y (year-end)	2.3	3.0	0.3	-1.1	-0.1	1.0	1.3	1.7
Broad money M2, % y/y (end-year)	-5.2	0.2	-1.7	2.6	7.3	8.0	8.4	8.5
Domestic private credit, % y/y	-4.1	-9.8	-9.6	-7.2	-4.2	-2.5	-0.5	0.5
Domestic bank credit/GDP	169.1	160.4	145.4	135.5	124.5	117.7	112.4	109.0
Policy rate, % (end-year)	1.00	0.75	0.25	0.05	0.05	0.00	0.00	0.00
10 year bond yield, % (year-end)	5.27	5.26	4.12	1.61	1.77	1.25	1.40	1.70
USD/EUR (year-end)	1.29	1.32	1.38	1.21	1.09	1.10	1.13	1.17
Fiscal accounts								
General government budget balance, % GDP	-9.6	-10.4	-6.9	-5.9	-5.1	-4.6	-3.2	-3.0
Revenue, % GDP	36.2	37.5	38.2	38.6	38.2	38.2	38.3	38.5
Expenditure, % GDP	45.8	48.0	45.1	44.5	43.3	42.8	41.5	41.5
of which interest expenditure, % GDP	2.5	3.0	3.4	3.4	3.1	2.9	2.7	2.7
Primary balance, % GDP	-7.2	-7.5	-3.5	-2.5	-2.0	-1.7	-0.5	-0.3
Public sector debt (gross),% GDP	69.5	85.4	93.7	99.3	99.2	100.2	99.5	98.8
of which domestic public debt, % GDP	-	-	-	-	-	-	-	-
of which external public debt,% GDP	-	-	-	-	-	-	-	-
% domestic public debt held by non-residents	42.6	29.1	40.0	42.5	50.4	n/a	n/a	n/a
Public debt held by the central bank, % GDP	-	-	-	-	-	-	-	-
Balance of payments								
Trade balance, EUR bn	-44	-29	-14	-22	-22	-19	-24	-26
Exports, EUR bn	216	224	236	239	250	259	267	276
Imports, EUR bn	260	253	250	261	272	278	291	301
Current account balance, EUR bn	-34.0	-2.4	15.6	11.2	14.7	16.8	15.6	13.0
as % of GDP	-3.2	-0.2	1.5	1.1	1.4	1.5	1.3	1.1
Foreign direct investment (net), EUR bn	9.2	-21.1	-18.5	8.0	29.4	15.7	12.0	12.0
Total FX reserves, EUR bn	-	-	-	-	-	-	-	-
Foreign exchange reserves excl gold, EUR bn	-	-	-	-	-	-	-	-
Total FX reserves, % GDP	-	-	-	-	-	-	-	-
Total external debt, % GDP	160.3	166.2	159.8	167.7	168.5	169.5	165.5	161.5
Net International Investment Position, % GDP	-91.9	-89.9	-94.3	-97.5	-89.9	-87.0	-84.0	-81.0
Credit ratings								
Moody's	A1	Baa3	Baa3	Baa2	Baa2	Baa2	n/a	n/a
S&P	AA-	BBB-	BBB-	BBB	BBB+	BBB+	n/a	n/a
Fitch	AA-	BBB	BBB	BBB+	BBB+	BBB+	n/a	n/a

Source: Haver, Eurostat, European Commission, Reuters Eikon, IMF, UBS estimates

UK

- **GDP growth to halve from 2.0% in 2016 to 1.0% in 2017, and to slow further to 0.7% in 2018**
- **Inflation to accelerate as a result of the weakness of the pound, with CPI averaging 2.8% in both 2017 and 2018**
- **Anaemic growth and a softening labour market to trigger more monetary easing around mid-2017**

Recovery continuing…so far

The UK economy has thus far continued the steady momentum that has seen fifteen consecutive quarters of positive growth, averaging +0.6% q/q, since the first quarter of 2013. The resilience of activity in the wake of the referendum on EU membership in June 2016 has been primarily a result of the very large depreciation of sterling, which has declined by 20% on a trade-weighted basis over the past year. While that has boosted net trade dynamics and benefitted domestic producers and retailers competing with international rivals, it is already showing up in rapidly accelerating producer prices, and is starting to feed through to CPI as well.

Rising CPI and a weaker labour market will squeeze the consumer

At the same time as consumer prices continue to rise more quickly next year, there is likely to be a softening of the domestic labour market, as companies activate the more defensive hiring plans they have warned of since the referendum. While some doubt remains about the timing and exact mechanisms through which the government will trigger Article 50 of the Lisbon Treaty and thus begin the formal two-year journey to the UK's exit from the EU, we still expect it to happen by the end of Q1 2017.

Mounting uncertainty will hit investment and hiring

This is the likely catalyst for hiring and investment to cool, and we forecast a gradual drift higher in unemployment from 5.0% at present to 5.5% in 2017 and 6.3% by the end of 2018. Nominal earnings are likely to stay soft in such an environment, and real wages should therefore be squeezed hard. Consumption and investment are both likely to slow next year, and are the key drivers of our expectation of weaker growth over the next two years.

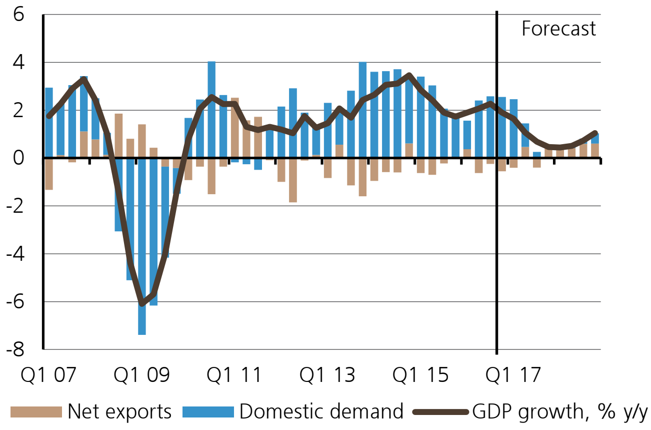
We expect more monetary easing to be required in 2017

Having eased monetary policy aggressively in the aftermath of the EU referendum, and signalled an expectation in August that more action would soon be needed, the MPC subsequently reverted to a neutral bias in November. The better outturn for growth in Q3, together with an upward revision to its CPI forecast, prompted this change of stance. However, we still view further easing as likely to be required by around the middle of 2017, and expect a cut in Bank Rate from 0.25% to 0.10% and a further £60bn of Gilt purchases to be endorsed. As in late 2011, when CPI was well above target but downside growth risks proliferated, we expect the MPC to focus on medium-term downside threats to its inflation target rather than be hamstrung by immediate and near-term upside price pressures.

Fiscal policy may be eased, but only modestly

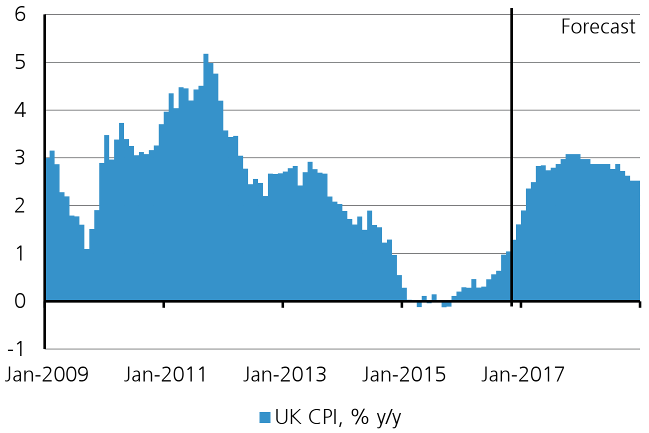
There are likely to be some changes made to the stance of fiscal policy too, but we expect any stimulus to be modest in scale, at least for the time being. The government continues to make clear its intention to eliminate the budget deficit when possible, even if it acknowledges a near-term need to allow automatic stabilisers to fully deploy and is open to the idea of a degree of front-loading of scheduled infrastructure spending. A more aggressive fiscal response is only likely to be considered if domestic growth slows more sharply than is currently expected.

Figure 160: Real GDP (% y/y) and contributions (ppt)



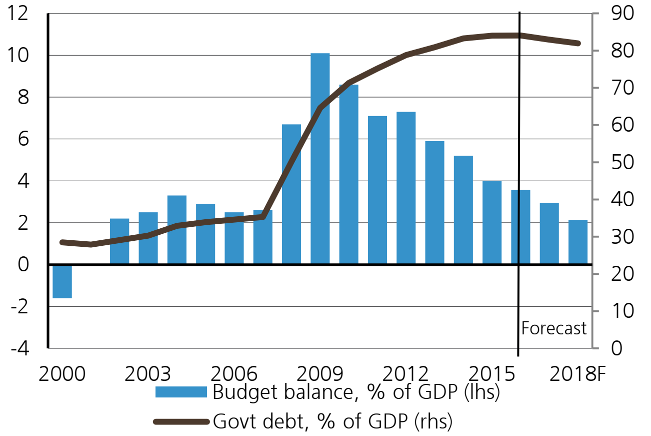
Source: ONS, UBS estimates

Figure 161: Inflation, % y/y



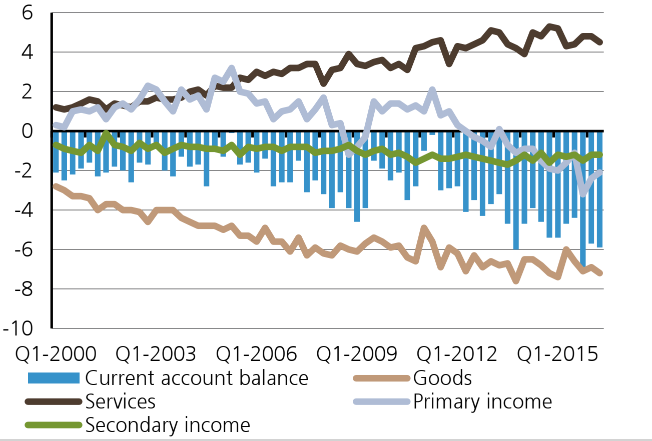
Source: Haver, UBS estimates

Figure 162: Budget deficit and public debt



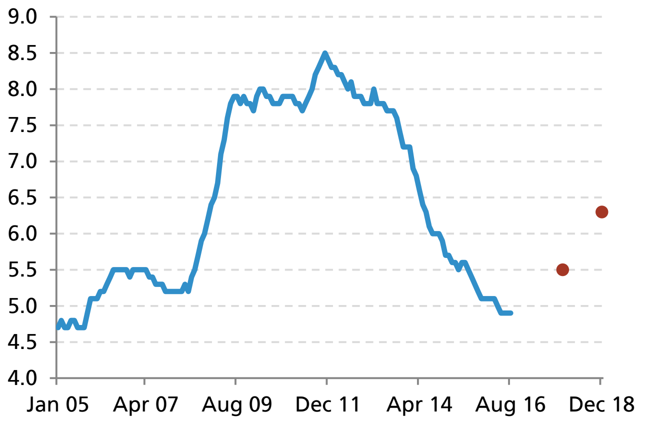
Source: Haver, UBS estimates

Figure 163: Current account and sub-components



Source: Haver, UBS

Figure 164: UK unemployment rate (%) and UBS forecasts

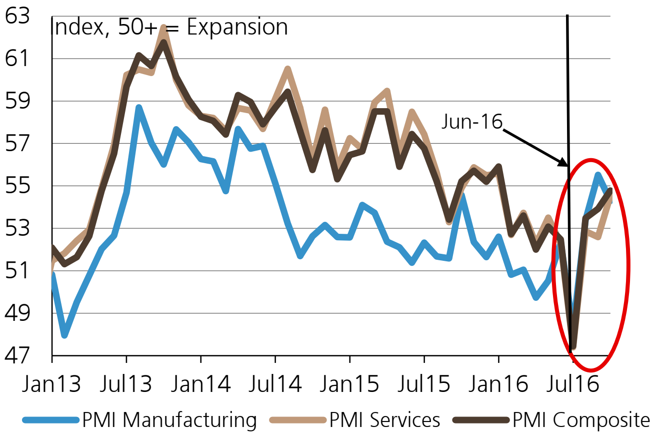


Source: ONS, UBS

Figure 165: Household saving ratio (% disposable income)

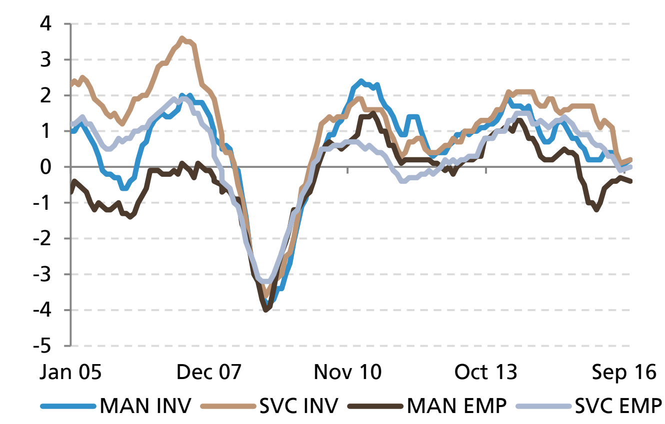
Source: ONS, UBS

Figure 166: Manufacturing and services PMI



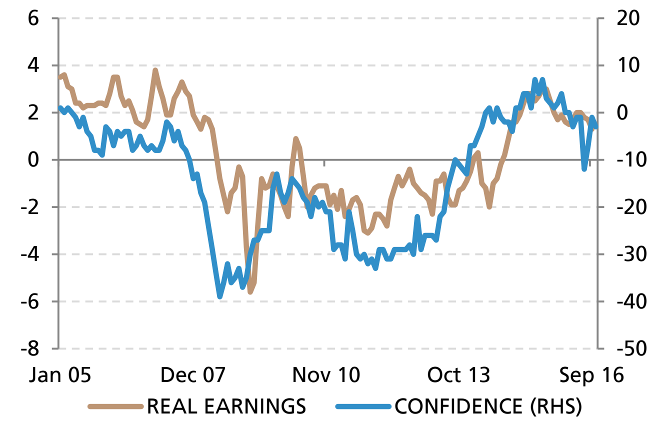
Source: Markit, Haver, UBS

Figure 167: Investment and employment intentions



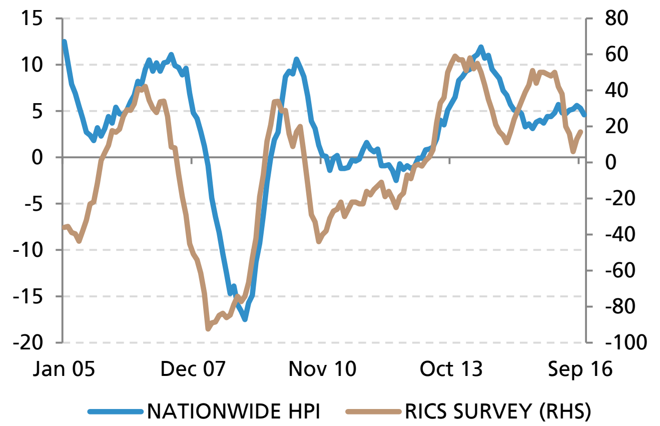
Source: Bank of England Agents' Scores, UBS

Figure 168: Consumer confidence and real earnings



Source: ONS, GfK, UBS

Figure 169: House prices (% y/y) and RICS survey

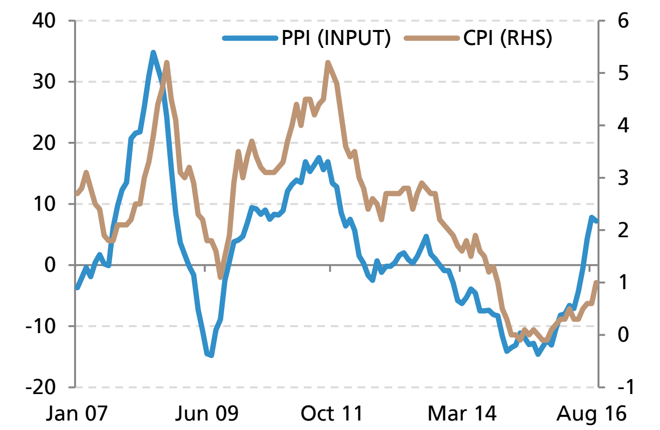


Source: Nationwide, RICS, UBS

Figure 170: Trade-weighted sterling index 2007-2016

Source: Bank of England, UBS

Figure 171: Input producer prices and CPI (% y/y)



Source: ONS, UBS

UNITED KINGDOM	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	1628	1675	1740	1822	1871	1941	2020	2091
GDP, USD bn	2569	2680	2743	2988	2831	2560	2361	2470
GDP per capita, USD	40602	42065	42791	46250	43488	39035	35751	37152
Real GDP growth, %	1.5	1.3	1.9	3.1	2.2	2.0	1.0	0.7
Private consumption, % y/y	-0.5	1.7	1.6	2.2	2.5	2.9	1.3	0.3
Government consumption, % y/y	0.2	1.7	0.3	2.3	1.5	1.4	2.0	2.0
Gross Fixed Capital formation, % y/y	1.9	2.3	3.2	6.7	3.4	1.1	0.6	-1.8
Exports, % y/y	5.8	0.6	1.1	1.5	4.5	2.5	1.7	2.0
Imports, % y/y	0.8	2.9	3.4	2.5	5.4	3.1	0.8	0.3
Unemployment rate, %	8.1	8.0	7.6	6.2	5.4	5.0	5.5	6.3
Industrial Production (%)	-0.6	-2.7	-0.7	1.5	1.3	1.0	-0.1	0.8
Prices, interest rates and money								
CPI inflation, % y/y (average)	4.5	2.8	2.6	1.5	0.0	0.7	2.8	2.8
CPI inflation, % y/y (year-end)	4.6	2.7	2.1	0.9	0.1	1.3	3.1	2.6
Broad money M2, % y/y (end-year)	-2.2	0.4	1.7	0.1	2.5	7.0	5.2	4.4
Domestic private credit, % y/y	-1.5	-0.5	-0.7	0.8	2.2	4.0	3.6	3.4
Domestic bank credit/GDP	97.8	94.2	90.0	86.7	86.3	87.1	86.9	86.7
BoE Repo rate, % (end-year)	0.50	0.50	0.50	0.50	0.50	0.25	0.10	0.10
10 year bond yield, % (year-end)	2.28	1.81	2.79	2.07	1.88	1.20	1.40	1.65
GBPUSD (year-end)	1.55	1.62	1.65	1.56	1.48	1.22	1.13	1.17
EURGBP (year-end)	0.84	0.81	0.83	0.78	0.74	0.90	1.00	1.00
Fiscal accounts								
General government budget balance, % GDP	-7.1	-7.3	-5.9	-5.2	-4.0	-3.6	-2.9	-2.1
Revenue, % GDP	36.7	36.0	35.9	35.7	36.1	36.2	36.1	35.9
Expenditure, % GDP	43.8	43.2	41.8	41.0	40.1	39.7	39.0	38.0
of which interest expenditure, % GDP	3.2	2.9	2.9	2.7	2.3	2.3	2.2	2.1
Primary balance, % GDP	-4.7	-5.3	-4.0	-3.6	-2.4	-1.5	-1.2	-1.0
Public sector debt (gross),% GDP	75.2	78.8	80.9	83.3	84.0	84.1	82.9	82.0
of which domestic public debt, % GDP	-	-	-	-	-	-	-	-
of which external public debt,% GDP	-	-	-	-	-	-	-	-
% domestic public debt held by non-residents	27.3	31.9	29.7	28.4	30.9	n/a	n/a	n/a
Public debt held by the central bank, % GDP	15.9	22.7	22.1	21.3	21.4	23.2	25.8	24.9
Balance of payments								
Trade balance, GBP bn	-95	-111	-121	-123	-126	-127	-110	-102
Exports, GBP bn	308	302	303	293	283	293	300	307
Imports, GBP bn	403	413	424	415	410	419	410	409
Current account balance, GBP bn	-29.1	-61.4	-76.4	-85.0	-100.2	-104.7	-90.0	-82.0
as % of GDP	-1.8	-3.7	-4.4	-4.7	-5.4	-5.4	-4.5	-3.9
Foreign direct investment (net), GBP bn	-33.3	22.0	7.2	117.4	75.2	62.7	-40.0	-40.0
Total FX reserves, USD bn	94	105	109	109	130	147	151	155
Foreign exchange reserves excl gold, USD bn	78	89	97	97	120	134	137	140
Total FX reserves, % GDP	3.6	3.9	4.0	3.7	4.6	5.7	6.4	6.3
Total external debt, % GDP	385.8	374.1	340.8	325.5	297.8	305.0	308.0	312.0
Net International Investment Position, % GDP	-5.9	-22.4	-16.2	-17.6	-14.4	-13.9	-11.0	-8.4
Credit ratings								
Moody's	Aaa	Aaa	Aa1	Aa1	Aa1	Aa1	n/a	n/a
S&P	AAA	AAA	AAA	AAA	AAA	AA	n/a	n/a
Fitch	AAA	AAA	AA+	AA+	AA+	AA	n/a	n/a

Source: Haver, BoE, ONS, Reuters Eikon, IMF, UBS estimates

Switzerland

- **GDP to grow by 1.5% in 2016, 1.3% in 2017 and 1.6% in 2018**
- **Inflation projected to turn positive in 2017**
- **SNB to remain on hold until well into 2018**

Continued recovery and growth above the Eurozone in 2018

GDP growth in Switzerland has accelerated further since its recent low in Q1 2015, when the franc appreciated sharply and quarterly growth was negative. We expect real GDP to increase by 1.5% in 2016 – almost twice its rate in 2015. Improved growth in Switzerland's main trading partners, notably the Eurozone, and solid private consumption growth, are key drivers. Looking ahead, we expect some moderation in growth in 2017 to 1.3%, reflecting weaker investment due to the uncertainty regarding ongoing talks with the EU about potential restrictions on the free movement of labour, as well as the broader impact of negotiations on the UK's departure from the EU. In 2018, we expect growth to rise back to around its trend level of 1.6%. This would be the first time since 2014 that Switzerland has grown more strongly than the Eurozone, owing to its higher growth potential (an estimated 1.6-1.7%).

Inflation has risen in 2016 and should turn positive in early 2017

Inflation has risen rapidly in 2016, from -1.3% y/y in January to -0.2% in October, reflecting the fading impact of the franc's strengthening in 2015 and energy base effects. We expect inflation to turn positive around the turn of the year and to rise to around 1.2% by the end of 2018. The slight increase in unemployment that we expect for 2017, due to lagged effects of below-potential growth, should help to moderate the pace of underlying inflation somewhat.

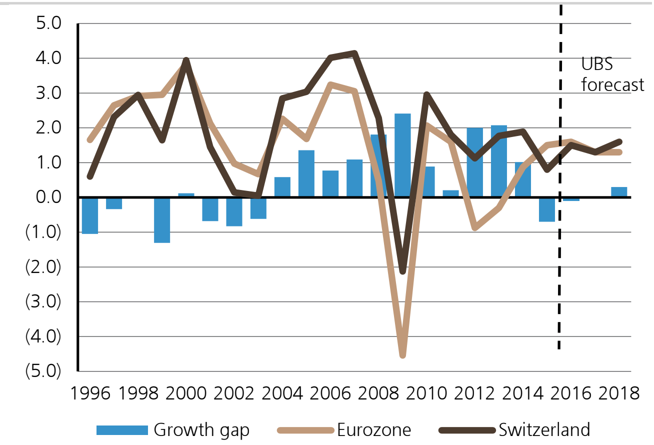
SNB to keep intervening and maintaining policy rates at current levels until 2018

The Swiss National Bank continues to charge the most negative policy interest rates on sight deposits across the central banks in the advanced economies. This policy is aimed at lowering appreciation pressures on the franc. The SNB regularly stresses that it views the currency as overvalued, and continues to intervene moderately in the foreign-exchange market to weaken it. Given increased evidence of the adverse side-effects of negative rates – such as increased demand for high-denomination cash – we view the hurdle for further SNB rate cuts as fairly high. In our view, this would only be an option if substantial interventions were necessary to prevent the franc from falling below the 1.05-1.07 range against the EUR. ECB policy is seen as a key determinant for the franc and we think appreciation pressure on the Swiss currency is unlikely to abate fully until the ECB has phased out its asset purchase program and starts normalising its policy stance. For this reason, we believe the first SNB rate hike is unlikely to occur before around the middle of 2018, by which time the ECB is expected to have tapered its QE program.

Uncertainty about prolonged Swiss-EU discussions on immigration restrictions could weigh on the outlook

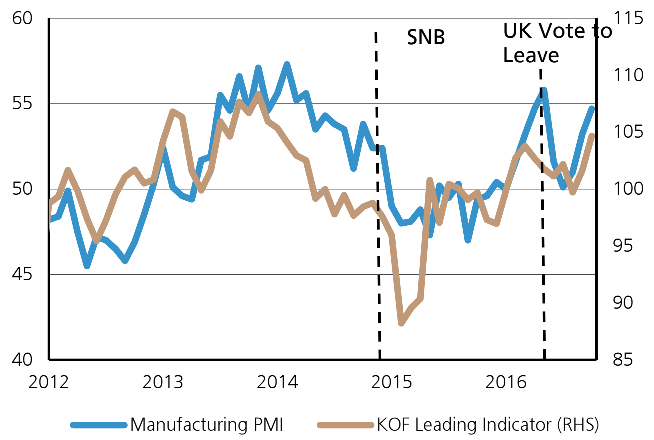
A key source of uncertainty regarding the outlook are the ongoing talks with the EU about potential restrictions on the free movement of labour. The 2014 referendum on restricting immigration into Switzerland envisaged a three-year timescale on implementing certain immigration limits. The latest Swiss proposal involves granting Swiss nationals slight advantages on the labour market, but thus far no mutually agreeable solution has been found. Business sentiment has not shown any signs of weakness so far, but a profound weakening of Swiss-EU relations would likely weigh on confidence and firms' investment plans. In addition, a pick-up in safe-haven flows into the franc, perhaps in response to a global shock event, would weigh on growth and complicate monetary policy-making.

Figure 172: Real GDP growth



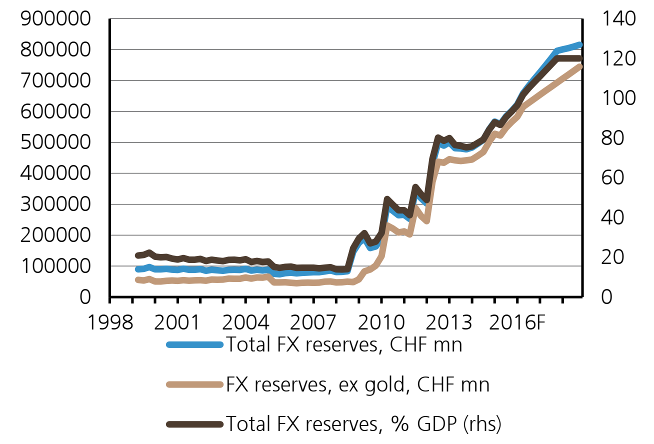
Source: Haver, UBS.

Figure 173: PMI and KOF leading indicator



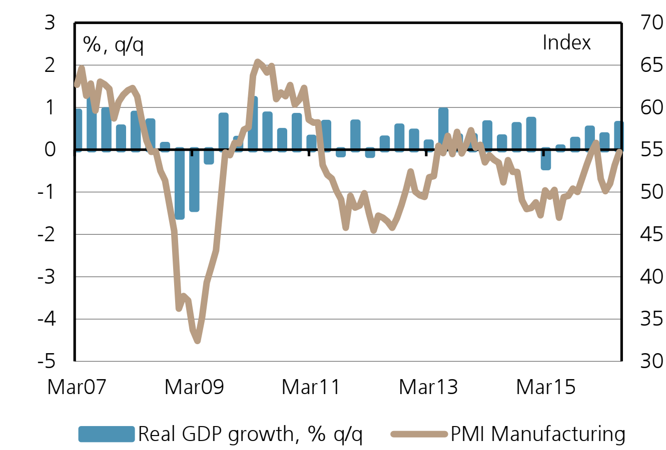
Source: Haver, UBS.

Figure 174: Switzerland - FX reserves



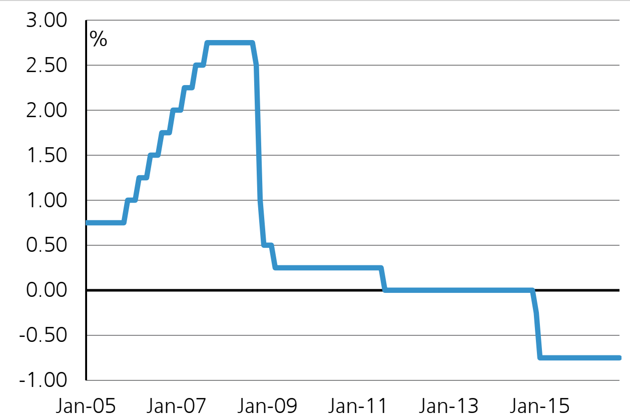
Source: Haver, UBS

Figure 175: GDP growth and PMI



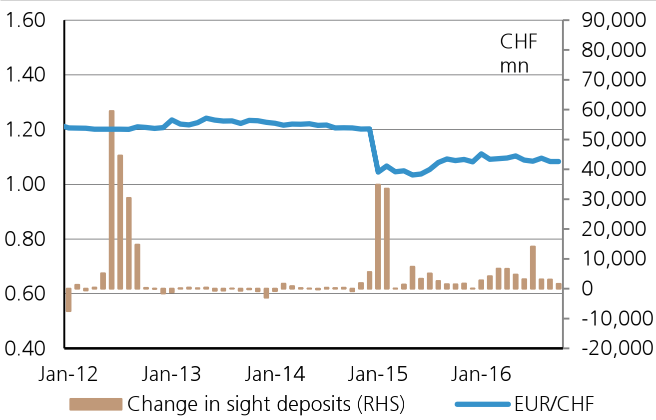
Source: Haver, UBS

Figure 176: SNB policy rate



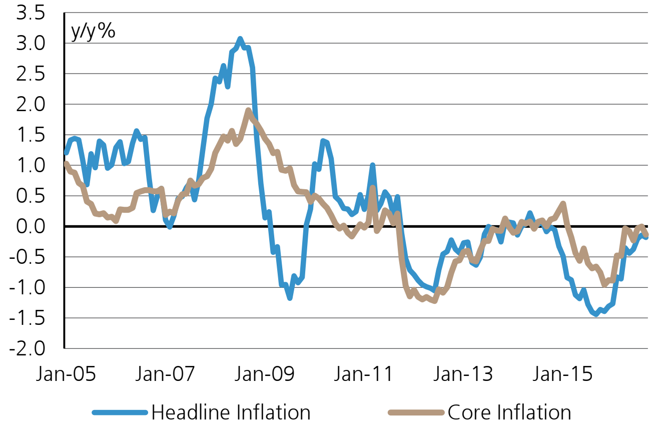
Source: Haver, UBS

Figure 177: Swiss franc and SNB interventions



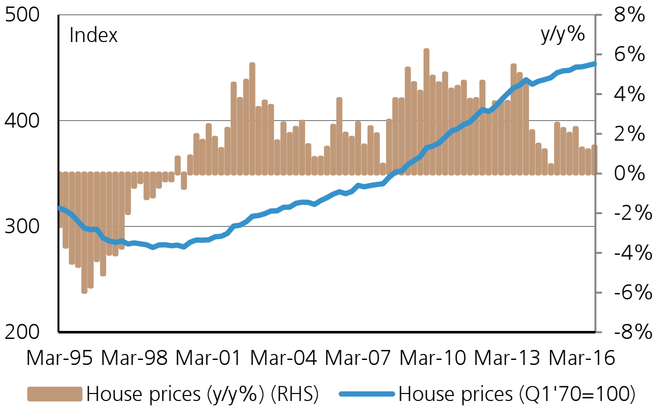
Source: Haver, UBS

Figure 178: Inflation



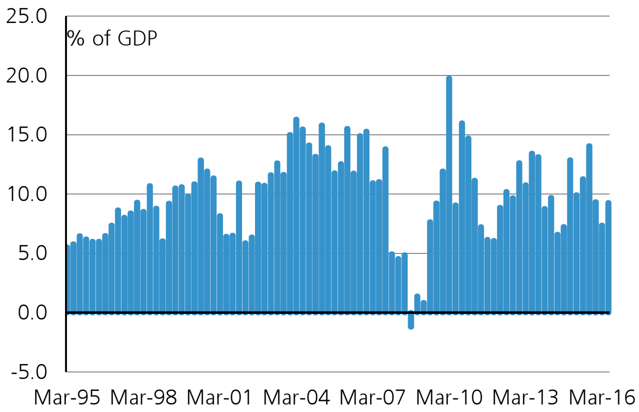
Source: Haver, UBS

Figure 179: House prices



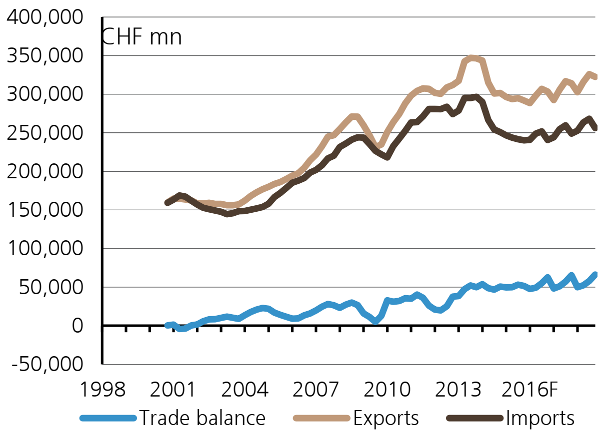
Source: Haver, UBS

Figure 180: Current account balance



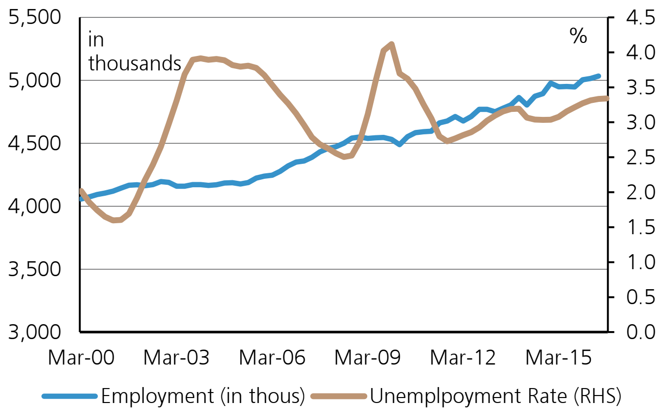
Source: Haver, UBS

Figure 181: Switzerland external sector



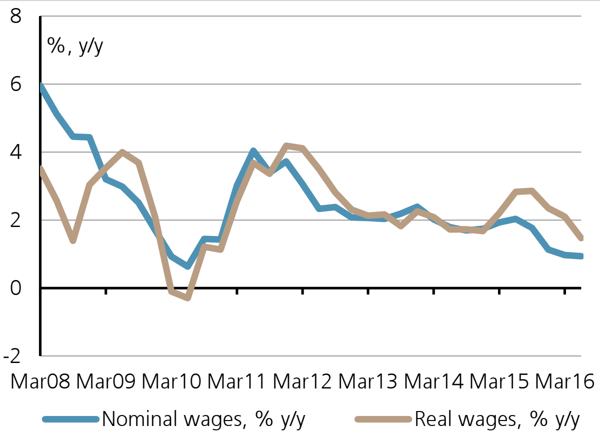
Source: Haver, UBS

Figure 182: Labour market



Source: Haver, UBS

Figure 183: Wage growth



Source: Haver, UBS

SWITZERLAND	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	618	623	635	644	645	652	663	680
GDP, USD bn	698	665	685	704	671	668	688	715
GDP per capita, USD	88258	83164	84717	86000	81564	80870	82881	85180
Real GDP growth, %	1.9	1.1	1.8	2.0	0.8	1.5	1.3	1.6
Private consumption, % y/y	0.9	2.6	2.2	1.2	1.0	1.0	1.1	1.2
Government consumption, % y/y	2.1	2.1	2.3	1.5	2.2	2.3	1.2	0.9
Gross Fixed Capital formation, % y/y	4.3	2.9	1.2	2.8	1.5	2.3	0.6	2.5
Exports, % y/y	3.7	3.1	0.1	5.1	2.0	4.9	2.7	3.0
Imports, % y/y	4.9	4.5	1.5	3.1	2.8	3.1	2.6	3.2
Unemployment rate, %	2.8	3.0	3.2	3.0	3.3	3.4	3.5	3.4
Industrial Production (%)	3.6	2.6	0.8	1.4	-2.5	0.5	1.5	1.5
Prices, interest rates and money								
CPI inflation, % y/y (average)	0.2	-0.7	-0.2	0.0	-1.1	-0.4	0.4	0.9
CPI inflation, % y/y (year-end)	-0.7	-0.4	0.1	-0.3	-1.3	0.0	0.6	1.2
Broad money M2, % y/y (end-year)	9.7	10.3	3.1	2.6	1.4	3.5	3.9	4.3
Domestic private credit, % y/y								
Domestic bank credit/GDP	177.6	184.4	189.6	203.3	206.2	210.0	212.0	214.0
Policy rate, % (end-year)	0.00	0.00	0.00	-0.25	-0.75	-0.75	-0.75	-0.50
10 year bond yield, % (year-end)	0.69	0.46	1.09	0.37	-0.09	-0.20	-0.05	0.15
USD/CHF (year-end)	0.91	0.93	0.90	0.96	0.99	0.98	0.98	0.97
EUR/CHF (year-end)	1.23	1.21	1.23	1.20	1.08	1.08	1.11	1.13
Fiscal accounts								
General government budget balance, % GDP	0.5	0.0	-0.2	-0.2	-0.2	0.2	0.2	0.0
Revenue, % GDP	33.7	33.5	33.7	33.5	33.4	33.9	33.8	33.5
Expenditure, % GDP	32.9	33.3	34.0	33.7	33.7	33.7	33.6	33.5
of which interest expenditure, % GDP	0.8	0.7	0.6	0.6	0.6	0.1	0.1	0.2
Primary balance, % GDP	1.5	1.0	0.3	0.4	0.3	0.3	0.3	0.2
Public sector debt (gross),% GDP	46.0	46.6	46.4	45.7	45.7	44.7	43.7	42.6
of which domestic public debt, % GDP	37.3	32.4	32.3	27.2	23.7	23.7	20.7	18.1
of which external public debt,% GDP	8.8	14.3	14.0	18.4	22.0	21.0	23.0	24.5
% domestic public debt held by non-residents	7.4	8.3	10.5	10.6	11.2	12.5	13	13.5
Public debt held by the central bank, % GDP	1.3	1.3	1.3	1.4	1.3	1.4	1.4	1.4
Balance of payments								
Trade balance, CHF bn	26.1	37.7	49.8	50.8	51.6	62.8	65.4	66.2
Exports, CHF bn	307	312	346	302	292	303	314	322
Imports, CHF bn	281	274	297	251	240	241	249	256
Current account balance, CHF bn	47.4	64.3	73.2	58.5	71.9	60.2	59.4	60.8
as % of GDP	7.7	10.3	11.5	9.1	11.1	9.2	9.0	8.9
Foreign direct investment (net), CHF bn	17.5	25.6	34.6	-10.0	1.4	25.8	25.8	25.8
Total FX reserves, CHF bn	319	490	478	542	602	704	796	816
Foreign exchange reserves excl gold, CHF bn	262	434	442	502	566	641	693	745
Total FX reserves, % GDP	51.6	78.6	75.2	84.1	93.3	108.0	120.0	120.0
Total external debt, % GDP	220.8	238.4	234.0	247.9	259.4	256.0	258.0	261.0
Net International Investment Position, % GDP	133.4	124.7	102.1	103.6	94.5	103.7	112.7	121.6
Credit ratings								
Moody's	Aaa	Aaa	Aaa	Aaa	Aaa	Aaa	n/a	n/a
S&P	AAA	AAA	AAA	AAA	AAA	AAA	n/a	n/a
Fitch	AAA	AAA	AAA	AAA	AAA	AAA	n/a	n/a

Source: Haver, European Commission, Reuters Eikon, IMF, UBS estimates

Gyorgy Kovacs
Economist
gyorgy.kovacs@ubs.com
+44-20-7568-7563

Anna Zadornova
Economist
anna.zadornova@ubs.com
+44-20-7567-4212

Jennifer Aslin
Associate Economist
jennifer.aslin@ubs.com
+44-20-7568-6585

Emerging Europe

UBS Research THESIS MAP

EMEA Economics – Outlook 2017/2018

PIVOTAL QUESTIONS

Q: What will drive the economic acceleration in EMEA in 2017 and 2018?

EMEA GDP growth is expected to pick up to 2.1% in 2017 and 2.4% in 2018 from 1.1% in 2016. The single most important driver of the cyclical upswing is Russia's moving out of the recession (2017 growth: +1.3%, 2018: +1.7%) on the back of higher oil prices and the revival of private consumption. Despite having the biggest improvement in growth Russia's absolute growth rates are at the lower end of the EMEA spectrum. However, in 2017, every EMEA country ex Russia (bar Turkey) is projected to pick up steam. In 2018, Kazakhstan, South Africa and Turkey should see additional acceleration.

Q: Which currencies are we bullish or bearish against the USD in 2017/18?

Our FX calls reflect the sustained increase in oil prices, somewhat higher global yields (Fed and ECB removing accommodation) and slowing China/weaker RMB. We are constructive on RUB and KZT on the back of oil prices. In CEE, we see the CZK and PLN appreciating against both EUR and USD, with the HUF mainly against USD. We remain cautious on TRY and ZAR: in Turkey this reflects a more challenging external financing situation, while in South Africa we believe that the current supporting factors could gradually dissipate and result in a further depreciation of the ZAR.

Q: What are the key macro implications of rising oil prices in EMEA?

The oil exporters (Russia, Kazakhstan and UAE) should enjoy rebounding growth, improving balance of payments and thus appreciating or stable exchange rates. This backdrop reduces the need for immediate fiscal consolidation and allows central banks to continue with rate cuts. As for energy importers, the widening external deficit would be the most problematic in Turkey. We would emphasize the inflationary impact of higher oil prices in CEE and South Africa, resulting in rate hikes in CEE and making it difficult for the SARB to cut rates.

Q: Which countries have fiscal / monetary room to offset an adverse external growth shock?

We see scope for fiscal easing in the Czech Republic, Hungary (because of low deficits), and potentially Russia, assuming that the oil-price recovery is not derailed. As regards monetary policy, a lot will depend on the nature of the shock, but in general we are sceptical whether any large-scale easing is deployable in Emerging EMEA. If the external growth shock would leave oil prices less affected, Russia could consider additional easing.

UBS VIEW

EMEA as a whole should benefit from the turnaround in Russia, though almost every country in EMEA should see some growth acceleration in 2017. The key risk factors are: oil-price shocks, slower global growth, faster increases in global yields and domestic (political) uncertainty.

EVIDENCE

Sequential data looks to begin to improve for the consumer, and many countries have moved away from their sequential bottom of Q1'16.

Emerging EMEA Outlook

Key global factors for EMEA

Key global factors: higher oil prices, tighter monetary conditions, only modest increase in 10Y yields and a softer USD

What are the most important characteristics of the global framework for EMEA?

1. **Oil prices should continue to rise towards $60 per barrel on average in 2017 and to $70 per barrel in 2018 (end-17: $65 and end-18: $72).** In the first place, the slowly rising oil price is good news for oil-exporting EMEA (Russia, Kazakhstan, UAE), but should increase the current account deficit for Turkey, raising the reliance on external financing flows. Higher oil prices should also add to inflationary pressures in Turkey, South Africa and CEE; for oil exporters with floating exchange rates, currency appreciation will likely work in the opposite direction, taming inflation pressures.

2. **Less supportive rate environment: tighter monetary conditions in the US and Europe.** Rising energy prices should aid the recovery in headline inflation in the major economies in 2017 and in 2018. This together with better economic conditions should allow the US Fed to raise rates by 25bps to 0.63% in December 2016, followed by two 25bps rate hikes in 2017 to 1.13% and then by another two in 2018 to 1.63%. Our Fed funds rate forecast is more hawkish than the current pricing of 0.84% for end-17 and 1.185% for end-18 (at the time of writing). The support from accommodative monetary conditions in the Eurozone is also likely to wane as we head into 2018. We expect the ECB to extend its QE program by six months to September and then start to taper. In general, UBS's view of major central banks starting to tighten policy implies that the scope for further monetary accommodation for most of the EMEA will narrow rapidly, bar Russia and Kazakhstan.

3. **However, UBS projects only relatively modest increases in longer-term yields.** UBS expects US 10Y Treasury yield at 2.25% by end-17 and at 2.50% by end-18, while in the Euro Area UBS expects 10Y bunds at 0.5% by end-17 and 0.9% by end-18. Importantly, not only global yields but volatility is also expected to be higher in 2017-18. This could be an important factor for the external deficit countries (Turkey, South Africa) or for countries with higher foreign participation on local currency bond markets (South Africa, Poland, and to a lesser extent Hungary).

4. **UBS expects some further weakness in USD vs the Euro (USD/EUR at 1.13 by end-2017 and 1.17 by end-2018)** and continued gradual depreciation of the RMB versus USD (to 7.5 end-18). This backdrop is also rather benign for Emerging EMEA FX, although the persistent depreciation of the RMB could have repercussions for the ZAR.

EMEA Growth outlook: Russia drives cyclical upswing, though the pick-up is broad-based

EMEA growth to accelerate to 2.1% in 2017 and to 2.4% in 2018 from 1.1% in 2016

We project Emerging EMEA — defined as Central Europe (Czech Republic, Hungary and Poland), Kazakhstan, Russia, South Africa, Turkey and UAE — growth to accelerate to 2.1% in 2017 and to 2.4% in 2018 from 1.1% in 2016. The 2.4% growth rate would be the strongest GDP number in the EMEA region since 2013.

We see three important points here:

Russia is the most important contributor to faster EMEA growth

1. **Russia's moving out of the recession (2017 growth: +1.3%, 2018: +1.7%) is the most important cyclical driver of stronger EMEA growth.** The cyclical recovery we project for in Russia reflects not just higher oil prices but also a revival of private consumption helped by resilient labour market, lower inflation, targeted increases in social spending and substantial households' deleveraging. The importance of Russia for Emerging EMEA GDP dynamics comes not only from its weight – Russia is more than 40% of Emerging EMEA GDP (PPP weighted) – but also from the massive swing in GDP from a contraction of 0.6% in 2016. In 2017, Russia should account for close to 90% of additional regional growth, while in 2018 it should account for more than three-quarters of the additional growth pick-up.

2017 should bring a broad-based growth pick-up in other countries as well

2. **In 2017 every country in Emerging EMEA ex-Russia bar Turkey should see somewhat faster momentum in GDP:** in Kazakhstan and UAE this is driven by oil prices, in Central Europe by higher inflow of EU funds versus 2016, and in South Africa by dissipating shocks (primarily from drought). Turkey is likely to see a small slowdown in GDP growth in 2017 due to the carry-over effects from the halt in activity in Q3 2016.

3. **In 2018 it is mainly Kazakhstan, South Africa and Turkey which are responsible for the acceleration in Emerging EMEA ex Russia economic activity.**

Poland to be the growth champion in EMEA

Poland is likely to be the growth champion in EMEA by posting 3.3% average growth in 2017-18. The only other country that could grow above 3% on average, on our forecasts, is Turkey. The UAE, the Czech Republic and Hungary are all expected to see GDP expansion in the 2.5-3% range. The group of countries growing at the lower end of our forecast range (1-2%) consists of Russia, South Africa and Kazakhstan. Hence, despite being the most important contributor to the acceleration of Emerging EMEA, Russia eventually should be one of the slowest-growing economies.

We are slightly below consensus growth forecast for 2017 – mainly because of Kazakhstan

Following a few downgrades to our 2017 numbers, summarised in the table below, our growth forecasts are still slightly (by 0.1pp) below consensus for the region. This is mainly because of Kazakhstan, where we are more cautious on how quickly Kashagan oil-field output will grow, while consensus is above the government's estimates for 1.9% GDP growth in 2017. We are more upbeat than consensus for Russia, owing to our bullish house view on oil; in CEE (Czech Republic and Hungary) above-consensus forecasts reflect our view that due to the very weak EU fund inflows in 2016, growth could benefit from the base effect in investments. In addition, the strong incoming quarterly data and the foreseen strength of the consumer in the Czech Republic could explain the difference versus consensus — our Czech forecasts are more aligned with the CNB's 2.9% growth forecast for both 2017-18.

Figure 184: EMEA real GDP forecasts

	New GDP forecasts, %				Old GDP forecasts, %		Consensus		UBS vs consensus		Difference between old & new UBS	
	2015	2016F	2017F	2018F	2016F	2017F	2016F	2017F	2016F	2017F	2016F	2017F
Poland	3.6	3.1	3.3	3.3	3.6	3.4	3.1	3.3	0.0	0.0	-0.5	-0.1
Hungary	2.9	2.0	2.7	2.7	2.4	2.7	2.0	2.6	0.0	0.1	-0.4	0.0
Czech Republic	4.2	2.7	2.9	2.7	2.6	2.6	2.5	2.5	0.2	0.4	0.1	0.3
Russia	-3.7	-0.6	1.3	1.7	-0.6	1.5	-0.6	1.2	0.0	0.1	0.0	-0.2
Kazakhstan	1.2	0.3	1.5	2.4	0.0	1.5	0.5	2.3	-0.2	-0.8	0.3	0.0
Turkey	4.0	3.2	3.0	3.1	3.2	3.0	3.0	3.0	0.2	0.0	0.0	0.0
South Africa	1.3	0.6	1.2	1.6	0.6	1.4	0.5	1.3	0.1	-0.1	0.0	-0.2
UAE	3.8	2.6	2.9	3.0	2.4	3.0	n/a	n/a	n/a	n/a	0.2	-0.1
EMEA	0.2	1.1	2.1	2.4	1.2	2.2	1.1	2.1	0.0	-0.1	-0.1	-0.1

Source: Haver, UBS estimates

We marginally revise lower our 2016-17 forecasts for EMEA countries

Our key forecast revisions are the following. As regards to our 2016 growth forecasts we lowered our projection for Hungary (2.0% vs 2.4% previously), and Poland (3.1% versus 3.6% previously) largely reflecting the slower inflow of EU funds and weaker data in Q3'16. We have lowered our 2017 forecasts for Poland (3.3% versus 3.4% previously), South Africa (1.2% versus 1.4% previously), but increased our forecast for the Czech Republic (2.9% versus 2.6% previously). We trimmed our 2017 GDP forecast for Russia from 1.5% to 1.3% to reflect the carry-over from weaker-than-expected activity in Q3'16. In contrast, the recent government announcement of stronger GDP growth in Q3 2016 in Kazakhstan prompted us to lift our 2016 forecast to +0.3% from 0%. Finally, in the UAE we incorporated stronger oil GDP growth but are now more cautious on 2017 non-oil GDP, resulting in a small downgrade to 2017 GDP outlook to +2.9%.

Key risks to our outlook

We see several external risks to the EMEA outlook. On the negative side: a more pronounced slowdown in Europe and/or China or a more aggressive rise in global yields could put pressure primarily on the current account deficit countries, while a fall in oil prices would hurt the energy exporters. On the positive side: potentially higher US growth in case of fiscal expansion, or stronger Eurozone reform momentum/fiscal push. On the domestic side the main risk relates to economic policy implementation.

Key regional themes

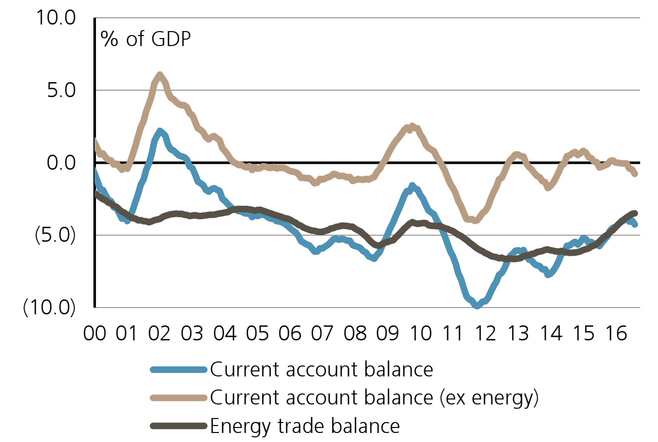
We highlight the following major regional themes in Emerging EMEA — in part the extension of the themes from the global space.

1) **The impact of higher oil prices.** Clearly, higher oil prices will likely affect the entire spectrum of macro variables, not just growth. The **oil exporters** (Russia, Kazakhstan and UAE) should benefit from higher oil prices in the form of rebounding growth, improving balance of payments (better trade numbers, potentially higher financing flows) and thus appreciating or stable exchange rates. This backdrop also reduces the need for immediate fiscal consolidation and, in Russia and Kazakhstan, allows central banks to continue with rate cuts. Importantly, we think that the room for monetary easing – especially at the time when global short-term rates are likely to be rising – will be dependent on how profligate the governments will be with the oil revenue windfall.

Key themes #1: Oil-price impact for energy exporters and importers

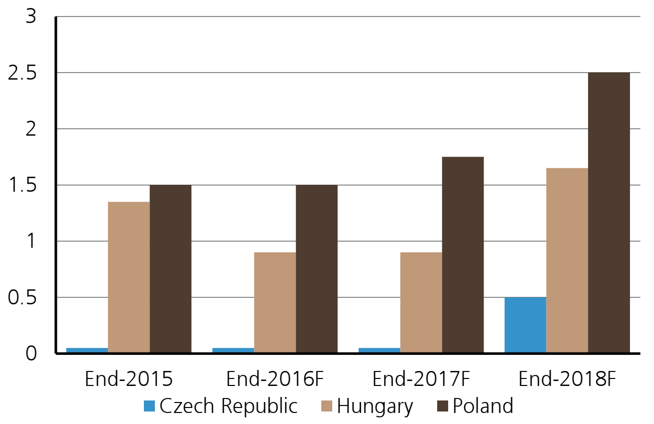
Amongst **oil importers** (Turkey and CEE), this will widen the imported energy bill — and thus we forecast a higher external deficit/smaller surplus in all of these economies. In our view, external deficit financing will be most problematic in **Turkey** (we project the external deficit worsening to 6.2% of GDP by end-18 from 4.3% of GDP currently), which is the major reason why we expect the TRY to depreciate and rates to increase. We would emphasize the inflationary impact of higher oil prices in **CEE:** this is one reason why we expect monetary policy normalisation in all of the countries (the CNB to drop the CZK floor in Q2 2017, rate hikes in all three CEE countries by end-2018). **South Africa** is a special case: the country is an importer of crude, but an exporter of processed oil products. In South Africa, our main focus re the oil price is the inflationary impact and thus it is one factor why we believe that the SARB will find it difficult to be in a position to cut rates.

Figure 185: Turkey – external balance, % of GDP



Source: Haver, CBT, UBS

Figure 186: CEE – policy rates, %



Source: Haver, UBS

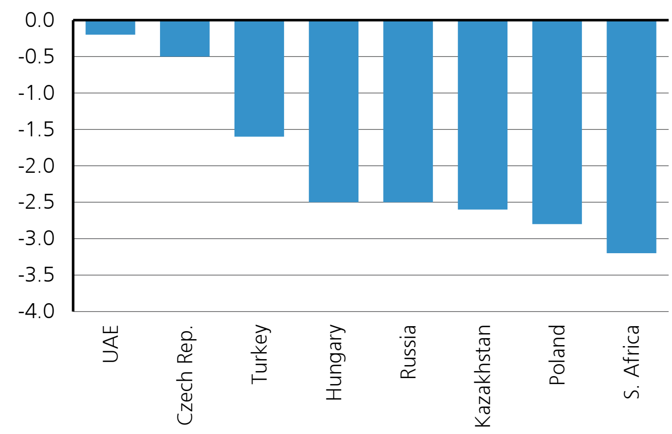
2) **Scope for fiscal policy to support growth.** The ability of a country to offset an external growth shock (e.g. a slowdown in the Euro Area) by counter-cyclical policies is an important factor for investors to keep in mind. We see **scope for fiscal easing in case of an adverse external growth shock in** the following countries: **Czech Republic, Hungary** (because of low deficits), and potentially **Russia and other oil**

Key themes #2: Who has scope for fiscal policy support in case of an adverse growth shock?

exporters, assuming that oil-market rebalancing is not derailed (low public debt, current account surplus – bar Kazakhstan).

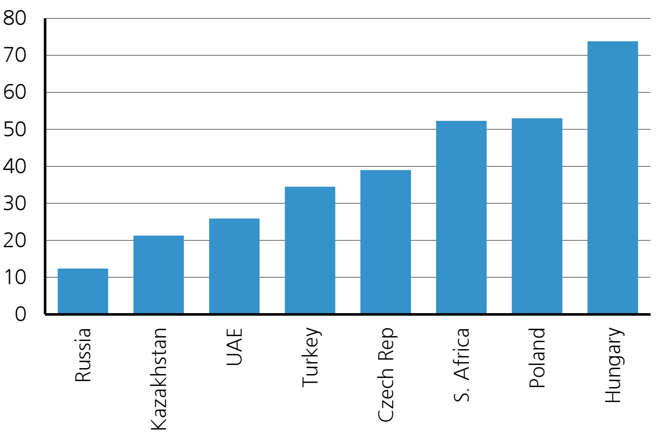
Turkey could potentially try to raise its budget deficit in the short-term, but we do not think this is a sustainable escape in the medium term due to the underlying worsening of the external deficit. A fiscal expansion would make the outlook for external financing requirement even more challenging and any pressure on the TRY and interest rates could easily offset impact of fiscal expansion. In our view, Poland's budget deficit is just too close to the 3% threshold of the excessive deficit procedure (EDP) to embark on any fiscal loosening — we rather believe that Poland would need to tighten fiscal policy in the face of an external shock to safely remain below the EDP threshold. South Africa's focus on trying to stabilize the debt dynamics in the medium term also prevents it from any major fiscal boost. It is quite possible that, similarly to Poland, it would need to pursue pro-cyclical fiscal tightening in case of an external shock.

Figure 187: Budget balance in 2017E, % of GDP



Source: UBS

Figure 188: Public debt in 2017E, % of GDP



Source: UBS

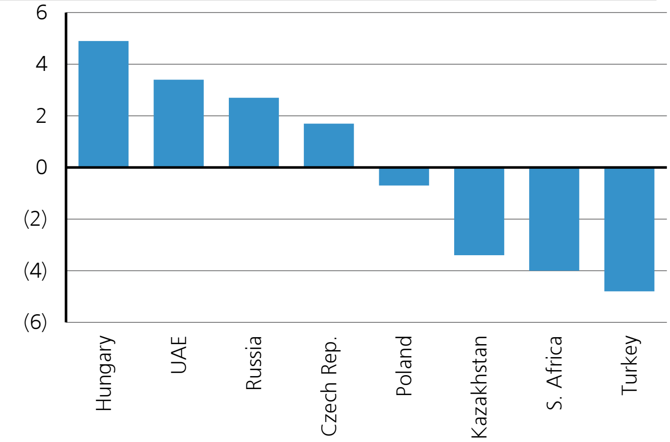
Key themes #3: Is there any scope left for monetary policy stimulus?

3) **The global environment of rising rates would constrain monetary policy support in Emerging EMEA and in extreme cases might require interest-rate hikes to shield domestic FX and bond markets from capital outflows.** In CEE, we think higher global yields will add to the domestic arguments for eventual withdrawal of monetary accommodation. In our view, the repercussions of higher yields globally will be most acutely felt in **countries with higher external deficits (Turkey/South Africa) and for countries with high presence of foreign investors in the local currency bond market (South Africa, Poland and, to a lesser extent, Hungary)**. Potential outflows from fixed income portfolio funds and any corresponding pressure on the exchange rates may require interest rates to go higher. At the same time, we believe that some of the oil exporters (Russia and Kazakhstan) will see enough of a boost to their trade surpluses to be able to continue their cautious monetary easing despite narrowing interest-rate differentials.

Could monetary policy in Emerging EMEA support the economy in case of an adverse growth shock? Here the answer is not straightforward — it will largely driven by the nature of the shock and the generated global policy response.

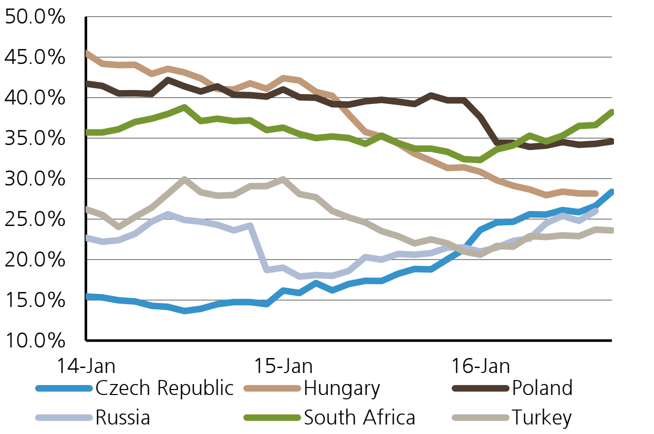
Generally speaking, the nearly closed output gaps in the CEE, the relatively high level of inflation expectations in South Africa and the corporate balance-sheet vulnerability to FX movements in Turkey make us sceptical whether any large-scale monetary easing can be deployed in these economies. In Russia, a lot will depend on how oil prices will behave in case of the shock and thus its impact on the RUB.

Figure 189: External balance, % of GDP (2016)



Source: UBS

Figure 190: Foreign investors' ownership of local currency bonds, % of total

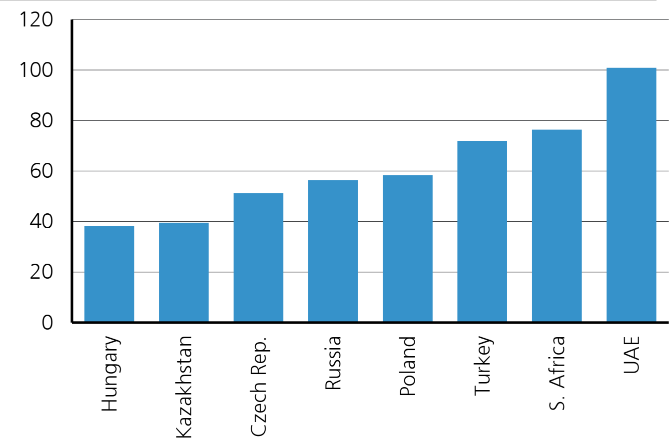


Source: Haver, UBS

Key themes #4: Which countries have the ability to re-lever to boost growth?

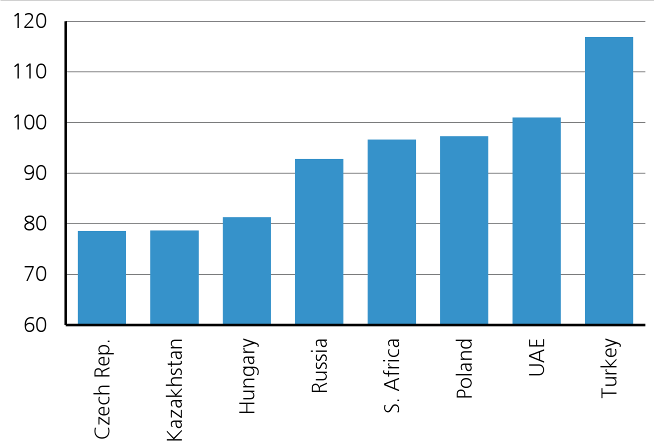
4. **Which countries could re-lever their economies to boost growth?** It is important to point out that this is not the same question as which countries could see the fastest increase in loan growth — which based on our bank analysts' expectations, are likely to be Turkey and South Africa. Our question wants to investigate the countries' theoretical ability to re-lever in case of suitable policies and change in the behaviour of borrowers – i.e. without creating major imbalances. In our view, the best space for seeing additional credit growth would be in countries where credit penetration is relatively low and banks have ample deposit bases to finance lending growth. **Countries that fit these criteria the clearest are the Czech Republic and Hungary**. In addition, we could see some re-leveraging in Poland (if and when some of the uncertainties regarding the sector are resolved) and in Russia in the consumer space.

Figure 191: Domestic bank credit to GDP (2016)



Source: UBS

Figure 192: Loan-to-deposit ratios, % (most recent)



Source: UBS

FX: constructive on oil exporters and CEE; bearish on Turkey, South Africa

Our FX forecasts reflect the view that the global macro backdrop should turn more constructive for energy exporters with the gradual increase in oil prices in 2017; while life should remain difficult for the current account deficit economies.

We are positive on oil exporters' and CEE FX; cautious on TRY, ZAR

Figure 193: EMEA FX forecasts

				Changes vs current rates, %	
	Current*	End-17F	End-18F	End-17F	End-18F
EUR/USD	1.09	1.13	1.17	-3.7	-7.4
USD/PLN	4.01	3.76	3.55	6.3	11.6
EUR/PLN	4.37	4.25	4.15	2.8	5.0
USD/HUF	282.4	274.3	265.0	2.9	6.2
EUR/HUF	307.7	310.0	310.0	-0.8	-0.8
USD/CZK	24.8	23.0	21.4	7.3	13.9
EUR/CZK	27.0	26.0	25.0	3.8	7.5
USD/TRY	3.25	3.45	3.70	-6.1	-13.8
EUR/TRY	3.54	3.90	4.33	-10.1	-22.2
USD/ZAR	14.1	15.25	15.75	-8.0	-11.5
EUR/ZAR	15.4	17.23	18.43	-12.0	-19.8
USD/RUB	65.69	55.00	52.00	16.3	20.8
EUR/RUB	71.5	62.2	60.8	13.1	14.9
USD/KZT	338.3	310	295	8.4	12.8

Source: Thomson Reuters, UBS. *10 November close

We expect the RUB to gain c.16% vs the USD by end-2017 and another 4.5% in 2018, assuming oil prices rise to average $70/bbl in 2018, despite narrowing interest-rate differentials. If we are right and oil prices average $60 in 2017, we expect the CBR to re-examine the merits of FX reserve accumulation, which could pose some downside risk to our RUB forecasts. In Kazakhstan, we expect the NBK to continue leaning against exchange-rate appreciation, and thus expect only c.13% appreciation by end-2018 from current levels.

Within the rest of EMEA we think that the Czech Koruna could see c. 14% currency appreciation against the USD on a two-year horizon, while the Polish Zloty could see c.11.5% strengthening until end-18. Most of these gains stem from UBS's call for a stronger EUR. In the Czech Republic we believe that the CNB could drop the CZK floor in Q2 2017 (as guided), while we see more PLN appreciation on the back of the strong growth and rising rates in Poland. The Hungarian Forint should also enjoy the stronger EUR effect, but we see the HUF largely flat against the EUR on the forecast horizon. While we could see some pressure on the CEE exchange rates from higher US rates and potential portfolio outflows, their rather solid external positions make them relatively defensive.

In contrast, we see more challenges for the TRY and the ZAR against the USD in the next two years. We see roughly 14% and 11.5% depreciation over the next two years, respectively. However, we see one particularly important difference between the two countries: in Turkey there is a balance sheet mismatch in terms of FX open position in the corporate space and there is also a relatively high dollarization of deposits, which could limit the scope of FX weakness that Turkey could accommodate without major costs to the real economy. In South Africa there are no balance sheet issues and a weaker FX is mainly imposing its "costs" via higher inflation.

In Turkey, the 14% depreciation is based on our forecast of the widening external deficit as higher oil prices and domestic demand-driven growth would take their toll on the external financing requirement. We believe that this pace of depreciation is beneficial for the economy: it creates some competitive advantage, but does not hurt corporate balance sheets or FX deposits. We see higher rates as necessary to control the pace of depreciation. Here the risk is that a renewed bout of TRY weakness could call for sharper rate hikes and could make it more difficult to stop the FX weakness without causing much damage to the economy.

The ZAR has clearly defied our forecast in 2016 and thus we have to be humble here. However, we feel that there is a lot of good news already priced in: higher commodity prices, prudent monetary policy action, and a close to record-high foreign positioning on the local-currency bond market. We believe that the external environment, which has already worsened for EM countries with a C/A deficit over the recent days, could turn even less friendly for South Africa (including China growth slowing and weaker RMB), which could build pressure on FX to weaken. Clearly domestic political developments have the power to move the ZAR in both directions.

Russia

- **Economy to return to growth in 2017 as private consumption recovers; further recovery in oil prices is likely to be a strong tailwind.**
- **Real policy rate to stay above 2.5-3% equilibrium level for most of 2017-18 as the CBR is squarely focused on anchoring inflation at 4%.**
- **Three-year plan for 3.6%-of-GDP fiscal consolidation is a positive signal but will likely undergo changes as oil prices rise and priorities for the next presidential term in 2018-2024 are determined.**

An uptick in private consumption is the key component for the cyclical recovery in 2017; a further rise in oil prices is a helpful but not a necessary condition

A year ago, we wrote "unless the oil prices take another significant step down, we think the economy is approaching the end of the recession". Oil prices fell by over 40% in the next 2.5 months, delaying the recovery by at least half a year. While bearing the oil-price risk in mind, we think a pick-up in domestic demand will finally drive the economy back to growth by the end of 2016.

A recovery in private consumption (a relatively modest 2.1%, after a 7.2% fall in the past 1.5 years) is central to our case. For most of 2016 consumption has diverged from the recovering real wages, as savings remained high, confidence low, and pension increases remained below inflation. Retail sales finally rebounded in September and we think the recovery will gather pace in early 2017, helped by payouts to pensioners in Jan-Feb 2017 and a gradual dissipation of precautionary savings. Q3 2016 IP data was weaker than expected, so we nudge down our 2017 GDP estimate to 1.3% from 1.5% previously; we expect GDP growth to accelerate to 1.7% in 2018. Our assumption of oil prices averaging $60/bbl in 2017 and $70/bbl in 2018 is secondary to our case for the cyclical rebound in 2017. We think that if oil prices stay in the $45-50/bbl range, the economy will still resume growth, but at a slower rate of 1% or slighly below.

Government and the CBR operate with the conservative assumption of oil at $40/bbl in 2017-19; we are markedly more upbeat on oil

When it comes to policies for 2017-19, the government and the CBR are working on the assumption of oil prices falling and staying at $40/bbl (for Urals, c.$42-$43/bbl for Brent). While this conservative approach to planning is prudent, it also means that if our house view on Brent rising to $70 on average in 2018 turns out to be right, there will likely be room for more accomodative fiscal and monetary policy. We think the uncertainty is greater on the fiscal side, given presidential elections due in March 2018, while for the CBR the question is about the pace of rate cuts rather than the overall direction.

The budget plan aims to have the budget near primary balance at $40/bbl oil by 2020 in preparation for re-introduction of the fiscal rule

After increasing the federal deficit to an estimated 3.7% of GDP in 2016 from 2.4% of GDP in 2015, for 2017-19 the government aims for significant fiscal consolidation of cumulative 3.6% of GDP. About 70% of savings are due to come from spending cuts, with the largest contribution due to come from outlays on defence. On the revenue side, the government has kept to the 2012 promise not to touch main non-oil taxes. Additional revenues are to come from the oil and gas sector, excise duties, redistribution of the CIT shares between the budgets and better tax collection; the Finance Ministry also continues to push for higher dividend payouts from SOEs. The share of hydrocarbon revenues in the budget is projected to decline from the peak of 51.3% in 2014 to 36% in 2019. Although the Finance Ministry proposals on re-introduction of the fiscal rule did not make it into the budget submitted to the parliament, it sees the consolidation over the next three years as essential preparation for the reintroduction of the fiscal rule from 2020.

On our numbers, hydrocarbon revenues are likely to be 1.1-1.3% of GDP p/a higher than planned, creating scope for smaller spending cuts and/or faster deficit reduction. We pencil in a midway outcome with the federal budget deficit falling to 1.6% of GDP by 2018 but non-oil deficit at 8.4%/GDP vs. 7.7% in the budget. We think that while a return to three-year fiscal planning is prudent in principle, in reality it does not imply policy certainty. The presidential elections due in March 2018 have likely led to delays in implementation of necessary but unpopular policies, such as increasing the retirement age. Should oil price indeed stay low, we also think that the government will re-examine the ideas around taxation of the non-oil sector, probably focusing on consumption and wealth (e.g. progressive income tax, higher VAT and/or property taxes, etc).

Presidential elections due in 2018 increase likelihood that some of the above-plan oil revenues will be spent, in our view

After slashing rates ahead of the inflation decline in 2015, in 2016 the CBR policy has turned much more cautious: the CBR limited itself to two 50bps cuts to 10% and guided for no more easing until Q1 2017 at the earliest. We think that as the date by which the CBR is supposed to bring inflation to 4% target approaches (end-2017), the policymakers have focused almost exclusively on the upside risks to inflation. The good news though that helped by a good harvest and a stronger RUB, inflation has been falling even slightly faster than the CBR's base case. Assuming that our upbeat view on oil is correct, the RUB is likely to continue appreciating, to 55.0 by end-2017 and 52.0 by end-2018, which should help to drive inflation down to 4.4% by end-2017 and 4.1% by end-2018. Therefore, we expect the CBR to resume cuts in February 2017 and proceed to lower the key rate to 7% by end-2018 (which would still imply real rates somewhat above the 2.5-3% equilibrium level). The CBR's initial response to recent volatility in the financial markets was quite relaxed but if the sell-off in the RUB becomes sustained, the CBR can delay cuts from Q1 later into 2017. The CBR's net lending to the banking system went into the red in November, so effective liquidity absorption will remain a key task; OBR issuance to complement deposit auctions is due to start in 2017.

CBR policy is likely to remain cautious, keeping real interest rates high; although appreciating RUB will likely allow a reduction in the key rate to 7% by end-2018

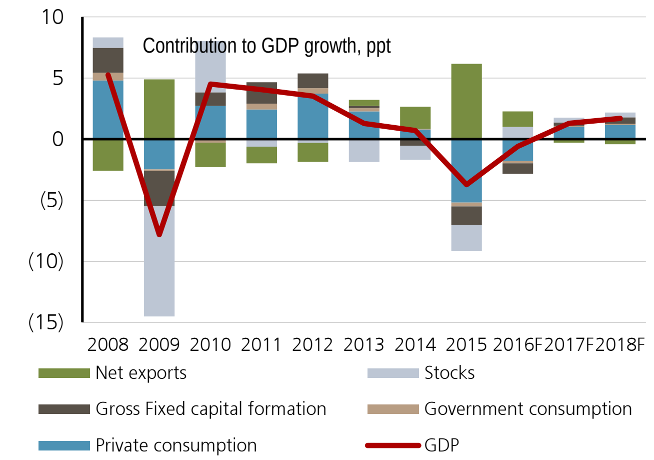
As oil prices drive the RUB up, we expect the CBR to again consider FX reserve accumulation, shelved after it bought $10bn in 2015; the CBR itself allows for the possibility in its "optimistic" $55/bbl scenario. We think the CBR could either act on its own to replenish reserves (for that, oil-price recovery has to be deemed sustainable), or act on behalf of MinFin if it starts to top up the Reserve Fund instead of drawing it down. Gross FX reserves would go up in both scenarios. The recovery in commodity prices halted the recent current-account deterioration, but lack of significant expansion in non-commodity exports and recovering domestic demand will likely keep the current account surplus at 2.5%-3% of GDP.

Oil prices at $60 will likely make the CBR consider buying FX into reserves again

In terms of risks to our base case, volatility in the oil market remains key – either due to market-specific events like the OPEC meeting on 30 November or due to changes in global economic dynamics, eg, a drop in global trade dampening growth in emerging economies. As we touch on above, even in the absence of a further rise in oil prices, we are still likely to see a return to growth, as well as further declines in inflation and policy rate – but at a slower pace. Uncertainty about foreign and economic policies under President-elect Trump could bring both upside and downside risks to growth in the US and globally (see "Trump victory, what now?" for a brief summary). The positive response of Russian officials to Trump victory points to a perception on the Russian side that the chances of an improvement in relations have risen, although it remains to be seen whether these expectations are met, in our view. We think that external deleveraging, conservative monetary policy and (planned) fiscal consolidation should make the Russian economy less vulnerable to external shocks compared to two years ago.

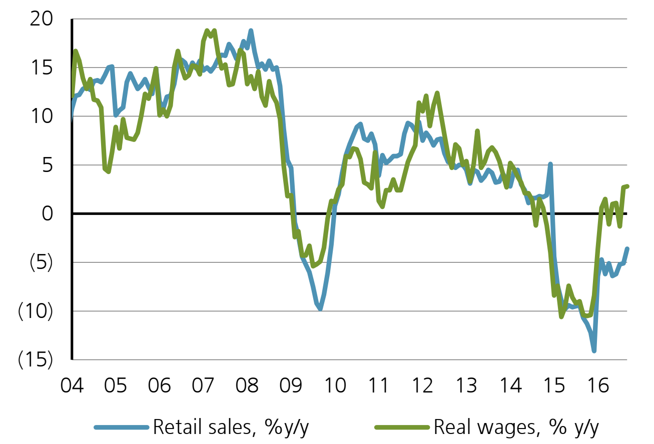
Risks from oil-price developments and global political developments can be both on the upside and the downside

Figure 194: Household consumption drives GDP recovery



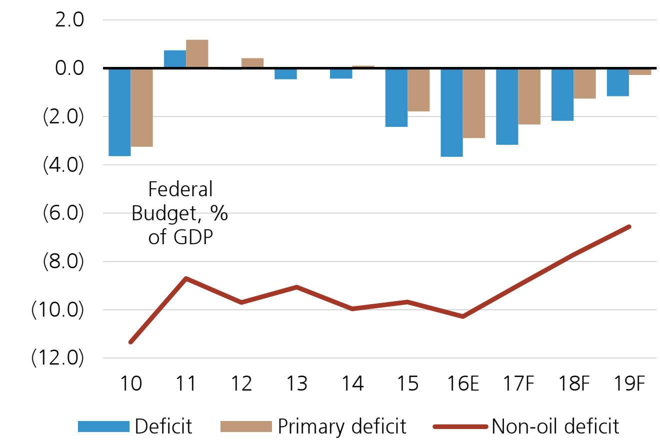
Source: Rosstat, Haver, UBS

Figure 195: Consumption yet to catch up with wages



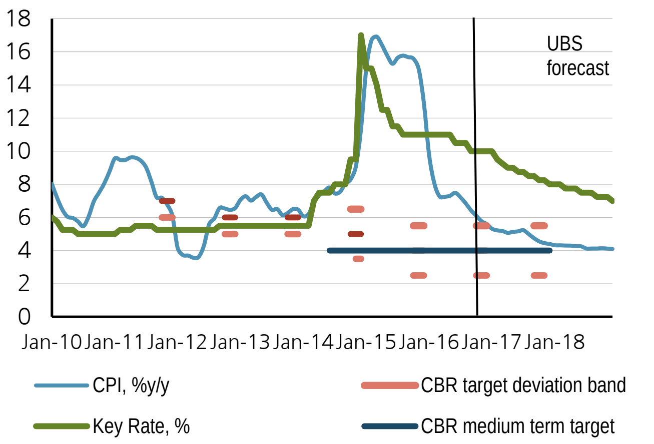
Source: Rosstat, Haver, UBS

Figure 196: Government aims for primary balance in 2019



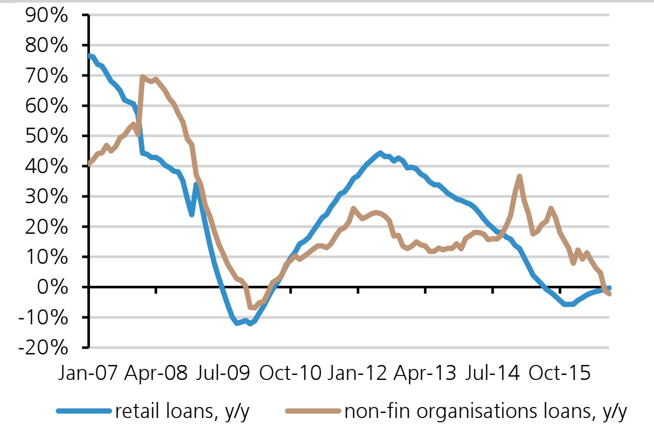
Source: Haver, Ministry of Finance, State Duma

Figure 197: We expect CBR to cut to 7% as CPI falls to target



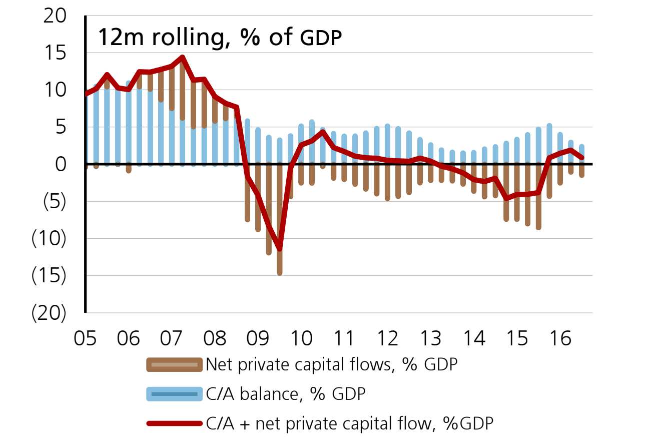
Source: Rosstat, Haver, CBR, UBS

Figure 198: Corporate credit slows, retail stabilises



Source: CBR, Haver, UBS

Figure 199: C/A decline offset by lower capital outflows



Source: CBR, Haver, UBS

RUSSIAN FEDERATION	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	59698	66927	71017	77945	80804	85540	91635	97386
GDP, USD bn	2032	2153	2231	2031	1326	1283	1549	1825
GDP per capita, USD	14209	15024	15523	13882	9051	8737	10528	12383
Real GDP growth, %	4.0	3.5	1.3	0.7	-3.7	-0.6	1.3	1.7
Private consumption, % y/y	4.8	7.4	4.3	1.5	-9.5	-3.5	2.1	2.4
Government consumption, % y/y	2.6	2.5	1.4	0.4	-1.8	-1.0	0.5	0.5
Gross Fixed Capital formation, % y/y	9.2	6.0	0.9	-0.6	-7.6	-4.5	1.5	3.0
Exports, % y/y	4.2	1.4	4.6	0.6	3.6	2.0	1.3	0.9
Imports, % y/y	13.8	9.7	3.6	-7.6	-25.7	-4.3	4.6	4.5
Unemployment rate, %	6.5	5.5	5.5	5.2	5.6	5.8	5.6	4.8
Industrial Production (%)	5.0	3.4	0.4	1.7	-3.3	0.0	1.4	1.9
Prices, interest rates and money								
CPI inflation, % y/y (average)	8.4	5.1	6.8	7.8	15.5	7.1	5.0	4.2
CPI inflation, % y/y (year-end)	6.1	6.6	6.5	11.4	12.9	5.6	4.4	4.1
Broad money M2, % y/y (end-year)	22.3	11.9	14.6	2.2	11.5	9.6	10.2	18.1
Domestic private credit, % y/y	28.7	20.2	18.7	27.3	8.1	-0.6	8.8	7.2
Domestic bank credit/GDP	41.4	44.4	49.7	57.6	60.1	56.4	57.3	57.8
Policy rate 1w repo/depo, % (end-year)	5.3	5.5	5.5	17.0	11.0	10.0	8.0	7.0
10 year bond yield, % (year-end)***	8.8	7.0	7.9	13.0	9.6	8.9	8.1	7.5
RUB/USD (year-end)	32.2	30.4	32.7	56.3	72.9	65.0	55.0	52.0
RUB/EUR (year-end)	41.7	40.2	45.1	68.3	79.4	71.5	62.2	60.8
Fiscal accounts								
General government budget balance, % GDP*	0.7	-0.1	-0.5	-0.4	-2.4	-3.7	-2.5	-1.6
Revenue, % GDP	0.0	0.0	18.3	18.6	16.9	15.5	16.5	16.4
Expenditure, % GDP	18.3	19.3	18.8	19.0	19.3	19.2	19.0	18.0
of which interest expenditure, % GDP	0.5	0.5	0.5	0.6	0.8	0.8	0.9	0.9
Primary balance, % GDP	1.1	0.5	0.1	0.1	-1.6	-2.9	-1.6	-0.7
Public sector debt (gross),% GDP**	9.0	9.7	11.1	13.2	13.6	13.2	12.4	12.1
of which domestic public debt, % GDP	7.0	7.4	8.1	9.3	9.1	9.4	9.3	9.4
of which external public debt,% GDP	1.9	2.3	3.1	3.9	4.5	3.9	3.1	2.7
% domestic public debt held by non-residents	3.7	19.9	23.9	18.7	21.5	26.0	26.4	26.1
Public debt held by the central bank, % GDP	0.6	0.6	0.5	0.5	0.6	0.4	0.3	0.3
Balance of payments								
Trade balance, USD bn	196.9	191.7	180.6	188.9	145.6	91.1	117.0	128.9
Exports, USD bn	515.4	527.4	521.8	496.8	339.6	283.5	349.3	411.7
Imports, USD bn	318.6	335.8	341.3	307.9	194.1	192.5	232.3	282.8
Current account balance, USD bn	97.3	71.3	33.4	57.5	65.8	32.5	46.1	46.0
as % of GDP	4.8	3.3	1.5	2.8	5.0	2.5	3.0	2.5
Foreign direct investment (net), USD bn	-11.8	1.8	-17.3	-35.1	-15.7	-15.0	0.0	-10.0
Total FX reserves, USD bn	498.6	537.6	509.6	385.5	368.4	402.0	414.5	438.4
Foreign exchange reserves excl gold, USD bn	454.0	486.6	469.6	339.4	319.8	335.0	345.4	365.3
Total FX reserves, % GDP	24.5	25.0	22.8	19.0	27.8	31.3	26.8	24.0
Total external debt, % GDP	538.9	636.4	728.9	599.9	518.5	417.8	379.3	342.8
Net International Investment Position, % GDP	7.4	6.6	5.9	15.4	26.0	23.7	22.1	21.9

Source: Rosstat, Ministry of Finance, Haver, Bloomberg, UBS
* Federal budget. **Includes state debt and state guarantees, excludes SOE debt. *** Zero coupon yield.

South Africa

- **We expect GDP to grow by 1.2% 2017 and 1.6% in 2018 from 0.6% in 2016 as the impact of past shocks dissipates and investment could gradually bounce. However, the structural bottlenecks and the need for fiscal consolidation should prevent South Africa from a more pronounced re-acceleration.**
- **We revise our ZAR forecast stronger for all horizons, but we still project some gradual softening towards 15.75 by the end of 2018. We expect some of the tailwinds behind the ZAR to fade and higher global financing costs to also weigh. We think that the SARB will keep rates on hold at 7%.**

GDP to grow by 0.6% in 2016, 1.2% in 2017 and 1.6% in 2018

We project a very gradual economic recovery in South Africa: we expect GDP growth of 0.6% in 2016, 1.2% in 2017 and 1.6% in 2018. We have trimmed our 2017 forecast from 1.4% – on account of softer investment spending. Our 2017 growth forecast is marginally softer than the consensus estimate of 1.3%.

Recovery reflects waning of past shocks; normalization of activity

In our view, this recovery reflects more the waning/absence of shocks of the previous years – the drought in 2016, electricity shortages in 2015, strikes in 2014 – and some recovery in confidence rather than any significant re-acceleration. The pace of rebound is likely to fall short of South Africa's potential growth rate of 2%. This is due to the structural headwinds the economy continues to face (e.g. limited product market competition, labour market problems including skill shortages, education outcomes), which in combination with the necessity to stick to fiscal consolidation would limit the economy's ability to re-accelerate – bar a comprehensive implementation of reforms.

Household consumption should remain the backbone of the economy. We see personal consumption expenditure (PCE) picking up momentum to 1.5% in 2018 from 0.7% in 2016 — on the back the decline in inflation and roughly stable pace of growth of compensation (7%). Despite the deleveraging of households — household debt to disposable income was 75.1% in Q2-16 — we do not see scope for any rapid rebound in consumer borrowing.

The pace of investment rebound could be the swing factor in GDP growth

Confidence comes into play with regards to the investment outlook. In essence, it was government investment that was supporting fixed capital formation in the last couple of years, while private investment has failed to add to growth since 2013 on average. Our current investment forecast assumes a continued high pace of government investment (c5%) in 2016-18, some faster capital outlays from state-owned enterprises already from 2017 onwards, while we only project a clear rebound in private investments in 2018. Here, the risk is symmetrical: a more upbeat turn in domestic business confidence could generate an earlier and stronger private business investment response, or equally a negative confidence shock could delay the projected investment pick-up.

We see a stronger ZAR than previously, but expect weakening to 15.75 vs USD by end-18

We believe a key aspect to our South African outlook is the change in our ZAR forecast. We have marked our ZAR path substantially stronger: we project the rand to trade at 14.2 against the USD by end-16 (16.0 previously) and 15.25 by end-2017 (17 previously). We project some further softness into 2018 to 15.75. With this revision we acknowledge that there were several forces that supported the ZAR: a) commodity prices rallying beyond our estimates, b) prudent policy-making – both monetary and fiscal, c) thus strong portfolio inflows into bonds (potentially reflecting market expectations that a sovereign downgrade or losing the investment grade rating is not too likely), and finally d) the breakdown of previous correlations with a softer RMB. The ZAR has also rallied around several political developments this year.

Our main reason for still calling for FX weakness is the projected fading of current tailwinds

So why are we sticking to our guns on a depreciating ZAR from here? The basic reason is that we think these tailwinds could fade going forward. *First*, in terms of commodity prices UBS expects some upside in gold and platinum prices, but not much in coal – most of the re-rating has already happened. At the same time, UBS expects oil prices (Brent) to rise to $60 in 2017 and to $70 in 2018. So we are not expecting much improvement in the terms of trade. *Second*, we project a fairly sticky external deficit of 3.6% of GDP in 2017-18. *Third*, UBS expects global central banks to be less accommodative (Fed hikes, ECB tapering in September) and sees higher US and Bund 10Y yields (and higher volatility) — which will make it more difficult to attract portfolio financing. The heavy positioning on the local currency bond market — foreign ownership rose above 38% by Sep-16, close to all-time highs — also cautions us on how strong the support might be from portfolio flows. *Finally*, we believe that the further downside in RMB (to 7.5 against USD by end-2018) could at some point become an important factor for ZAR behaviour and induce some downside.

Risk: positive momentum in domestic politics/reforms; continued commodity prices rise

We are humble regarding our ZAR forecast and we identify two risks that could keep it much closer to current levels: a) if domestic political developments/reform implementation could attract further inflows into South African assets, and b) a continued strong rise in commodity prices.

CPI to fall to 5.5% by end-18E; SARB to remain on hold at 7%, but the bar to rate cuts is high

We project inflation to bounce to 6.5% y/y by end-2016, but then grind lower to 5.7% by end-17 and to 5.5% by end-18. We have incorporated both our FX and oil price forecasts (upside factors), the announced change in electricity prices and assumed that food price inflation would revert back to 5.5% by end-2017 from 11.6% y/y in September 2016. Core inflation would also come lower to 4.8% y/y by end-2017 from 5.6% y/y currently. We project headline CPI to drop sustainably below the upper end (6%) of the SARB's target starting from Q2-2017. The risks are also symmetric here: an oil price shock could keep CPI above our projection, while a stronger exchange rate could result in a faster drop in inflation.

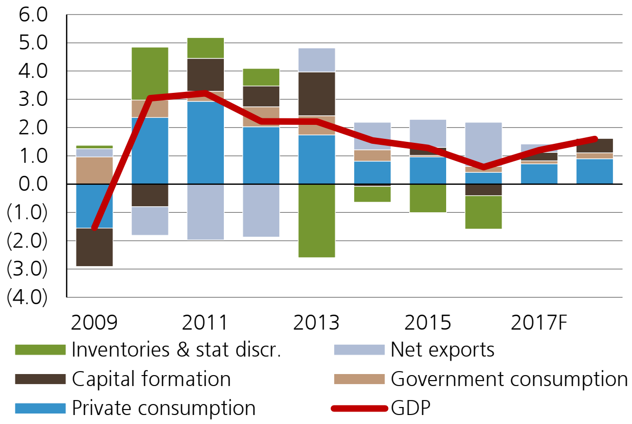
We revise our policy rate forecast to reflect our new FX and CPI paths: we now project the SARB to keep its policy rate flat at 7% throughout 2017-18 (versus our previous call of a 7.50% policy rate by end-2017). We think that the bar to rate cuts is rather high: the SARB would either need to see sustained strength of the ZAR (our risk case) or a visible decline in inflation expectations.

There are still some risks around fiscal consolidation, but the MTBPS path is the right one

We think the Medium-Term Budget Policy Statement set out the right path to fiscal consolidation: aiming to cut the budget deficit to 2.7% of GDP in 2018 from 3.4% of GDP in 2016. However, there are still risks around the budget implementation: a) the Treasury would have to come up with an additional ZAR 33bn unspecified tax increase in 2017 (0.7% of GDP) and then another ZAR 15bn in 2018 (0.3% of GDP); b) contingency reserves have been drastically reduced (ZAR 6bn in 2017 and ZAR 10bn in 2018); c) execution risks around controlling the wage bill; and d) potentially optimistic growth outlook for 2018 (2%).

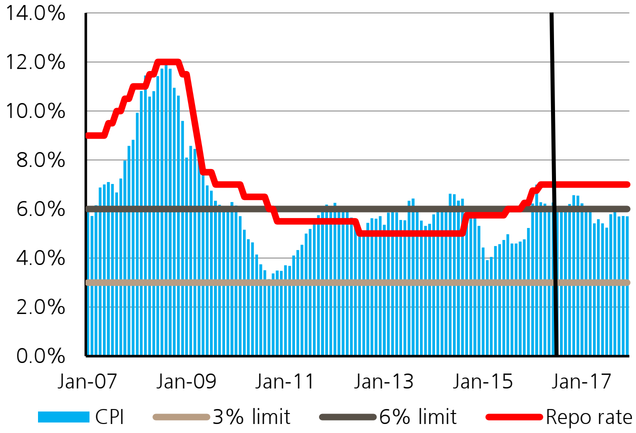
As in the past we are not making any explicit calls on the rating agencies' actions. We believe a lot of focus would be on the progress with reforms and we do not think that the risk of a downgrade is priced in. A rating downgrade by S&P on 2 December (or later) would not mean the loss of investment grade rating in the strictest sense as the other two agencies are still at investment grade.

Figure 200: GDP growth and contributions



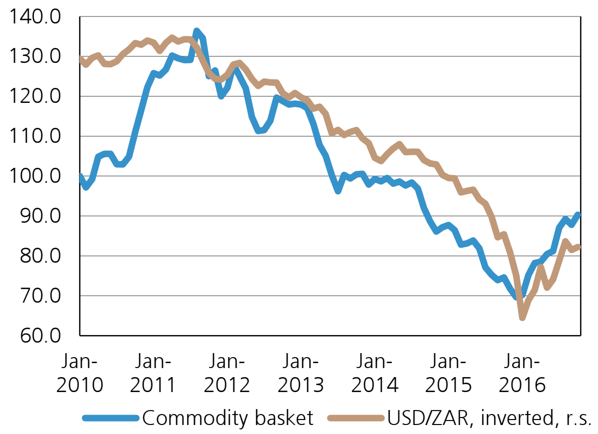
Source: SARB, Haver, UBS

Figure 201: Inflation and policy rate outlook



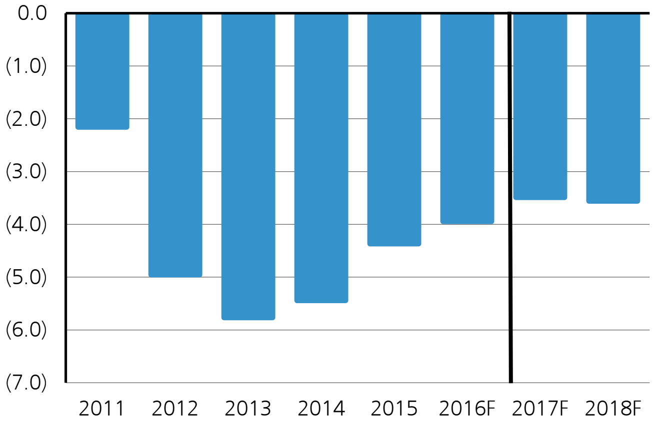
Source:

Figure 202: ZAR and commodity basket*



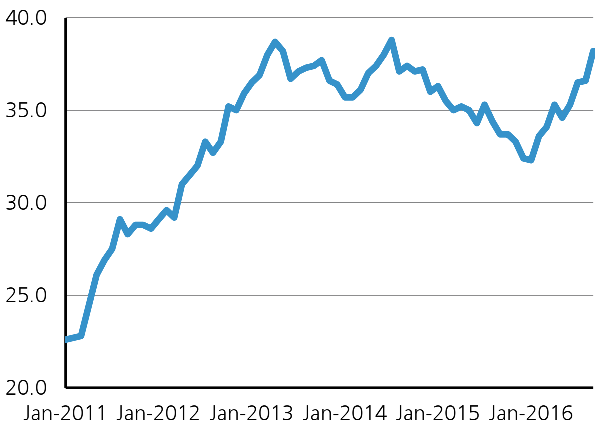
Source: Haver, UBS. USD price index for gold, platinum and coal prices.

Figure 203: External balance, % of GDP



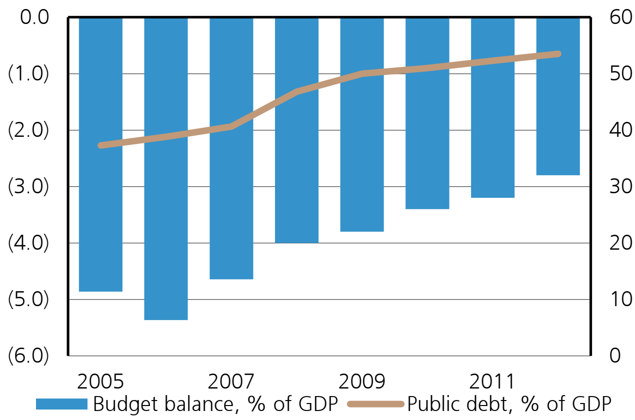
Source: SARB, Haver, UBS

Figure 204: Foreign holdings of local currency bonds, % of total



Source: National Treasury, Haver, UBS

Figure 205: Budget balance and public debt, % of GDP



Source: National Treasury, Haver, UBS

SOUTH AFRICA	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	3024	3254	3549	3813	4014	4292	4591	4926
GDP, USD bn	417	397	366	350	313	288	312	318
GDP per capita, USD	8112	7594	6891	6478	5716	5157	5489	5504
Real GDP growth, %	3.2	2.2	2.2	1.5	1.3	0.6	1.2	1.6
Private consumption, % y/y	4.9	3.4	2.9	1.4	1.6	0.7	1.2	1.5
Government consumption, % y/y	1.7	3.4	3.3	1.9	0.3	1.0	0.5	1.0
Gross Fixed Capital formation, % y/y	5.7	3.6	7.6	-0.4	1.4	-2.0	1.5	2.5
Exports, % y/y	4.3	0.1	4.6	2.6	9.0	2.5	4.5	4.5
Imports, % y/y	10.5	6.0	1.8	-0.5	5.7	-2.5	3.5	4.5
Unemployment rate, %	24.8	24.9	24.7	25.1	25.4	26.5	27.0	27.4
Industrial Production (%)	2.9	2.0	1.5	0.1	-0.1	1.5	2.0	2.5
Prices, interest rates and money								
CPI inflation, % y/y (average)	5.0	5.7	5.8	6.1	4.6	6.3	5.7	5.6
CPI inflation, % y/y (year-end)	6.1	5.6	5.4	5.3	5.2	6.5	5.7	5.5
Broad money M2, % y/y (end-year)	7.2	3.9	9.7	8.6	9.6	5.2	9.0	10.0
Domestic private credit, % y/y	6.2	10.4	6.3	8.6	10.2	6.0	9.0	11.0
Domestic bank credit/GDP	73.3	75.0	73.0	73.7	77.1	76.4	77.9	80.6
Policy rate, % (end-year)	5.5	5.0	5.0	5.8	6.3	7.0	7.0	7.0
10 year bond yield, % (year-end)	8.5	7.3	8.2	8.0	9.7	9.2	9.4	9.6
USD/ZAR (year-end)	8.1	8.5	10.5	11.6	15.6	14.2	15.3	15.8
EUR/ZAR (year-end)	10.5	11.2	14.4	14.1	17.0	15.6	17.2	18.4
Fiscal accounts								
General government budget balance, % GDP	-4.9	-5.4	-4.6	-4.0	-3.8	-3.4	-3.2	-2.8
Revenue, % GDP	27.1	27.3	27.6	28.2	29.6	30	30	30
Expenditure, % GDP	32.0	32.7	32.3	32.2	33.4	33.4	33.2	32.8
of which interest expenditure, % GDP	2.8	2.9	3.1	3.0	3.1	3.1	3.1	3.1
Primary balance, % GDP	-2.1	-2.5	-1.5	-1.0	-0.7	-0.3	-0.1	0.3
Public sector debt (gross),% GDP	37.3	38.8	40.6	46.8	50.0	51.0	52.3	53.5
of which domestic public debt, % GDP	34.5	37.3	40.1	42.4	45.3	45.9	47.1	48.2
of which external public debt,% GDP	3.7	3.6	4.0	4.4	4.8	5.1	5.2	5.4
% domestic public debt held by non-residents	28.6	35.9	36.4	36	32.4	39	39	39
Public debt held by the central bank, % GDP	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Balance of payments								
Trade balance, USD bn	7.0	-3.8	-7.1	-6.3	-2.7	-0.6	-0.6	-0.3
Exports, USD bn	109.6	100.5	96.6	92.6	81.7	75.0	81.8	94.3
Imports, USD bn	102.5	104.3	103.7	98.9	84.4	75.6	82.4	94.6
Current account balance, USD bn	-9.0	-19.7	-21.1	-19.1	-13.7	-11.6	-11.2	-11.5
as % of GDP	-2.2	-5.0	-5.8	-5.4	-4.4	-4.0	-3.6	-3.6
Foreign direct investment (net), USD bn	4.5	1.6	1.7	-1.9	-3.6	-1.0	-0.5	-0.5
Total FX reserves, USD bn	48.9	50.7	49.6	49.1	45.8	47.3	47.3	47.3
Foreign exchange reserves excl gold, USD bn	42.6	44.0	44.8	44.3	41.5	42.0	42.0	42.0
Total FX reserves, % GDP	11.7	12.8	13.5	14.0	14.6	16.4	15.2	14.9
Total external debt, % GDP	28.3	35.7	37.3	41.3	39.3	50.5	51.5	52.0
Net International Investment Position, % GDP	-11.7	-14.5	-4.3	-8.0	17.4	10.0	18.0	18.0
Credit ratings								
Moody's	A3	Baa1	Baa1	Baa2	Baa2	Baa2 (n)	n/a	n/a
S&P	BBB+	BBB	BBB	BBB-	BBB-	BBB- (n)	n/a	n/a
Fitch	BBB+	BBB+	BBB	BBB	BBB-	BBB- (st)	n/a	n/a

Source: SARB, StatsSA, National Treasury, IMF, Haver, UBS.

Turkey

- **Our main assumption is that Turkey will face a rising current account deficit, in part due to higher oil prices and the structure of growth. This should result in a persistent TRY depreciation and we see the TRY softening to 3.7 vs the USD by end-2018.**

- **To be able to control the pace of TRY weakening – and thus avoid potential rise in deposit dollarization or a major hit to corporate sector balance sheets – we believe that the CBT will have to hike rates in 2017. In an environment of persistent external financing pressures we think Turkey's growth is likely to be limited to 3% in the next two years, with risks skewed to the downside.**

We base our outlook on the external financing challenges: we project the external deficit at 6.2% of GDP by end-2018…

We build our 2017-18 macroeconomic outlook up from the external financing framework. UBS forecasts oil prices to rise to $60 per barrel in 2017 and $70 per barrel in 2018. In addition, we predict a lasting fall-out in tourism revenues: while net tourism revenues reached $21.2bn in 2015, on our projections it would fall to $13.5bn this year, and then rebound gradually to $17.5bn in 2017 and to $20bn in 2018. This would push the Turkish external deficit from around 4.3% of GDP currently to 5.8% of GDP in 2017 and to 6.2% of GDP in 2018.

…with potentially more expensive and uncertain financing flows

We think the outlook for financing is not getting any easier. So far in 2016 (based on data available until August), there was a 60% y/y drop in FDI inflows, and the bulk of the financing has come from portfolio inflows into debt and other investments. However, when we look at weekly data of portfolio inflows into Turkish local currency government bonds and equities, in net terms there were no new foreign portfolio inflows into these asset classes since mid-July (bonds: $-295m, equities: $+258mn). As our colleagues expect further Fed rate hikes, ECB's tapering from September 2017 onwards and higher global 10Y yields we believe that external financing will become more expensive and potentially more difficult to secure. Any kind of political uncertainty (domestic or geopolitical) could complicate the external financing situation further.

We see TRY under pressure and are aware of the balance sheet vulnerabilities to FX moves…

This, in our view, will keep the Turkish lira under persistent depreciation pressure in the next two years — barring any kind of major economic reforms that would change the outlook for sentiment and/or potentially for exports. As we have previously argued, the important point about FX weakness in Turkey is it has balance sheet vulnerability with regards to sharp and significant Lira movements — basically affecting both the liabilities and assets sides of the banking system:

a) Around $191bn or 41% of total deposits in the banking system are FX-denominated (more than 60% in in USD, rest is other currencies), with household FX deposits accounting for c55% of total FX deposits.
b) The non-financial corporate sector has a net FX short position of USD 211bn on its balance sheet in August 2016 (29.5% of GDP), predominantly reflecting the FX borrowing from Turkish resident banks. While some part of this open FX exposure is hedged through different channels (exports revenues, financial hedges, foreign assets of holding companies, etc), we think the magnitude is too large to be ignored given the uncertainty about the extent of protection offered. The joint work with our bank analyst, Cihan Saraoglu, (Turkey: revisiting the economic cycle) highlighted that the risk is concentrated in energy, tourism and construction sectors.

Turkey needs a level of TRY depreciation that helps on the external front to gain some competitiveness, but will not hurt the corporate sector too badly. Thus we expect the TRY to weaken to 3.45 against USD by end-2017 (3.30 previously) and to 3.70 by end-2018, implying 14% depreciation from current levels. We think a much faster TRY weakness could exacerbate these vulnerabilities via increased deposit dollarization and/or corporate NPL problems and would necessitate a much harsher reaction from authorities to safeguard the financial system.

…and thus we project TRY to depreciate to 3.70 by end-18

Achieving a gradual adjustment in any currency is easier said than done. We think though one necessary ingredient is for the Central Bank of Turkey (CBT) to start raising interest rates in 2017. The fact that the CBT shied away from easing in October supports our view that the central bank is paying attention to the TRY movements. We project a 150bps increase in the O/N lending rate to 9.75bps from the current 8.25bps level. In terms of which lever, the lira or rates, would adjust if external financing pressures were to mount, we believe it is the policy rate. Our argument is that once again controlling FX movements is important for financial stability and thus even more aggressive rate hikes could take place (2014 January template of 425-500bps hikes on different policy instruments).

CBT would need to start raising the O/N lending rate in 2017

Where does this scenario leave us with regards to growth, inflation and fiscal situation? We expect GDP growth of 3.0% in 2017 and 3.1% in 2018 (3.2% in 2016), but importantly we envisage a shift between drivers of growth to more balanced composition: we see slower growth of household consumption as the impact of the 30% minimum wage hike fades, and importantly scaled back government spending. Investments are inherently difficult to estimate but could see some rebound after the particularly soft 2016. This would allow net exports to show an improving, though still negative, contribution to GDP growth. We believe the risk to our GDP forecast is to the downside – mainly from sharper FX movements or stronger monetary policy response.

Growth to be around 3% in 2017-18, but with a more balance composition. However, risks are to the downside

Due to higher oil prices and TRY depreciation we see CPI at 7.2% and 6.5% by end-2017 and 2018 respectively, implying a miss of the CBT's 5% inflation target. Clearly the recent improvements in food prices could exert some downward pressure on inflation if maintained – food inflation slowed to 4.2% y/y recently in September 2016, well below the historical average of 9% – but we are more cautious about extrapolating this. We expect prudent fiscal policy: deficits of 1.5-2% of GDP in 2016-18. One important implication of the growth outlook is that the unemployment rate should stay above 10% in the next two years.

Inflation above the CBT's 5% target in both 2017-18. Fiscal policy to remain prudent

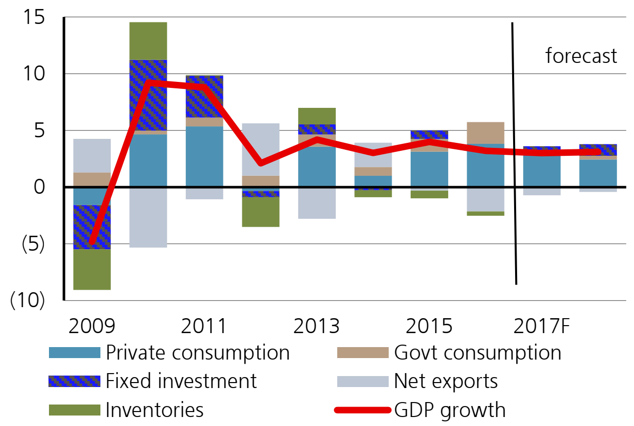
Could Turkey escape this low pace of growth via, for example, fiscal expansion? Our answer is: not in the medium-term. We think while in the short term a fiscal boost could temporarily lift growth, but in the end a higher budget deficit would boost the external deficit and thus could generate FX pressures, which in return would hit growth quickly via the above-discussed vulnerabilities.

Fiscal expansion cannot lift growth sustainably due to the twin deficit problem

Thus we continue to believe that economic reforms are necessary for Turkey to break the link between external financing restraints and growth and to raise potential growth. There are three broad reform areas that are important: a) strengthening macro-economic resilience (boosting savings, better controlling inflation and wage growth); b) boosting productivity (reducing informality, skills upgrades, improving educational outcomes, reducing tax wage for low-skilled workers); and c) better integration into global value chains (investing into R&D, vocational training).

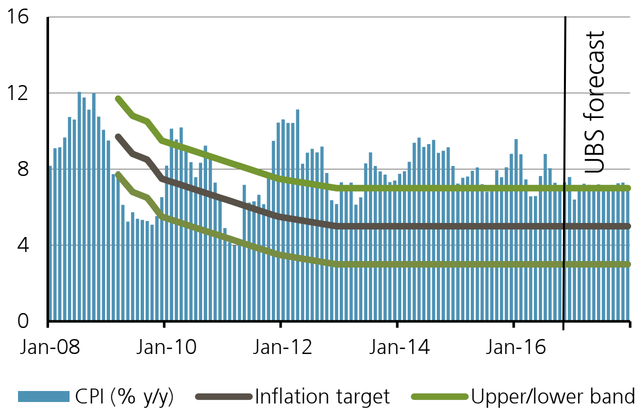
Economic reforms could lift potential growth

Figure 206: GDP growth and contributions



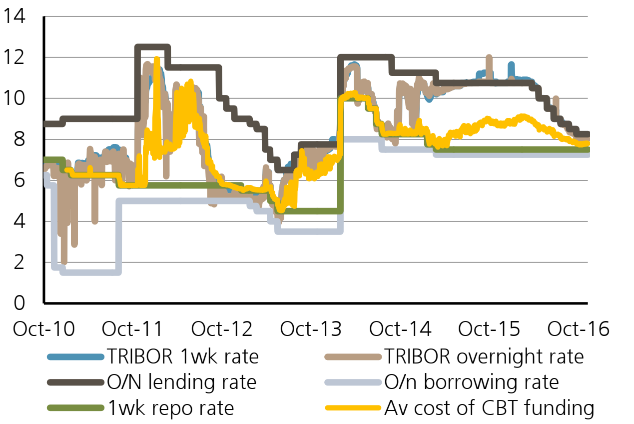
Source: Haver, UBS

Figure 207: Inflation outlook, % y/y



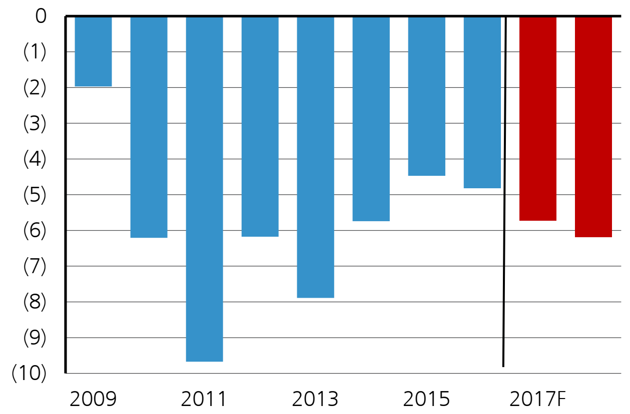
Source: Haver, UBS

Figure 208: CBT rates



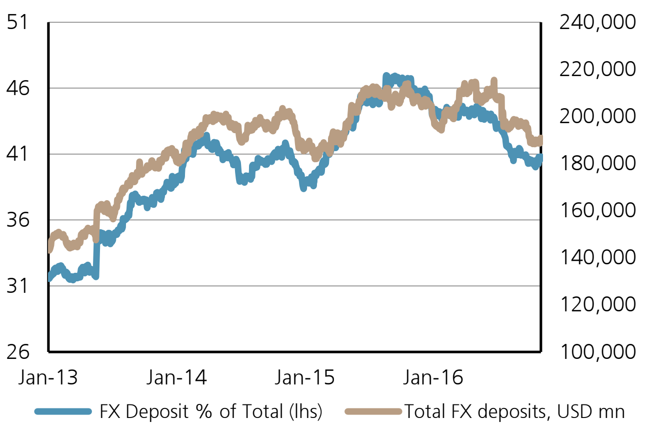
Source: Haver, UBS

Figure 209: External balance, % of GDP



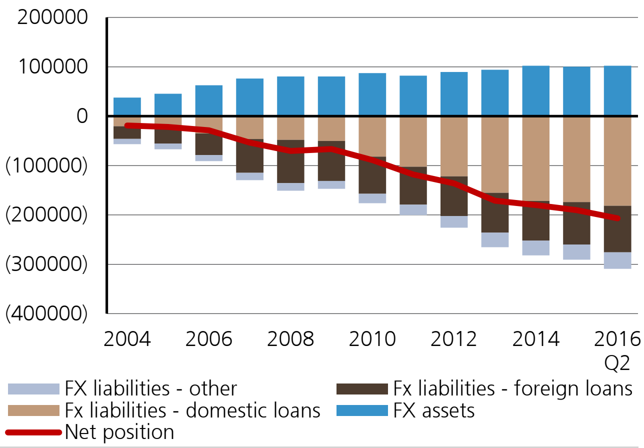
Source: Haver, UBS

Figure 210: FX deposits in the banking system



Source: Haver, UBS

Figure 211: FX-denominated assets and liabilities of nonfinancial companies, USD mn



Source: CBT, Haver, UBS

TURKEY	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	1298	1417	1567	1748	1954	2173	2395	2630
GDP, USD bn	775	786	820	798	718	710	720	736
GDP per capita, USD	10484	10554	10875	10476	9328	8994	9031	9133
Real GDP growth, %	8.8	2.1	4.2	3.0	4.0	3.2	3.0	3.1
Private consumption, % y/y	7.7	-0.5	5.1	1.4	4.5	5.5	4.0	3.5
Government consumption, % y/y	4.7	6.1	6.5	4.7	6.7	11.5	0.0	2.0
Gross Fixed Capital formation, % y/y	18.0	-2.7	4.4	-1.3	3.6	0.0	4.0	5.0
Exports, % y/y	7.9	16.3	-0.2	7.4	-0.8	1.0	4.0	4.5
Imports, % y/y	10.7	-0.4	9.0	-0.3	0.3	8.0	6.0	5.5
Unemployment rate, %	13.0	11.2	9.2	8.4	9.1	10.4	10.6	10.6
Industrial Production (%)	-9.9	12.8	10.1	2.5	3.0	3.0	2.5	3.0
Prices, interest rates and money								
CPI inflation, % y/y (average)	6.5	8.9	7.5	8.9	7.7	7.8	7.0	6.5
CPI inflation, % y/y (year-end)	10.4	6.2	7.4	8.2	8.8	7.8	7.2	6.5
Broad money M2, % y/y (end-year)	14.8	10.2	22.2	11.9	17.1	12.0	12.0	12.0
Domestic private credit, % y/y	34.7	19.5	33.8	17.5	19.4	11.5	11.5	11.5
Domestic bank credit/GDP	47.6	52.1	62.9	66.2	70.8	72.0	72.8	74.0
Policy rate, % (end-year)*	7.9	5.6	6.8	8.5	8.8	7.8	9.8	9.8
10 year bond yield, % (year-end)	10.0	6.6	10.2	8.0	10.7	10.6	11.0	11.0
USD/TRY (year-end)	1.92	1.78	2.15	2.33	2.92	3.20	3.45	3.70
EUR/TRY (year-end)	2.34	2.31	2.56	2.91	3.02	3.62	3.90	4.33
Fiscal accounts								
General government budget balance, % GDP	-1.4	-2.1	-1.2	-1.3	-1.2	-1.8	-1.6	-1.5
Revenue, % GDP	34.6	35.0	37.2	36.4	37.0	36.6	37.0	37.0
Expenditure, % GDP	36.0	37.1	38.4	37.7	38.2	38.4	38.6	38.5
of which interest expenditure, % GDP	3.2	3.4	3.2	2.9	2.8	2.8	2.8	2.8
Primary balance, % GDP	1.8	1.3	2.0	1.6	1.6	1.0	1.2	1.3
Public sector debt (gross),% GDP	41.2	38.8	38.7	36.3	36.0	35.0	34.5	34.0
of which domestic public debt, % GDP	29.1	28.0	26.6	24.6	23.4	25.0	25.0	25.0
of which external public debt,% GDP	12.1	10.8	12.2	11.7	12.6	10.0	9.5	9.0
% domestic public debt held by non-residents	19.5	28.6	28.1	29.1	21	23.5	23.5	23
Public debt held by the central bank, % GDP	0.6	0.6	0.6	0.5	0.5	0.4	0.4	0.3
Balance of payments								
Trade balance, USD bn	-89.2	-65.4	-79.9	-63.6	-52.2	-42.0	-59.0	-70.0
Exports, USD bn	142.4	161.9	161.8	169.0	144.5	143.0	149.0	156.0
Imports, USD bn	231.6	227.3	241.7	232.6	196.7	185.0	208.0	226.0
Current account balance, USD bn	-75.0	-48.5	-64.7	-45.8	-32.1	-34.5	-41.5	-45.5
as % of GDP	-9.7	-6.2	-7.9	-5.7	-4.5	-4.9	-5.8	-6.2
Foreign direct investment (net), USD bn	13.8	9.2	8.8	5.5	11.8	6.0	10.0	10.0
Total FX reserves, USD bn	88.3	119.2	131.0	127.3	110.5	123.0	123.0	123.0
Foreign exchange reserves excl gold, USD bn	78.5	99.9	110.9	106.9	92.9	104.0	104.0	104.0
Total FX reserves, % GDP	11.4	15.2	16.0	15.9	15.4	17.3	17.1	16.7
Total external debt, % GDP	39.2	43.0	50.4	52.1	59.2	61.0	62.0	62.0
Net International Investment Position, % GDP	-44.5	-53.6	-51.1	-57.4	-56.6	-59.0	-60.5	-62.0
Credit ratings								
Moody's	Ba2	Ba1	Baa3	Baa3	Baa3	Ba1 (sta)	n/a	n/a
S&P	BB	BB	BB+	BB+	BB+	BB (neg)	n/a	n/a
Fitch	BB+	BBB-	BBB-	BBB-	BBB-	BBB- (neg)	n/a	n/a

Source: CBT, TurkStat, IMF, EuroStat, Haver, UBS. *Average costs of financing until end-2016, O/N lending rate in 2017-18

Poland

- **We expect 3.3% GDP growth in both 2017/18 following 3.1% in 2016. We cut 2016/17 GDP numbers due to lower EU fund inflows.**
- **We project CPI to rebound in 2017 and reach the NBP's 2.5% target in 2018 on the back of tight labour market and higher energy prices. The NBP should hike rates by 25bps in Q4-17 and then by 75bps to 2.50% in 2018. We forecast the PLN to appreciate to 4.15 vs EUR by end-18.**

Constructive macro view on Poland

We remain constructive on the Polish macro outlook: Poland is likely to be the growth champion in EMEA in 2017-18, with inflation rising back to target by 2018 and the NBP raising its policy rates to zero by end-2018. The solid external position in combination with the NBP's policy response should result in a stronger PLN on the forecast horizon.

Growth to reach 3.3% in 2017-18, and should be well balanced

We project Polish GDP growth to accelerate from 3.1% this year (3.6% previously) to 3.3% in 2017 (previously 3.4%) and 2018. The downward revision reflects the slower absorption of EU funds. We see growth being well-balanced. Household consumption should benefit from the tightening of the labour market, which drove employment to record highs and also started to generate upward pressure on wages. Consumer confidence has also improved and household's still have the ability to leverage up. Investment spending should benefit from the expected bounce in EU fund absorption – here the question is to what extent the banking system would constrain private credit growth with the uncertainties around the final form of the CHF loan solution. As we only project a marginal slowdown in the Euro Area, exports should continue to do well.

As the budget deficit should be close to 3% of GDP in 2017, Poland cannot deploy additional fiscal stimulus in case of an adverse growth shock

As we believe that the government would like to keep its budget deficit below the Excessive Deficit Procedure's threshold of 3% of GDP (we project 2.8% of GDP in 2017), Poland cannot really deploy any counter-cyclical fiscal easing in case of an adverse external growth shock. If the external shock is particularly severe, Poland might need to carry out pro-cyclical fiscal tightening to make sure it can avoid the EDP. In this regard, Poland is different from the Czech Republic and Hungary, which have more fiscal scope to manoeuvre.

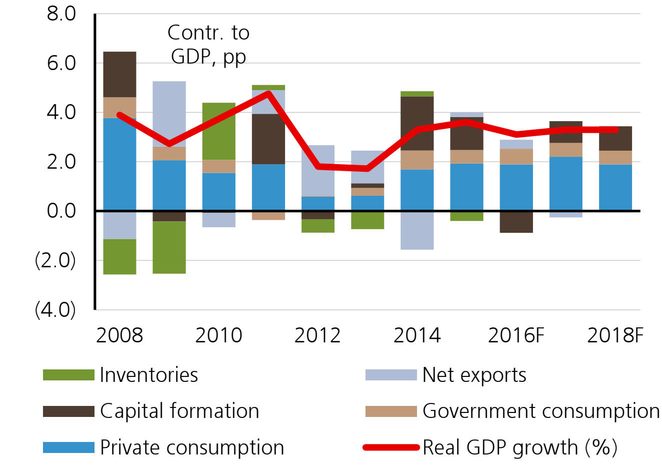
CPI to reach 2.5% mid-2018, we expect the NBP to start hiking rates in Q4 2017

We expect inflation to continue to rise from -0.5% y/y in October-2016 to below 2% by end-2017 and then reach the National Bank of Poland's inflation target of 2.5% by mid-2018. The pick-up in CPI should be driven by: a practically closed output gap, a further rise in nominal wage growth and higher energy prices. We expect the NBP to start raising rates in Q4-2017 by 25bps to 1.75%, followed by three more 25bps hikes to 2.50% in 2018. This would get Poland to a zero real policy rate by end-2018. This view would be in line with the UBS view on major central banks removing accommodation: Fed to start rate hiking again from Dec-2016 and the ECB to taper from Sep-2017. We acknowledge that the risk to our view is that the NBP would only consider moving in 2018 – in case of any external shocks that could derail the recovery or keep inflation lower for longer.

PLN to appreciate to 4.15 against EUR by end-2018

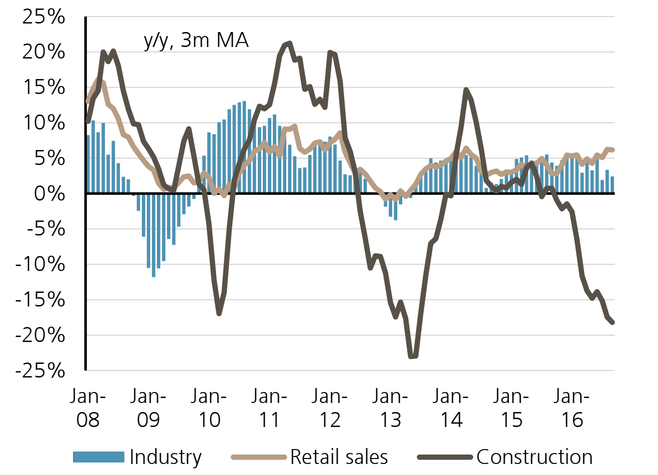
As we forecast a very solid external financing framework for Poland – the small current account deficit to be financed by EU funds booked on the capital account and by FDI – and project higher yields, we believe that Poland could start to attract inflows again, which could lead to a gradual PLN appreciation against the EUR to 4.15 by end-2018. Here one issue is that the government could control the pace of PLN strengthening by deciding on how much EU funds/Eurobond receipts will be converted off-market with the NBP.

Figure 212: Growth driven by domestic demand



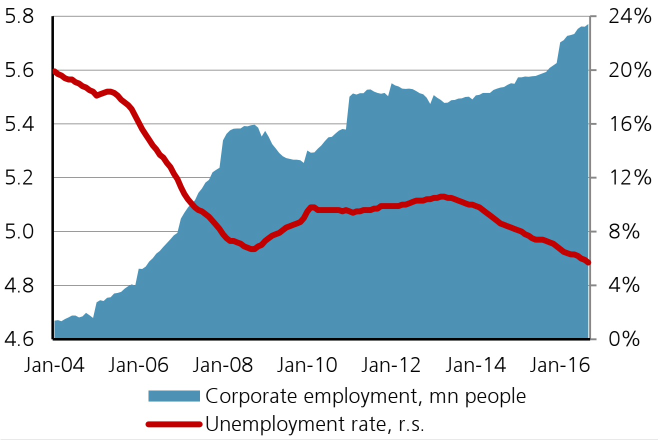
Source: Haver, UBS

Figure 213: Consumer buoyant but construction weakens



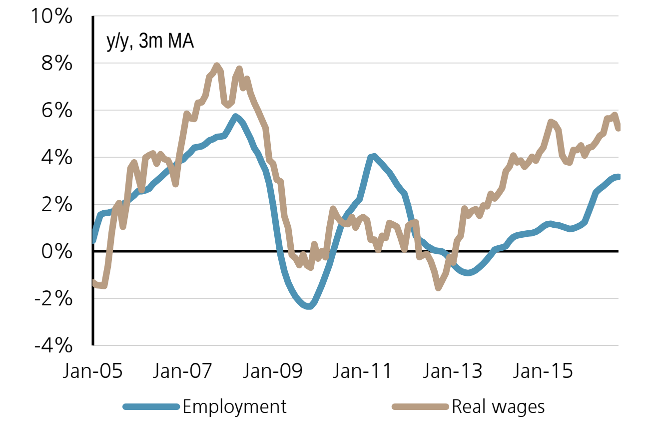
Source: GUS, Haver, UBS

Figure 214: Unemployment at historical lows and falling



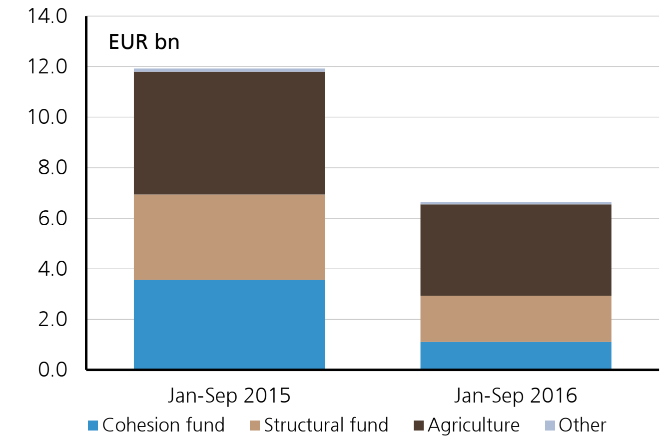
Source: GUS, Haver, UBS

Figure 215: Tightening labour market pushes wages up



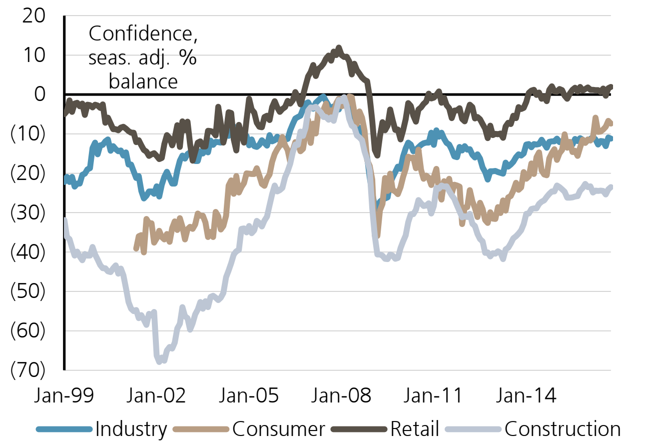
Source: GUS, Haver, UBS

Figure 216: Drop in EU funds absorption likely temporary



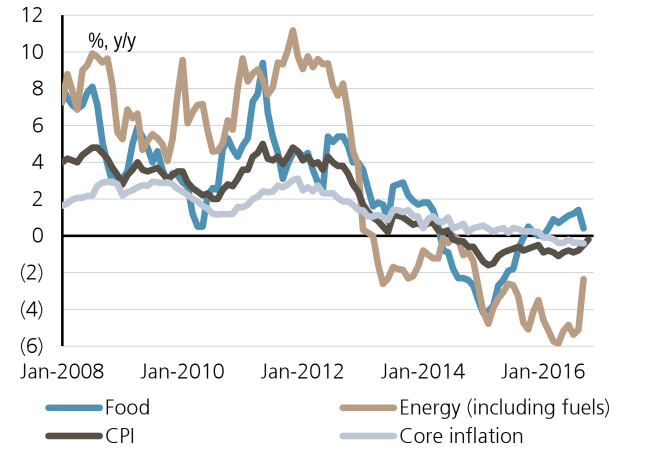
Source: Ministry of Finance, UBS

Figure 217: Consumer confidence on the rise



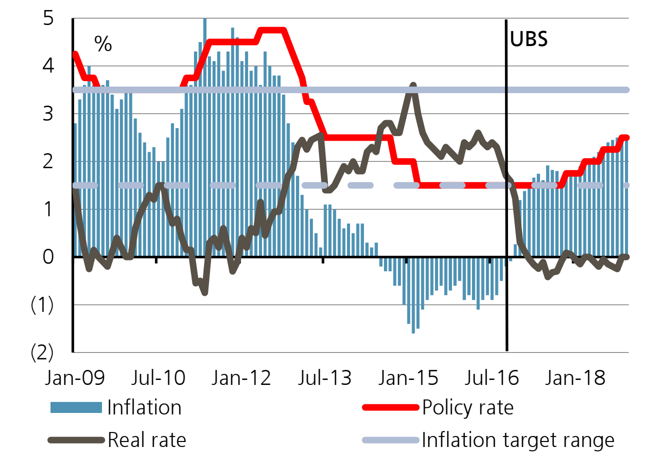
Source: EC, Haver

Figure 218: Inflation kept low by energy prices, for now



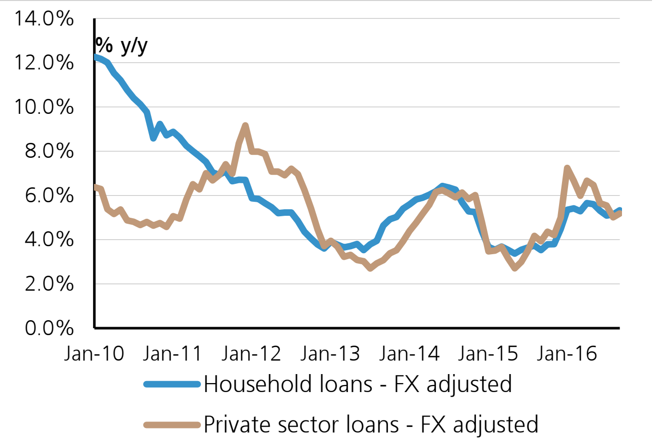
Source: GUS, Haver, UBS

Figure 219: NBP likely to start tightening in late 2017



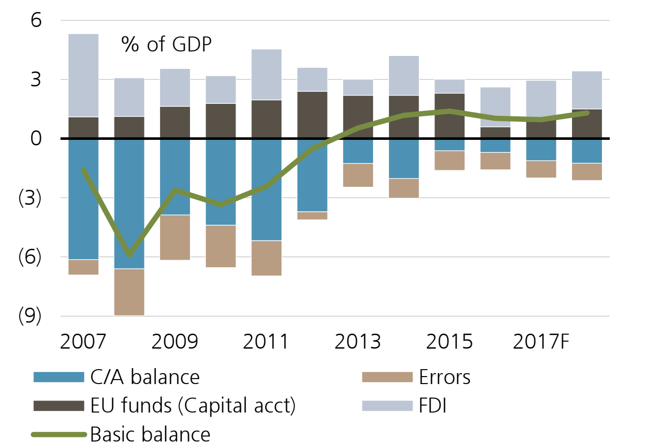
Source: GUS, Haver, NBP, UBS

Figure 220: Stable retail loan growth, slowing corporate



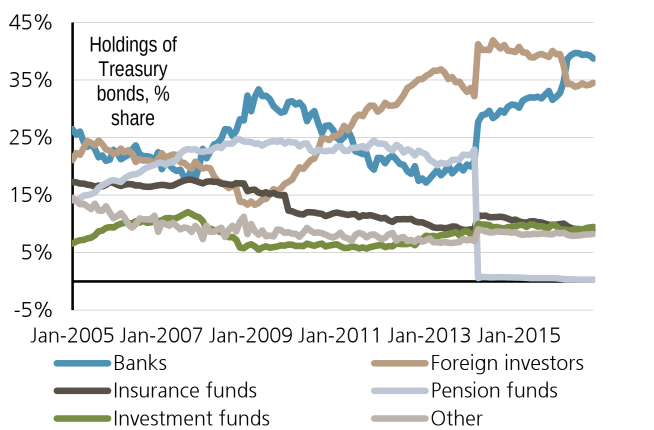
Source: NBP, Haver, UBS

Figure 221: Rock-solid external financing background



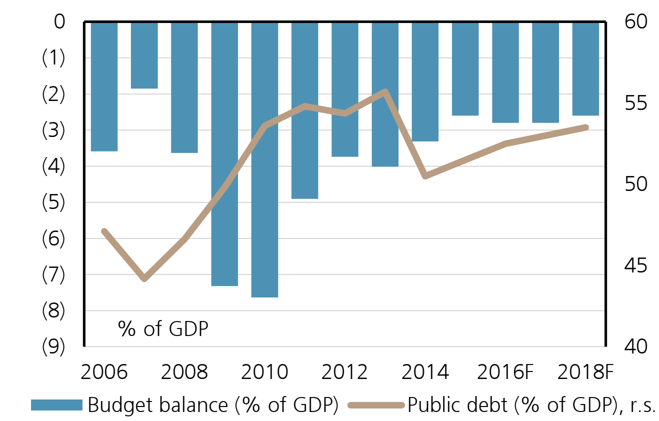
Source: NBP, Haver, UBS

Figure 222: Foreigners have cut back PLN bond holdings



Source: Ministry of Finance, Haver, UBS

Figure 223: Poland will likely aim to stay out of EDP



Source: Eurostat, Haver, UBS

POLAND	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	1567	1629	1656	1719	1790	1833	1923	2031
GDP, USD bn	529	499	524	545	475	469	502	556
GDP per capita, USD	13904	13101	13770	14325	12477	12350	13212	14644
Real GDP growth, %	4.8	1.8	1.7	3.3	3.6	3.1	3.3	3.3
Private consumption, % y/y	3.0	0.9	1.0	2.7	3.1	3.0	3.5	3.0
Government consumption, % y/y	-2.2	0.2	1.9	4.8	3.4	4.0	3.5	3.5
Gross Fixed Capital formation, % y/y	9.3	-1.5	0.8	10.0	6.1	-4.0	4.0	4.5
Exports, % y/y	7.9	4.3	4.9	6.4	6.6	7.0	4.5	5.0
Imports, % y/y	5.5	-0.6	1.7	9.9	6.0	6.0	5.0	5.0
Unemployment rate, % (year-end)	12.5	13.4	13.4	11.4	9.8	8.8	8.5	8.3
Industrial Production (%)	7.0	1.0	2.4	3.5	4.8	3.3	3.0	3.5
Prices, interest rates and money								
CPI inflation, % y/y (average)	4.3	3.9	0.9	0.0	-0.9	-0.7	1.6	2.2
CPI inflation, % y/y (year-end)	4.6	2.5	0.7	-1.0	-0.5	0.3	1.7	2.5
Broad money M2, % y/y (end-year)	11.5	4.2	6.7	8.8	9.7	9.0	9.0	9.0
Domestic private credit, % y/y	13.9	0.7	3.3	5.8	7.1	5.0	6.5	6.5
Domestic bank credit/GDP	55.7	54.0	54.7	55.5	56.9	58.4	59.2	59.7
Reference rate, % (end-year)	4.5	4.3	2.5	2.0	1.5	1.50	1.75	2.5
10 year bond yield, % (year-end)	5.9	3.7	4.3	2.5	3.0	3.3	3.4	3.6
USD/PLN (year-end)	3.4	3.1	3.0	3.5	3.9	3.9	3.8	3.5
EUR/PLN (year-end)	4.42	4.12	4.15	4.26	4.26	4.30	4.25	4.15
Fiscal accounts								
General government budget balance, % GDP	-4.9	-3.7	-4.0	-3.3	-2.6	-2.8	-2.8	-2.6
Revenue, % GDP	38.8	38.9	38.4	38.9	38.9	39.5	40.0	40.0
Expenditure, % GDP	43.7	42.6	42.4	42.2	41.5	42.3	42.8	42.6
of which interest expenditure, % GDP	2.4	2.7	2.6	2.0	1.8	1.8	1.8	1.8
Primary balance, % GDP	-2.5	-1.0	-1.4	-1.3	-0.8	-1.0	-1.0	-0.8
Public sector debt (gross, ESA95),% GDP	54.8	54.4	55.7	50.5	51.1	52.5	53.0	53.5
of which domestic public debt, % GDP	37.3	37.0	38.7	32.6	33.5	34.5	35.0	35.8
of which external public debt,% GDP	17.5	17.3	17.0	17.9	17.9	18.1	17.5	17.7
% domestic public debt held by non-residents	29.6	35.6	33.6	39.8	39.5	34.5	35.0	40.0
Public debt held by the central bank, % GDP	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Balance of payments								
Trade balance, USD bn	-18.5	-10.5	-0.4	-4.3	2.4	2.4	0.6	-0.4
Exports, USD bn	184.2	181.3	198.0	210.8	190.8	194.6	206.2	225.3
Imports, USD bn	202.8	191.8	198.4	215.1	188.5	192.2	205.6	225.7
Current account balance, USD bn	-27.4	-18.5	-6.6	-11.0	-2.9	-3.3	-5.7	-7.1
as % of GDP	-5.2	-3.7	-1.3	-2.0	-0.6	-0.7	-1.1	-1.3
Foreign direct investment (net), USD bn	13.6	6.0	4.2	10.9	3.4	9.5	10.0	11.0
Total FX reserves, USD bn	98.0	109.0	106.4	100.3	94.7	110.0	115.0	120.0
Foreign exchange reserves excl gold, USD bn	92.6	103.4	102.2	96.5	91.4	106.7	111.7	116.7
Total FX reserves, % GDP	18.5	21.9	20.3	18.4	19.9	23.5	22.9	21.6
Total external debt, % GDP	70.8	70.2	69.8	72.8	71.9	72.5	70.0	66.0
Net International Investment Position, % GDP	-62.4	-65.4	-69.0	-69.1	-62.8	-60.5	-58.0	-55.0
Credit ratings								
Moody's	A2	A2	A2	A2	A2	A2 (n)	n/a	n/a
S&P	A-	A-	A-	A-	A-	BBB+ (n)	n/a	n/a
Fitch	A-	A-	A-	A-	A-	A- (st)	n/a	n/a

Source: Haver, Bloomberg, NBP, GUS, IMF, Eurostat, UBS

Czech Republic

- **The Czech economy continues to show strong macro fundamentals in 2017-18. The economy has scope to rely on countercyclical policy in case of an external shock.**

- **We expect the CNB to exit the CZK floor in Q2 2017, but only hiking rates in 2018 to 0.5%. The resulting negative rate should help to slow the appreciation of the CZK.**

Strong growth, accelerating inflation and a corresponding normalization of monetary policy

In our view, the Czech economy in 2017-18 will be characterized by decent growth momentum (2.9% and 2.7% in 2017-18 vs 2.7% in 2016), accelerating inflation and a corresponding normalization of monetary policy. Although 2017 — being an election year — should bring some fiscal easing in the form of higher public sector wages, the budget deficit is likely to remain very subdued (-0.5% of GDP in 2017-18) and public debt should decline to below 40% of GDP. Importantly, the solid fundamentals allow Czech policymakers to rely on countercyclical policies (mainly fiscal loosening) to offset any external growth shock. We discuss two aspects of our forecasts.

Our above-consensus 2017 growth forecast is driven by private consumption, a rebound in investments and fiscal loosening

First, our GDP estimate for 2017 is well above consensus (2.5%). We expect economic growth to benefit from: a) robust private consumption – fuelled by record high employment, rising wage growth and positive consumer sentiment; b) rebounding private and government investments partially on the back of higher EU funds' absorption; and c) expected fiscal loosening in 2017 (an increase in headline budget deficit by 0.5pp). In our view, the major downside risks to the Czech outlook are external: e.g. softer Euro Area growth, potentially higher oil prices.

We expect the CNB to exit the CZK floor in Q2 2017, first rate hike only in 2018

Second, the outlook for monetary policy. We believe that — in line with the current guidance — the Czech National Bank (CNB) will drop the Koruna floor (27 versus the EUR) in Q2 2017. We think the exit from the floor is essentially tied to the CNB's forecast that inflation will increase above the 2% target around Q2 next year: we expect CPI to exceed 2% from May 2017 onwards, primarily due to rising core inflation and higher energy prices (fuel and household utilities).

The size of the CNB balance sheets was 46% of GDP in October, and the CNB has spent a cumulative EUR 18.1bn (10.6% of 2016 GDP) on FX intervention since July-15. The central bank indicated that it is ready to intervene to make sure that the currency does not quickly appreciate back to the pre-floor level (25.5-25.7 against the EUR) and potentially could consider temporarily introducing negative rates to discourage speculation. We do not see scope for the CNB to raise rates in 2017, when the central bank would likely be focusing on stemming the FX appreciation. However, in 2018 we think the central bank would be able to operate under more normal policy circumstances (considering also the ECB tapering and Fed hikes) and thus could raise the policy rate back to 0.5%, from 0.05% currently. This means that the Czech Republic should have negative real policy rates of (-1.8%) to (-2.5%) starting from H2 2017. In our view this should help to limit the pace of appreciation and we project the CZK to reach 26.0 against the EUR by end-17 and 25.0 by end-18.

Additional ECB QE or a major Euro Area growth shock could delay the exit from the floor

We do not think that it is likely that the CNB would drop the floor before Q2, but additional ECB QE (more significant extension that what is priced in) or a major Euro Area growth shock could delay the exit from the floor.

CZECH REPUBLIC	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	4023	4042	4077	4261	4472	4616	4849	5095
GDP, USD bn	228	207	208	206	182	187	204	230
GDP per capita, USD	21694	19715	19797	19534	17248	17726	19277	21662
Real GDP growth, %	2.0	-0.8	-0.7	2.0	4.2	2.7	2.9	2.7
Private consumption, % y/y	0.3	-1.5	0.7	1.5	2.8	2.5	2.5	2.0
Government consumption, % y/y	-3.0	-1.8	2.3	1.8	3.4	2.0	2.0	2.0
Gross Fixed Capital formation, % y/y	1.1	-3.2	-2.7	2.0	7.3	-2.0	2.5	5.0
Exports, % y/y	9.3	4.3	0.0	8.9	7.0	5.5	4.5	5.0
Imports, % y/y	6.7	2.7	0.1	9.8	7.9	4.0	3.5	5.0
Unemployment rate, %	6.7	7.0	6.9	6.1	5.0	4.0	3.7	3.7
Industrial Production (%)	6.1	-0.7	0.6	5.0	4.4	4.5	5.5	5.5
Prices, interest rates and money								
CPI inflation, % y/y (average)	1.9	3.3	1.4	0.4	0.3	0.5	2.1	2.3
CPI inflation, % y/y (year-end)	2.4	2.4	1.4	0.1	0.1	0.8	2.5	2.3
Broad money M2, % y/y (end-year)	4.1	4.6	5.0	6.6	8.4	9.0	8.5	9.0
Domestic private credit, % y/y	6.5	2.6	6.3	3.5	5.2	7.0	6.5	6.5
Domestic bank credit/GDP	49.3	50.0	51.4	50.2	50.6	51.2	51.9	52.6
Policy rate, % (end-year)	0.75	0.05	0.05	0.05	0.05	0.05	0.05	0.50
10 year bond yield, % (year-end)	3.60	2.00	2.53	0.70	0.50	0.60	0.90	1.25
USD/CZK (year-end)	19.94	19.06	19.89	22.82	24.77	24.55	23.01	21.37
EUR/CZK (year-end)	25.80	25.14	27.43	27.70	27.00	27.00	26.00	25.00
Fiscal accounts								
General government budget balance, % GDP	-2.7	-3.9	-1.2	-2.0	-0.6	0.0	-0.5	-0.5
Revenue, % GDP	40.4	40.7	41.6	40.8	42.2	40.0	40.5	40.5
Expenditure, % GDP	43.1	44.6	42.7	42.8	42.8	40.0	41.0	41.0
of which interest expenditure, % GDP	1.2	1.2	1.2	1.1	0.9	0.9	0.8	0.7
Primary balance, % GDP	-1.5	-2.7	0.0	-0.9	0.3	0.9	0.3	0.2
Public sector debt (gross),% GDP	39.9	44.6	45.0	42.6	40.3	40.0	39.0	38.0
of which domestic public debt, % GDP	36.2	39.5	40.2	38.0	36.3	36.0	35.1	34.2
of which external public debt,% GDP	3.7	5.1	4.9	4.6	4.0	4.0	3.9	3.8
% domestic public debt held by non-residents	14.2	12.2	15.0	14.5	21.3	30.0	30.0	20.0
Public debt held by the central bank, % GDP	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Balance of payments								
Trade balance, USD bn	5.3	7.5	8.5	10.6	8.5	9.9	9.1	8.6
Exports, USD bn	138.6	131.8	135.9	146.7	131.3	132.6	139.2	151.4
Imports, USD bn	133.3	124.3	127.4	136.1	122.8	122.8	130.1	142.8
Current account balance, USD bn	-3.8	-2.2	-1.1	0.3	1.7	3.2	2.9	2.8
as % of GDP	-1.7	-1.1	-0.5	0.1	0.9	1.7	1.4	1.2
Foreign direct investment (net), USD bn	4.2	6.2	-0.4	6.5	-1.1	0.5	1.5	1.5
Total FX reserves, USD bn	40.3	44.9	56.2	54.5	64.5	85.8	101.7	105.3
Foreign exchange reserves excl gold, USD bn	40.2	44.9	56.3	53.4	64.9	85.8	101.7	105.3
Total FX reserves, % GDP	17.7	21.7	27.0	26.5	35.4	45.8	49.9	45.9
Total external debt, % GDP	57.3	60.0	66.7	68.3	68.8	71.5	71.5	72.0
Net International Investment Position, % GDP	-45.2	-45.9	-41.4	-36.6	-30.7	-27.0	-23.0	-20.0
Credit ratings								
Moody's	A1	A1	A1	A1	A1	A1 (sta)	n/a	n/a
S&P	AA-	AA-	AA-	AA-	AA-	AA- (sta)	n/a	n/a
Fitch	A+	A+	A+	A+	A+	A+ (sta)	n/a	n/a

Source: CNB, CZSO, IMF, EuroStat, Haver, UBS.

Hungary

- **We expect economic growth to accelerate to 2.7%, reflecting pre-election fiscal stimulus and better EU fund absorptions.**
- **While the VAT cuts would help to limit the rise in CPI in 2017, we expect the NBH to hike rates to 1.65% in 2018, from 0.9% currently. The huge external surplus in combination with negative policy rates should help the HUF to stabilize around 310 vs EUR.**

We lower our 2016 forecast to 2%, but see a pick-up to 2.7% in 2017-18

Hungary was off to a weak start in H1 2016, primarily due to a decrease in EU funds (-75% y/y). We lower our 2016 GDP forecast to 2% for 2016, from 2.4% previously, reflecting soft Q3-16 high-frequency indicators. However, we expect GDP growth to pick up steam to 2.7% in 2017-18 due to: a) strong consumer with solid wage gains, rising employment and the possibility to lever up; b) pre-election fiscal stimulus in 2017; and c) rebound in EU fund absorption.

Our growth forecast is marginally more positive than the consensus number for 2017 (2.6%). Similarly to the Czech case, we see fiscal space in Hungary to partially offset an adverse external growth shock, as our budget deficit projection of 2.5% of GDP in 2017 leaves some scope for manoeuvre.

Despite rising inflationary pressures, headline CPI should only hit 3% in 2018

We think in Hungary the most interesting discussion is on monetary policy and the exchange rate. Consumer prices have already climbed to 1.0% y/y by Oct-16, and considering UBS's forecast for higher oil prices, CPI should climb higher in the next two years. Hungary has the fastest nominal wage dynamics in CEE (5.2% YTD), and core inflation (ex food and energy) is hovering at elevated levels (1.4-1.5% y/y), which means that pressure could quickly build to lift CPI towards the National Bank of Hungary's (NBH) 3% target. However, the government aims to reduce VAT on several items in 2017 (internet services, eggs, poultry, restaurants), which could slice off around 0.4pps from CPI next year. This means that inflation would "only" hit 2.3% y/y by end-2017 and reach 3% in the course of 2018.

We expect the NBH to raise its policy rates by 75bps in 2018, keeping negative real rates in the next two years

How would the central bank react? We expect the NBH to raise rates in 2018 by a cumulative 75bps to 1.65% from 0.9% currently on the back of rising inflationary pressures. This would also be consistent with UBS's view on global central banks' policy actions: ECB tapering from September 2017 at the latest and Fed raising rates to 1.63% by end-2018. Considering that the Hungarian central bank's recent policy action to quantitatively limit its key instrument, the 3-month deposit facility has started to push the interbank rate (BUBOR) below the policy instrument by 15bps to just 0.75%, Hungary's real rate was already -25bps in October. Using our inflation and the policy rate path (applying current BUBOR spread), we believe that real BUBOR rates will be negative between (-25bps) to (-150bps) until end-2018.

HUF could remain stable around 310 vs EUR due to strong external position

Why we believe this is not going to be a problem in Hungary is the rock-solid current account surplus, which we expect at 4.6% of GDP in 2017 and at 3.6% of GDP in 2018 (with higher EU fund flows as a financing item). In addition, Hungary has already seen substantial portfolio outflows from its local-currency bond market — with foreigners' share falling to just 28% in August 2016. As a result we forecast the HUF to remain 310 versus the EUR in the next two years.

Risk: delayed monetary policy response

As the NBH guidance is for rates on hold even until 2019, there is a risk that the central bank would like to delay the tightening cycle — in which case the HUF could depreciate beyond our forecast.

HUNGARY	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	28134	28628	30065	32180	33212	34012	35699	37653
GDP, USD bn	140	127	134	139	119	120	128	140
GDP per capita, USD	13885	12565	13307	13715	11778	12154	13081	14259
Real GDP growth, %	1.8	-1.7	1.9	3.7	2.9	2.0	2.7	2.7
Private consumption, % y/y	0.8	-2.3	0.2	1.8	3.1	5.5	4.0	3.0
Government consumption, % y/y	0.2	-1.4	2.5	2.9	0.5	2.0	1.0	1.0
Gross Fixed Capital formation, % y/y	-1.3	-4.4	7.3	11.2	1.9	-8.5	3.0	4.0
Exports, % y/y	6.6	-1.8	6.4	7.6	8.4	5.5	4.5	5.0
Imports, % y/y	4.5	-3.5	6.3	8.5	7.8	6.5	5.5	5.0
Unemployment rate, %	10.7	10.7	9.1	7.1	6.2	4.7	4.5	4.3
Industrial Production (%)	5.7	-1.4	1.8	7.6	7.5	2.5	3.0	4.0
Prices, interest rates and money								
CPI inflation, % y/y (average)	3.9	5.6	1.7	-0.2	0.3	0.4	2.2	2.7
CPI inflation, % y/y (year-end)	4.1	5.2	0.4	-0.9	0.9	1.4	2.3	3.0
Broad money M2, % y/y (end-year)	7.0	-1.2	4.4	9.4	7.4	7.5	8.0	8.0
Domestic private credit, % y/y	-0.8	-13.5	-5.4	-0.8	-10.5	-1.0	2.0	5.0
Domestic bank credit/GDP	65.6	56.0	51.0	46.6	39.5	38.2	37.1	36.9
Policy rate, % (end-year)	7.00	5.75	3.00	2.10	1.35	0.90	0.90	1.65
10 year bond yield, % (year-end)	9.75	6.09	5.84	3.60	3.30	3.30	3.55	3.75
USD/HUF (year-end)	240.6	218.3	220.9	259.4	287.2	281.8	274.3	265.0
EUR/HUF (year-end)	311.3	288.0	297.0	314.9	313.1	310.0	310.0	310.0
Fiscal accounts								
General government budget balance, % GDP	-5.5	-2.3	-2.5	-2.1	-1.6	-1.6	-2.5	-2.5
Revenue, % GDP	44.3	46.3	47.0	47.5	48.7	46.0	46.0	46.0
Expenditure, % GDP	49.8	48.6	49.5	49.6	50.3	47.6	48.5	48.5
of which interest expenditure, % GDP	4.3	4.0	4.0	4.0	3.6	3.6	3.6	3.6
Primary balance, % GDP	-1.2	1.7	1.5	1.9	2.0	2.0	1.1	1.1
Public sector debt (gross),% GDP	81.0	78.5	77.3	76.2	74.7	74.0	73.3	72.5
of which domestic public debt, % GDP	39.2	44.5	45.0	45.9	48.1	50.0	51.3	52.5
of which external public debt,% GDP	41.8	34.0	32.3	30.3	26.6	24.0	22.0	20.0
% domestic public debt held by non-residents	39.2	46.9	45.9	41.1	31.4	28.5	29.5	30.0
Public debt held by the central bank, % GDP	0.6	0.5	0.5	0.5	0.1	0.1	0.1	0.1
Balance of payments								
Trade balance, USD bn	4.1	3.8	4.5	3.4	4.7	5.7	6.0	5.6
Exports, USD bn	99.9	89.9	95.6	99.2	89.5	92.3	97.6	105.1
Imports, USD bn	95.8	86.2	91.1	95.9	84.8	86.5	91.6	99.6
Current account balance, USD bn	1.3	2.3	5.3	2.8	5.3	5.6	5.9	5.1
as % of GDP	0.9	1.8	4.0	2.0	4.4	4.7	4.6	3.6
Foreign direct investment (net), USD bn	1.4	2.7	1.5	3.9	-0.2	0.0	0.5	0.5
Total FX reserves, USD bn	48.8	44.7	46.5	42.0	33.1	26.4	25.4	29.8
Foreign exchange reserves excl gold, USD bn	48.9	44.7	49.6	42.0	33.0	26.3	25.3	29.7
Total FX reserves, % GDP	34.8	35.2	34.6	30.3	27.8	22.1	19.8	21.4
Total external debt, % GDP	149.7	129.9	118.4	117.1	108.2	103.5	97.0	87.0
Net International Investment Position, % GDP	-96.6	-101.4	-92.4	-80.4	-66.4	-64.0	-62.0	-52.0
Credit ratings								
Moody's	Ba1	Ba1	Ba1	Ba1	Ba1	Ba1 (p)	n/a	n/a
S&P	BB+	BB	BB	BB	BB	BBB- (st)	n/a	n/a
Fitch	BBB-	BB+	BB+	BB+	BB+	BBB- (st)	n/a	n/a

Source: NBH, CSO, IMF, EuroStat, Haver, UBS.

Kazakhstan

- **Recovery started, pace depends on oil output and prices; we expect growth to accelerate from 0.3% in 2016 to 2.4% in 2018**
- **We expect the NBK to curb KZT appreciation and continue rate cuts**
- **Questions remain over banks' asset quality and their ability to resume lending to the real sector**

Economy has absorbed the initial devaluation shock and has likely returned to growth in Q3 2016. We now expect 2016 GDP growth at 0.3%, rising to 1.5% in 2017 and 2.4% in 2018; faster Kashagan output ramp-up is an upside risk

Recent data indicates that by Q3 2016 the economy had absorbed the initial shock from last year's KZT devaluation. The inflation shock was short-lived, and headline CPI is on track to fall from the peak of 17.8% y/y in mid-year to the NBK's 6-8% target range by the start of 2017. Lower inflation and a pick-up in nominal wage growth drove a rebound in consumption. The growth shock was cushioned by government outlays, financed in part from the National Oil Fund and pension savings, which buoyed investment and construction sectors, while a good harvest supported agriculture. Following the Economy Ministry announcement of GDP expanding by a faster-than-expected +0.4%y/y in Jan-Sep 2016, we lift our 2016 forecast to 0.3% from 0, and expect recovery to gain traction in 2017 and 2018 (1.5% and 2.4%). In light of the past delays, we conservatively assume the recently started Kashagan field adds 3% p/a to oil output, so there is upside risk to our forecasts.

Stronger oil prices and further deposit de-dollarisation should create room for more rate cuts

Helped by the rebound in oil prices, the NBK has successfully curbed financial market volatility, got a grip on short-term interest rates and replenished short-term KZT liquidity. De-dollarisation of deposits (see charts overleaf) helped to stabilise the KZT exchange rate and allowed the NBK to start normalising policy rates. Public sentiment is still sensitive to exchange-rate volatility, but assuming that oil prices continue to rise towards $70 in 2018 as we expect, we think that the NBK will have scope for another 50bps rate cut to 12% by end-2016 and further easing to 8% by end-2018. The NBK targets 6-8% inflation in 2016-17, and aims to lower inflation to 3-4% by 2020.

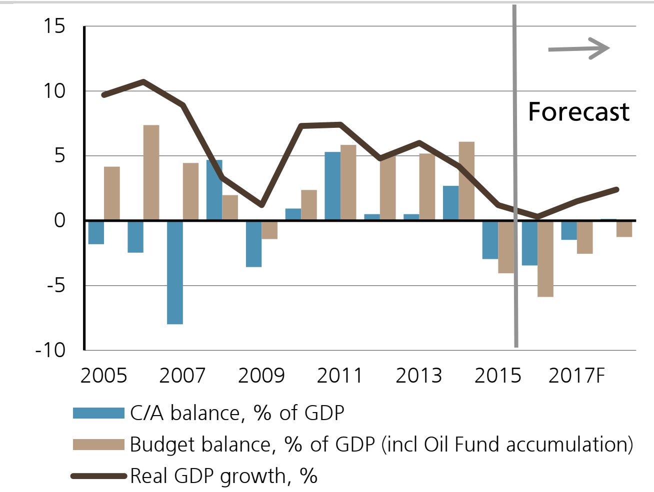
The KZT became more responsive to oil but the appetite for appreciation is limited

The NBK has used the 2016 oil-price rally and KZT normalisation to top up reserves (est. 48.6% of GDP including the Oil Fund), but has stepped away from the market in the last couple of months. We expect the KZT to remain a managed float, and think that the authorities will aim to preserve the competitiveness gains the devaluation brought to the domestic industry. So we forecast a limited (compared to RUB) appreciation of KZTUSD to 310 by end-2017 and 295 by end-2018.

Despite official data showing stable NPLs, banks

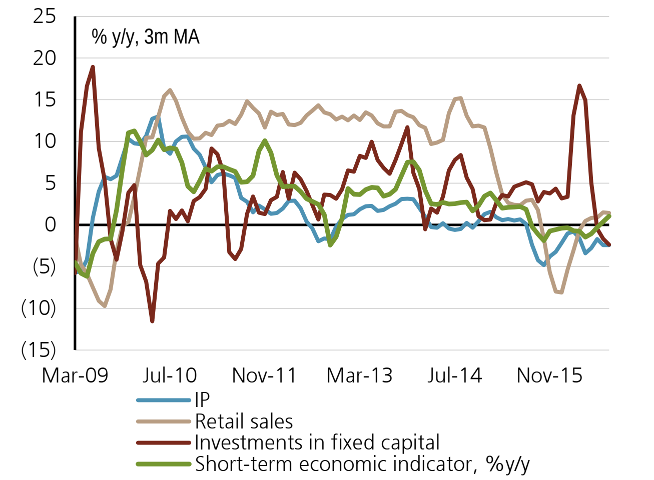
Banking system remains the Achilles' heel of the nascent recovery, in our view. Surprisingly, the official data showed very little increase in the non-performing loans ratio, although the ratings agencies warned about likely under-reporting. Interest-rate normalisation is yet to feed through to a pick-up in bank lending, and the currency mismatch between banks assets (mainly KZT) and liabilities (mainly FX) has narrowed but not closed. Officials at the NBK have conceded that the authorities have to act more vigorously to clean up remaining problems and rehabilitate financial intermediation. However, the implementation has lagged, with bank stress test originally planned for September still under discussion at the time of writing.

Figure 224: Growth and deficits about to turn around



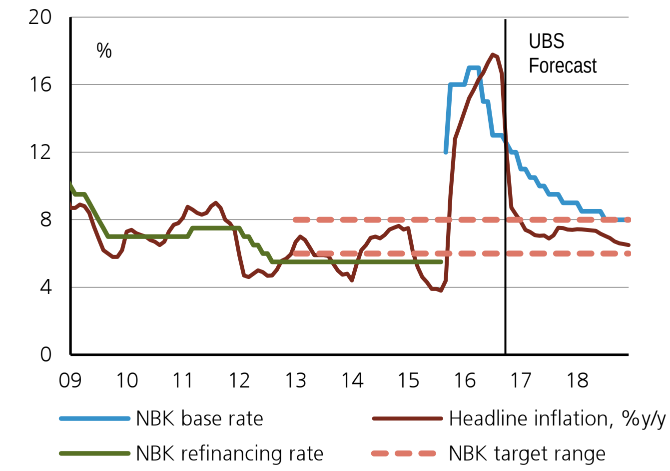
Source: Haver, UBS

Figure 225: Consumption bottomed, investment strong



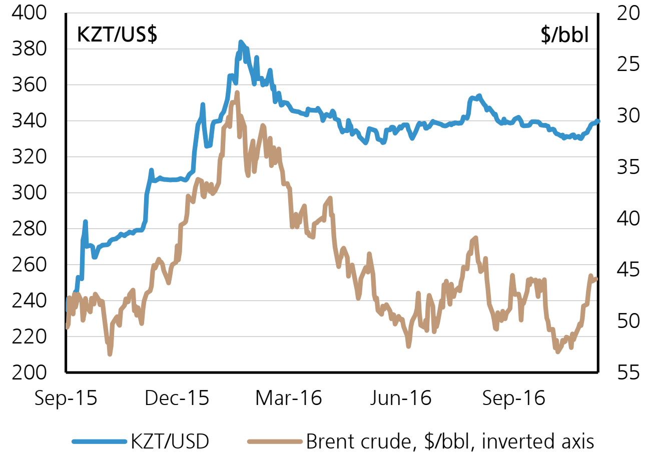
Source: stat.gov.kz, Haver, UBS

Figure 226: CPI falling sharply as devaluation shock fades



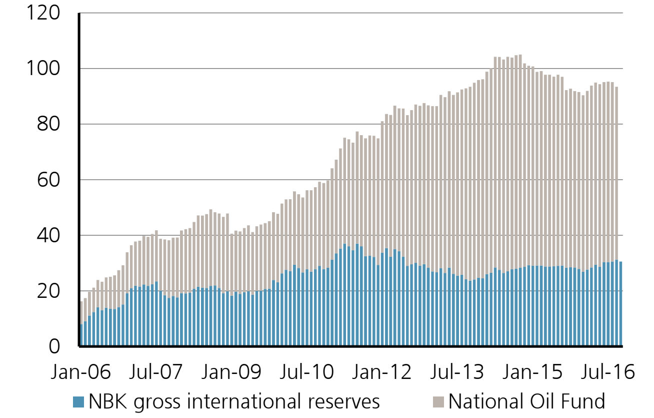
Source: Haver, NBK, UBS

Figure 227: KZT now tracks oil moves to some extent



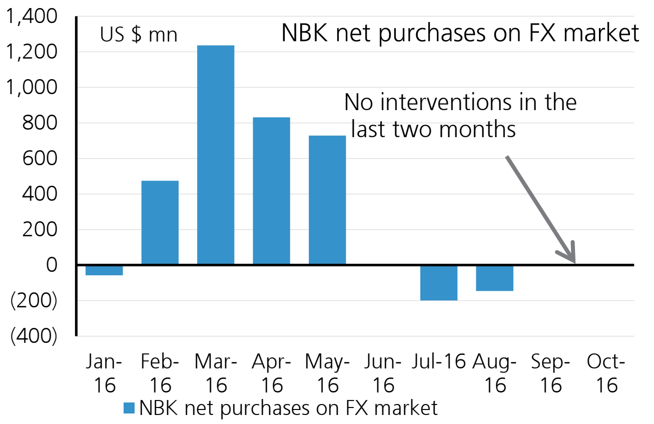
Source: Haver

Figure 228: NBK partially rebuilt FX reserves



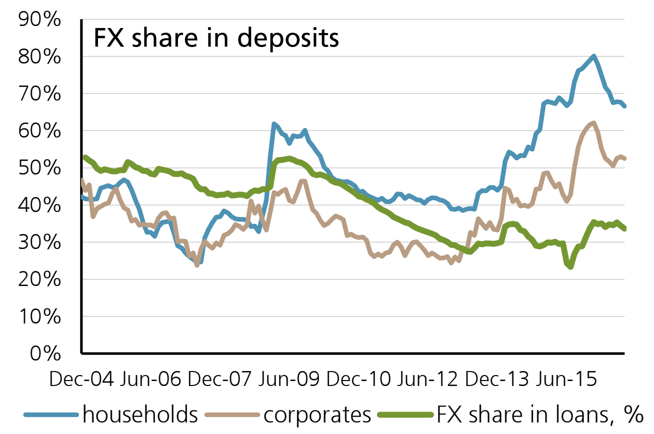
Source: NBK, Haver

Figure 229: Including via FX interventions



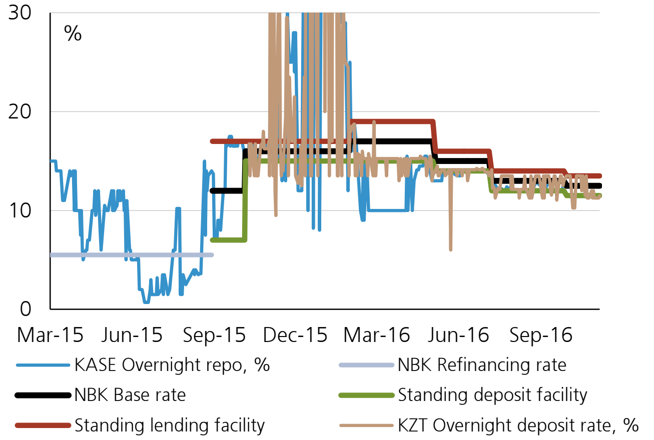
Source: NBK

Figure 230: De-dollarisation progressing



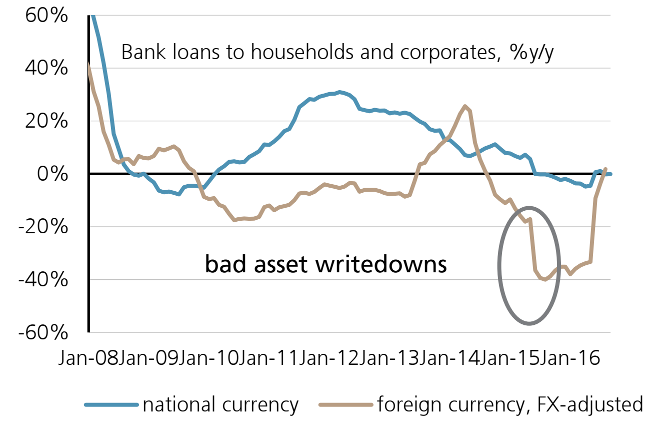
Source: NBK, Haver, UBS

Figure 231: NBK gets a grip on short-term interest rates



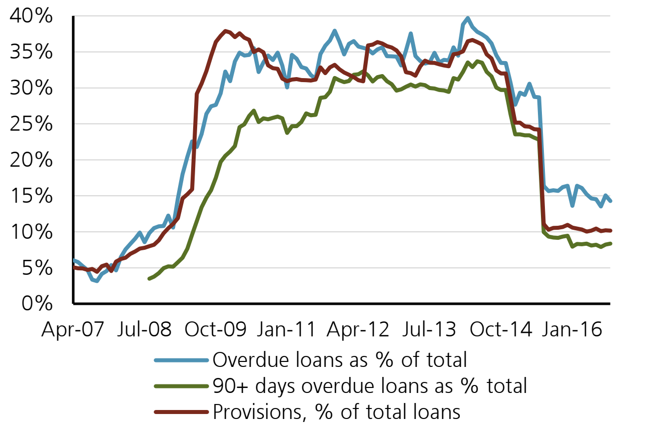
Source: Bloomberg, NBK, UBS

Figure 232: Credit growth remains depressed



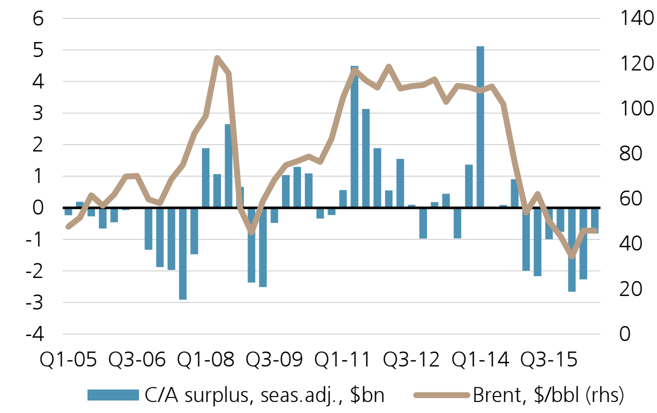
Source: NBK, Haver, UBS

Figure 233: NPLs stable but may be under-reported



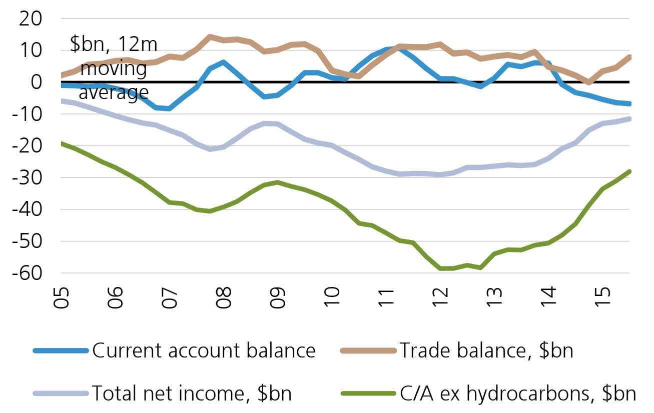
Source: NBK, UBS

Figure 234: C/A deterioration started to reverse



Source: NBK, Haver

Figure 235: Hydrocarbons sector drives FDI pick-up



Source: NBK, Haver, UBS

KAZAKHSTAN	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	28243	31015	35999	39676	40884	45666	51357	57253
GDP, USD bn	193	208	237	221	184	134	161	190
GDP per capita, USD	11553	12299	13786	12709	10427	7448	8831	10258
Real GDP growth, %	7.4	4.8	6.0	4.2	1.2	0.3	1.5	2.4
Private consumption, % y/y	12.0	10.1	10.6	1.1	1.5	-1.0	1.4	2.3
Government consumption, % y/y	11.9	13.5	1.7	9.8	3.0	3.0	3.0	3.0
Gross Fixed Capital formation, % y/y	3.4	9.9	5.5	4.4	4.7	4.0	2.0	3.0
Exports, % y/y	0.4	4.8	2.7	-2.5	-4.2	-8.0	3.3	2.9
Imports, % y/y	2.8	24.8	7.8	-4.0	-0.6	-9.3	5.9	6.0
Unemployment rate, %	5.4	5.3	5.2	5.0	5.0	5.0	4.9	4.8
Industrial Production (%)	3.3	0.5	1.3	0.2	-1.7	-1.0	2.0	2.9
Prices, interest rates and money								
CPI inflation, % y/y (average)	8.3	5.2	5.8	6.6	6.7	14.7	7.3	7.0
CPI inflation, % y/y (year-end)	8.1	6.1	4.7	7.3	13.8	8.3	7.4	6.5
Broad money M2, % y/y (end-year)	21.3	7.3	1.5	-8.2	7.9	12.0	9.0	10.0
Domestic private credit, % y/y	15.5	12.4	12.8	5.9	4.6	6.0	5.0	8.0
Domestic bank credit/GDP	41.3	42.2	40.9	39.1	45.0	39.6	37.0	35.8
Base rate, % (end-year)	7.5	5.5	5.5	5.5	16.0	12.0	9.0	8.0
>5 year bond yield, % (year-end)***	6.2	5.7	5.8	6.4	7.1	7.1	7.3	7.1
USD/KZT (year-end)	148.0	150.3	153.6	182.4	339.5	330.0	310.0	295.0
EUR/KZT (year-end)	191.5	198.3	211.8	221.4	370.0	363.0	350.3	345.2
Fiscal accounts								
General govt budget balance, % GDP*	5.8	5.0	5.2	6.1	-4.1	-5.9	-2.6	-1.3
Revenue, % GDP	23.6	23.3	21.6	23.7	13.2	11.7	13.4	14.7
Expenditure, % GDP	17.8	18.3	16.4	17.6	17.2	17.6	16.0	16.0
of which interest expenditure, % GDP	0.5	0.5	0.5	0.5	0.5	0.6	0.6	0.6
Primary balance, % GDP	6.3	5.5	5.7	6.6	-3.6	-5.3	-2.0	-0.7
Public sector debt (gross),% GDP	12.2	13.0	12.9	14.6	18.8	22.5	21.3	19.1
of which domestic public debt, % GDP	9.3	10.0	10.1	10.7	11.5	12.5	13.0	12.0
of which external public debt,% GDP	3.0	3.0	2.8	4.0	7.3	10.0	8.3	7.1
% general govt debt held by non-residents	19.6	18.8	16.4	15.7	28.0	26.0	22.0	20.0
Public debt held by the central bank, % GDP	0.0	0.1	0.6	1.1	0.8	0.7	0.8	0.7
Balance of payments								
Trade balance, USD bn	43.9	38.8	34.3	36.0	12.5	9.7	15.7	21.9
Exports, USD bn	84.2	86.0	85.1	80.1	46.3	40.2	49.7	57.9
Imports, USD bn	40.3	47.2	50.8	44.1	33.8	30.5	34.0	36.0
Current account balance, USD bn	10.2	1.1	1.2	6.0	-5.5	-4.6	-2.4	0.3
as % of GDP	5.3	0.5	0.5	2.7	-3.0	-3.4	-1.5	0.1
Foreign direct investment (net), USD bn	8.6	11.9	8.0	4.8	3.4	8.0	4.5	4.5
Total FX reserves, USD bn	29.3	28.3	24.7	29.2	27.9	32.0	35.0	38.0
Foreign exchange reserves excl gold, USD bn	25.2	22.1	19.2	21.8	20.3	24.4	27.4	30.4
Total FX reserves, % GDP	15.2	13.6	10.4	13.2	15.1	23.9	21.8	20.0
Total external debt, % GDP**	32.6	33.3	32.1	35.2	38.9	56.1	49.7	43.2
Net International Investment Position, % GDP	-17.0	-17.0	-14.1	-18.2	-22.7	-17.4	-21.0	-22.6
Credit ratings								
Moody's	Baa2	Baa2	Baa2	Baa2	Baa2 (s)	Baa3 (n)	n/a	n/a
S&P	BBB+	BBB+	BBB+	BBB+	BBB (n)	BBB- (n)	n/a	n/a
Fitch	BBB	BBB+	BBB+	BBB+	BBB+ (s)	BBB (st)	n/a	n/a

Source: NBK, Haver, Bloomberg, UBS. * incl National Oil Fund. ** excluding intercompany debt. *** MEUKAM

United Arab Emirates

- **GDP growth is likely to bottom at 2.6% in 2016, rising to 3% in 2018**
- **After spending cut, raising non-oil revenues is the next fiscal priority**
- **Oil recovery to $70 in 2018 should return fiscal and external surpluses**

A jump in oil output lifted 2015 GDP growth to 3.8% but we expect growth to slow to 2.6% in 2016 as non-oil sectors slow

UAE's GDP expanded by 3.8% in 2015, up from a downwardly revised 3.1% in 2014. The acceleration was driven by a pick-up in oil output, even as non-oil growth eased under pressure from lower oil prices, fiscal consolidation and slower credit growth. Production of oil dipped in early 2016, however: on IEA data, output was up 2.5% y/y in Q1-Q2 2016 after +6.3% in 2015. We expect oil GDP to grow by 2% in 2016 and to slow down further into 2018.

We expect GDP growth to recover towards 3% in 2018 on higher oil prices and a smaller fiscal drag

The factors holding back growth in non-oil sectors have largely remained in place in 2016 but recovery in oil prices towards $70/bbl in 2018 and a likely end to nominal government spending cuts should help to propel growth higher, offsetting the drag from slower oil output expansion. Overall, we expect GDP growth to bottom out at 2.6% y/y in 2016 and to accelerate towards 3% in 2018.

The focus of fiscal consolidation efforts shifts from spending cuts to generating non-oil revenues

In the first phase of fiscal consolidation, the authorities cut energy subisides, non-essential spending and transfers to Abu Dhabi GREs, totalling c.13% lower nominal spending in 2015, with smaller cuts planned for 2016. The emphasis for 2018 and beyond is on non-oil revenue mobilisation, with preparations under way to introduce 5% VAT from 1 January 2018. This will likely lead to a temporary jump in inflation of up to c.3pp, on our numbers, although since only large companies are obliged to register in the initial stage, the impact could well be smaller. The increase would be from low levels, since a strong AED and a weak property market dampen price pressures. A hike in excise duties and a broadening of the CIT are also debated.

Public sector is likely to be less of a drag on AED liquidity but interest rates should still rise as the US Fed hikes rates

Lower funding requirements (we expect general government balance to swing back into surplus in 2018), and from 2016 greater reliance on debt issuance rather than on drawing down public-sector deposits should help to ease domestic funding constraints. However, we expect domestic interest rates to continue rising, since the Central Bank is likely to raise policy rates in lockstep with the US Fed. This would probably act as a brake on domestic lending, and we expect only a modest acceleration in credit growth from 6-6.5% this year to 7.5% in 2017-18.

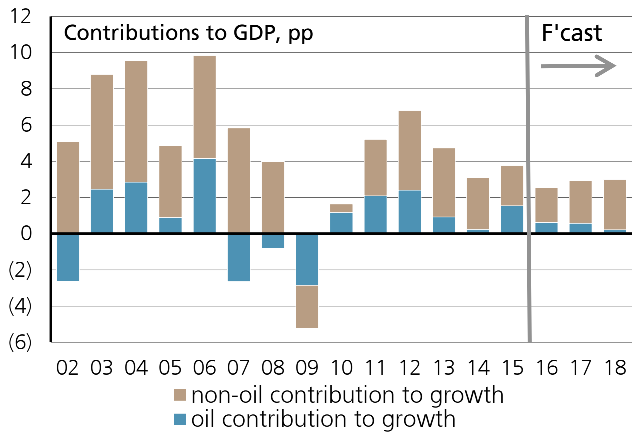
Property market remains weak: flatlining sale prices and sliding rental prices

The property market remains subdued: on REIDIN data, residential sales prices have stabilised after a correction in 2015 but no rebound is visible, while rental prices continued to slide. As of September 2016, residential prices were down 1.8% y/y in Dubai and -0.1%y/y in Abu Dhabi.

Risks to outlook: oil prices, capital outflows, developments elsewhere in the GCC

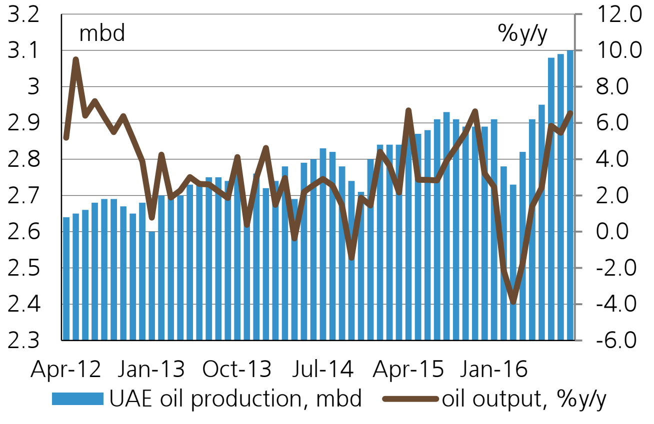
In our view, the key near-term risks to our base-case outlook centre around 1) oil prices; 2) capital outflows (e.g. due to a rapid move up in global yields or due to the country no longer being perceived as a safe haven due to geopolitical changes); and 3) policy mistakes, such as mismanagement of the still substantial leverage of the government-related entities. Extensive trade and financial linkages to the rest of the GCC could also become vulnerable, although the recovery in oil prices, we think, has somewhat reduced the chances of negative spillovers from the rest of the bloc.

Figure 236: GDP growth, oil vs non-oil sectors



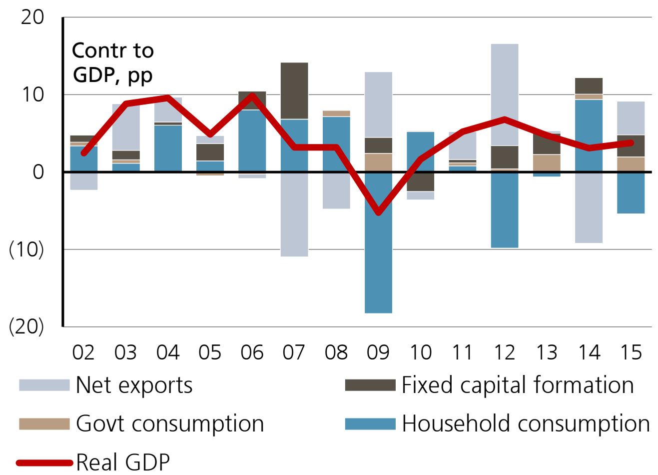
Source: Haver, UBS

Figure 237: Oil output



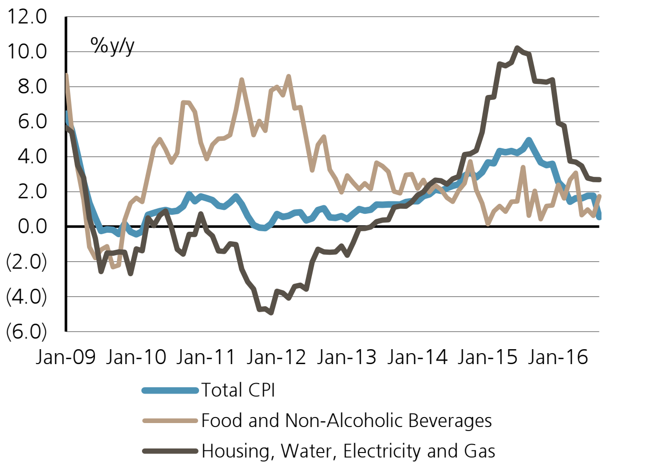
Source: IEA Oil Market Report, UBS

Figure 238: GDP growth by expenditure



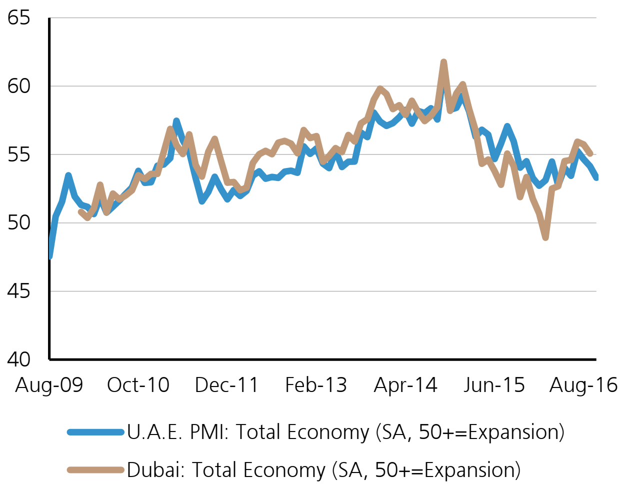
Source: Haver, UBS

Figure 239: Utility price hikes' effect on CPI faded away



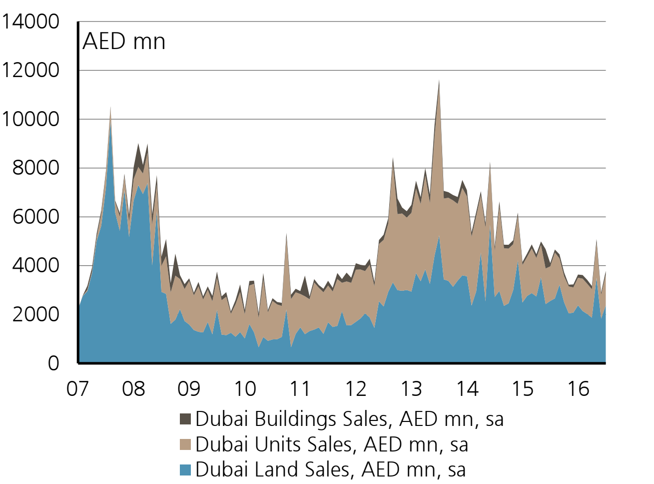
Source: Haver, UBS

Figure 240: UAE PMIs remain range-bound



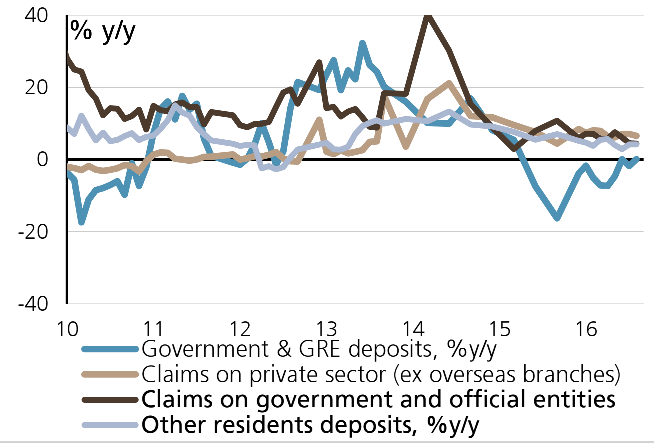
Source: Haver

Figure 241: Dubai property market remains subdued



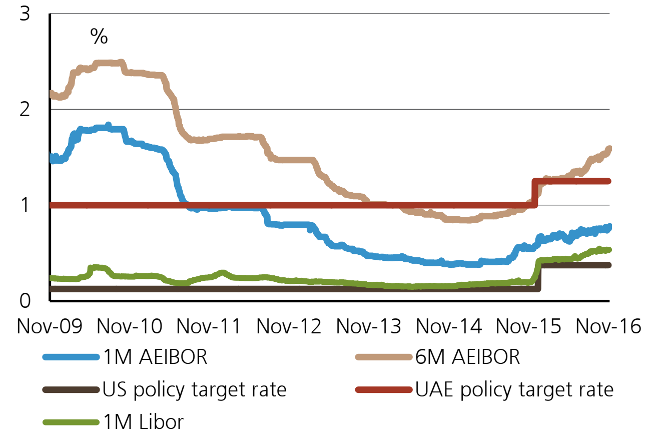
Source: Dubai Land Department, Haver

Figure 242: Bank lending and deposits



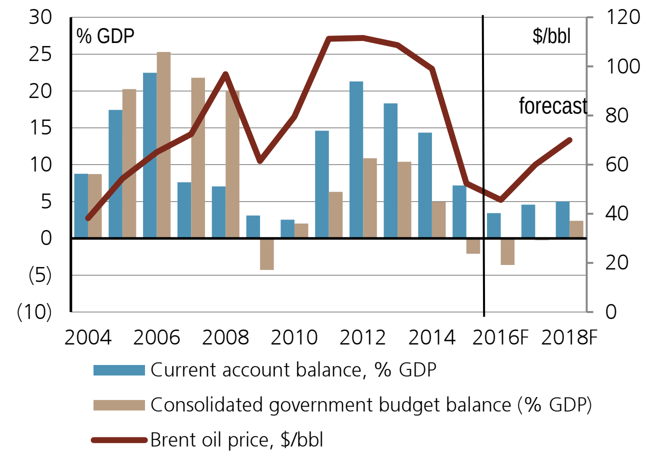
Source: Haver, UBS

Figure 243: Interest rates



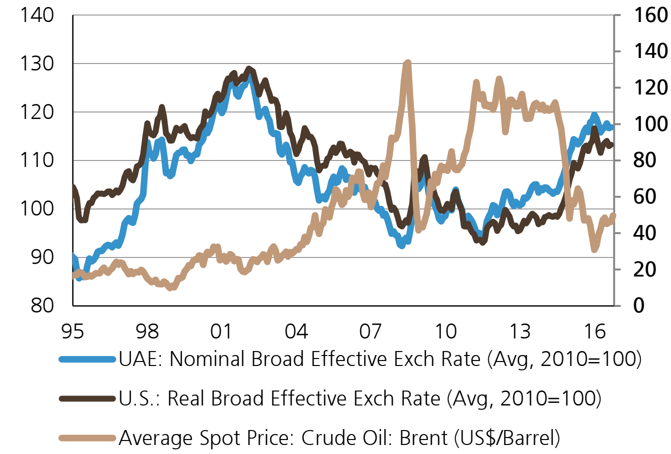
Source: Haver, UBS

Figure 244: Fiscal and external balances



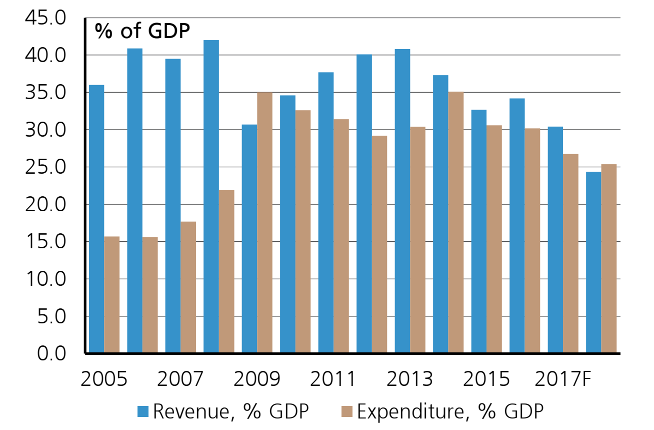
Source: Haver, UBS

Figure 245: USD peg keeps REER elevated relative to oil



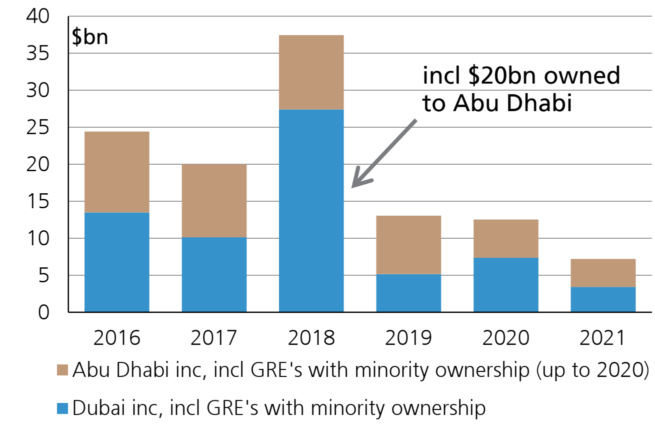
Source: Haver

Figure 246: Government revenues and expenditure



Source: IMF, Haver, UBS

Figure 247: Abu Dhabi inc and Dubai inc debt schedule



Source: IMF, UBS

UNITED ARAB EMIRATES	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	1280	1371	1427	1476	1360	1367	1575	1704
GDP, USD bn	349	374	389	402	371	372	429	464
GDP per capita, USD	39176	40592	41607	42584	38087	37898	42467	44640
Real GDP growth, %	5.2	6.8	4.7	3.1	3.8	2.6	2.9	3.0
Oil GDP growth, % y/y	6.6	7.6	2.9	0.8	5.0	2.0	1.9	0.7
Non-oil GDP growth, % y/y	4.5	6.4	5.6	4.1	3.2	2.8	3.4	4.0
Unemployment rate, %	-	-	-	-	-	-	-	-
Industrial Production (%)	-	-	-	-	-	-	-	-
Prices, interest rates and money								
CPI inflation, % y/y (average)	0.9	0.7	1.1	2.3	4.1	1.4	1.2	4.4
CPI inflation, % y/y (year-end)	0.2	0.6	1.5	3.1	3.6	0.3	1.5	4.7
Broad money M2, % y/y (end-year)	5.1	1.6	22.8	7.9	5.5	4.0	14.0	7.4
Domestic private credit, % y/y	3.4	1.6	3.3	11.5	8.4	6.5	7.5	7.5
Domestic bank credit/GDP	79.8	76.8	79.2	81.2	95.2	100.9	94.1	93.5
Policy rate (repo), % (end-year)	1.0	1.0	1.0	1.0	1.3	1.5	2.0	2.5
10 year bond yield, % (year-end)	-	-	-	-	-	-	-	-
USD/AED (year-end)	3.67	3.67	3.67	3.67	3.67	3.67	3.67	3.67
EUR/AED (year-end)	4.75	4.84	5.06	4.46	4.00	4.04	4.15	4.29
Fiscal accounts								
General government budget balance, % GDP	6.3	10.9	10.4	5.0	-2.1	-3.6	-0.2	2.4
Revenue, % GDP	37.7	40.1	40.8	37.3	32.7	34.2	30.4	24.4
Expenditure, % GDP	31.4	29.2	30.4	35.1	30.6	30.2	26.8	25.4
of which interest expenditure, % GDP	0.2	0.3	0.4	0.2	0.3	0.3	0.3	0.3
Primary balance, % GDP	6.5	11.2	10.8	5.2	-1.8	-3.3	0.1	2.7
Public sector debt (gross),% GDP	23.0	22.1	20.7	21.0	22.4	24.9	25.9	27.1
of which domestic public debt, % GDP	15.8	15.1	14.3	15.3	16.5	17.6	19.0	20.0
of which external public debt,% GDP	7.2	6.9	6.4	5.7	5.9	7.3	6.9	7.1
% domestic public debt held by non-residents	-	-	-	-	-	-	-	-
Public debt held by the central bank, % GDP	7.7	6.6	3.9	3.5	3.8	3.6	3.5	3.0
Balance of payments								
Trade balance, USD bn	106.7	141.8	140.5	126.9	92.2	80.0	90.9	95.7
Exports, USD bn	302.2	360.0	371.5	367.7	333.5	338.3	369.8	399.7
Imports, USD bn	195.6	218.2	231.0	240.8	241.4	258.3	278.9	304.0
Current account balance, USD bn	51.0	79.6	71.3	57.8	26.6	12.8	19.7	23.2
as % of GDP	14.6	21.3	18.3	14.4	7.2	3.4	4.6	5.0
Foreign direct investment (net), USD bn*	0.8	-8.4	0.7	1.8	1.7	1.5	1.9	2.1
Total FX reserves, USD bn	37.3	47.0	68.2	78.4	93.9	82.0	90.0	100.0
Foreign exchange reserves excl gold, USD bn	37.3	47.0	68.2	78.4	93.7	81.7	89.7	99.7
Total FX reserves, % GDP	10.7	12.6	17.5	19.5	25.3	22.0	21.0	21.5
Total external debt, % GDP	39.6	38.7	44.3	48.8	60.2	60.1	56.3	53.6
Net International Investment Position, % GDP	-	-	-	-	-	-	-	-
Credit ratings**								
Moody's	Aa2	Aa2	Aa2	Aa2	Aa2(sta)	Aa2(neg)	n/a	n/a
S&P	AA	AA	AA	AA	AA(sta)	AA(sta)	n/a	n/a
Fitch	AA	AA	AA	AA	AA(sta)	AA(sta)	n/a	n/a

Source: Central Bank of UAE, Ministry of Economy, IMF, World Bank, IIF, Bloomberg, UBS.
* Moody's also rates the Federal Government of the UAE Aa2, with a negative outlook
** Emirate of Abu Dhabi. Moody's also rates the Federal Government of the UAE Aa2, with a negative outlook.

China

Tao Wang
Economist
wang.tao@ubs.com
+852-2971-7525

Donna Kwok
Economist
donna.kwok@ubs.com
+852-3712-3160

Ning Zhang
Economist
ning.zhang@ubs.com
+852-2971-8135

Lan Chen, CFA
Economist
lan.chen@ubssecurities.com
+86-213-866-8802

Jennifer Zhong
Associate
jennifer-a.zhong@ubssecurities.com
+86-105-832-8324

UBS Research THESIS MAP

2017-18 Outlook: Growth to continue edging down as inflation stabilizes

PIVOTAL QUESTIONS

Q: Is China facing another property downturn?
Yes. Ongoing property policy tightening and uncertainties over potential demand and supply are expected to weaken property investment and construction in 2017, but today's relatively lower inventory levels and construction activity should mean smaller adjustments than in 2014-15.

Q: How much more fiscal stimulus can the government add?
As much as is needed to achieve its growth target. China still needs more infrastructure and has the fiscal capacity to add more stimulus, as government debt remains manageable and most incremental investment spend is funded via quasi-fiscal means. However, the physical constraint of finding ever more investable projects may limit future stimulus impulse to ~2% of GDP a year.

Q: Will corporate and debt restructuring pick up pace?
Most likely. We don't expect major policy shifts or gutsy reforms in 2017, but economic pressures will likely result in faster corporate debt restructuring and modestly slower credit growth.

Q: Will the RMB depreciate further?
Yes. Diverging policies between the Fed and the PBC (and other major central banks), and persistent capital outflow pressures are expected to drive the RMB weaker against the USD.

UBS VIEW

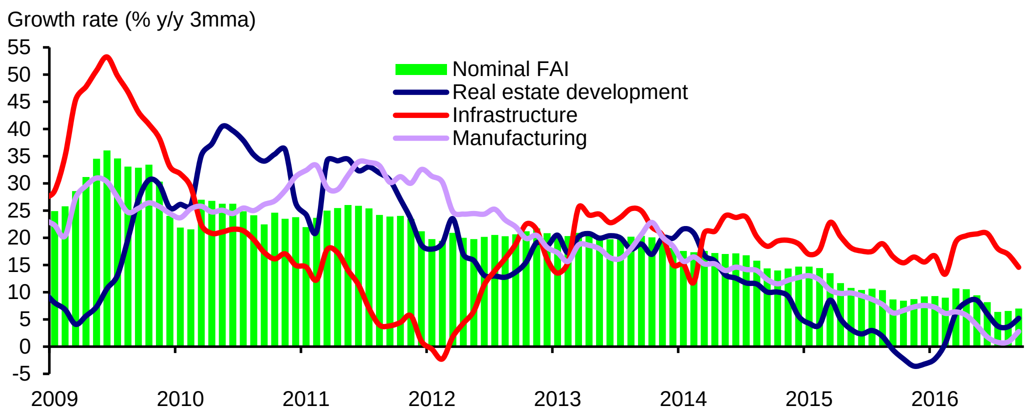
Real GDP growth to slow to 6.4% in 2017 and 6.0% in 2018. CPI inflation to edge up to 2.1% in 2017 and slow to 1.8% in 2018, with PPI staying positive. We expect no change in benchmark interest rates and see USDCNY at 7.2 and 7.5 at end-2017 and 2018, respectively.

EVIDENCE

Our property analysis and Evidence Lab survey suggest that front-loading of future demand and ongoing policy tightening will lead to somewhat weaker property activities in the future. Our studies also suggest that exports are unlikely to recover strongly, though China has sufficient fiscal capacity to help largely but not fully offset downward pressures on growth.

WHAT'S PRICED IN?

Our 2017 and 2018 GDP growth forecasts are around current consensus levels. Financial markets seem to be sanguine about the slowdown in China and less worried about a financial crisis than a year ago, and are looking for positive surprises in China's commodity demand. Concerns for capital outflows and a sharp RMB depreciation remain, however.



Source: CEIC, UBS estimates

China

- **China's GDP growth to grind lower to 6.4% in 2017 and 6.0% in 2018**
- **CPI to edge up to 2.1% in 2017; no change in benchmark rates**

Another property adjustment will pressure growth…

This year's property rebound saw property destocking take place across all city tiers…

China's property sales rallied this year and construction rebounded after 2 years of downward adjustments. National property sales leapt 27% in Q1-Q3, on improved affordability, easier/cheaper credit access, and government support (see China Housing Evidence Lab Survey). New housing starts also rebounded to 7% y/y from a double-digit decline in 2014-15, as real estate investment accelerated. Destocking occurred across all city tiers, further supporting the price rally.

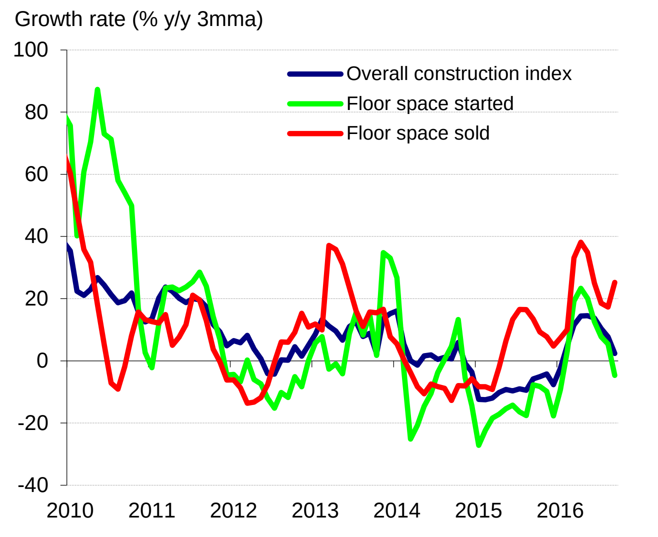
… but is unlikely to be repeated next year as property sales, construction and investment slow.

However, front-loading of housing purchase and property-cooling measures mean weaker future property activities. Fundamentally, housing ownership is high and urbanization is slowing. We expect property sales to slow sharply towards year-end and in 2017 to 0-2%. While property construction and investment have been slow to recover and still have some catching up to do in the next few months – to support Q4's and this year's overall GDP print – they will likely slow in 2017 too.

That said, the upcoming round of downward property adjustments should be on a smaller scale than last time.

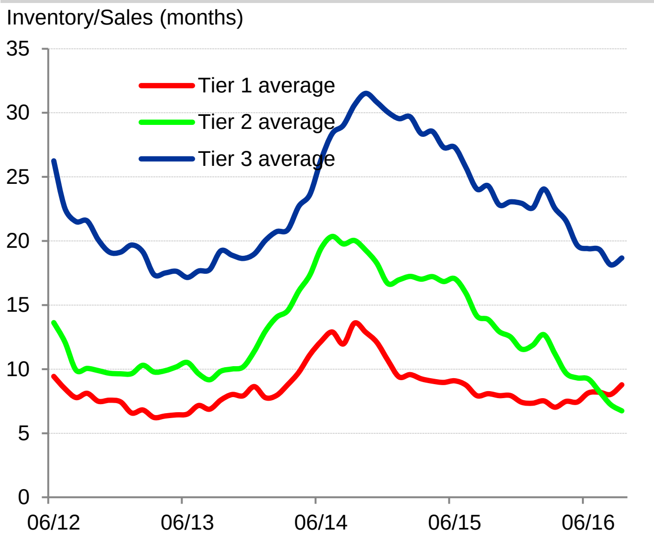
This round of property adjustments should be milder than in 2014-15. Property-cooling measures so far have been modest and will likely remain differentiated; inventory levels have come off significantly versus two years ago; and this year's property construction and investment rebound has been modest, so the subsequent drop will not be as steep. In addition, multiple related industrial sectors have seen substantial downward adjustments and visible destocking these past 2-3 years. We expect new property starts to ease to **0-2% in 2017 as real estate FAI slows to a low-single-digit pace from ~6% this year**. We expect slow property adjustments to continue in 2018 as urbanization slows, investment demand drops, and the impact of the earlier front-loading of sales hits harder. While households have room to further increase leverage and reallocate financial wealth to property, it would depend on property price expectations, which have already started to soften.

Figure 248: Property activities rebounded this year



Source: CEIC, UBS estimates

Figure 249: Inventory has come down significantly



Source: CREIS, Wind, UBS estimates

…… but be largely offset by more fiscal support…

We expect more fiscal support to counter downward growth pressures in 2017-18, given the government's commitment to meeting its growth target. In case of a worse-than-expected property downturn in 2018 and beyond, fiscal policy would likely intensify and property tightening policies ease again, but risks of a sharper GDP deceleration would rise. This is because leverage would be much higher by then, and households far more leveraged than in 2014. Fiscal capacity would also be more constrained with less space available for further build-up.

Expect more fiscal policy easing as and when growth weakens more visibly…

China still has plenty of firepower to provide fiscal stimulus. Most of China's fiscal stimulus comes from quasi-fiscal channels, funded by credit. We estimate that China's augmented fiscal deficit (AFD) including local government financial vehicles (LGFV), land revenue-funded spending and policy-bank-funded government projects, exceeds 10% of GDP. Nevertheless, we believe total government debt remains manageable, and the use of corporate and policy bank balance sheets provides additional quasi-fiscal space. Even though some of this will likely be borne by the government, it has sizeable assets to dispose of, if necessary. We expect the general government deficit to rise by 0.5% of GDP but AFD by more in 2017-18.

… delivered mainly via quasi-fiscal channels, backed by credit.

PPP's growing importance as a quasi-fiscal channel. Policy banks and public-private partnership (PPP) schemes will play an increasingly pivotal role in delivering quasi-fiscal financing, backed by special construction bonds and the PBC's PSL facility. Growth of PPP schemes has accelerated through this year, with announced PPP projects totalling RMB 12.5 trillion by end-September (>50% higher than at the start of 2016) and the value of projects being "implemented" reaching RMB 1.6 trillion. We estimate that PPP projects have contributed RMB 700-800 billion to FAI this year and think that the potential for sizable FAI uplift over the next two years is large (likely RMB 3-4 trillion in project implementation in 2017). But, it is important to note that PPP is more of a substitute than an addition to traditional government- or LGFV-funded infrastructure, so it is not actually all new stimulus.

PPP has the potential to deliver a sizeable FAI uplift over the next two years, up to RMB 3-4 trillion in project implementation in 2017.

China still needs additional infrastructure but may find it difficult to add more than 2% of GDP a year. China still needs to invest more in railways, urban public transport networks, urban utilities and pipelines, new energy, and environmental protection / clean-up projects. That said, not every city needs to build a subway, and finding investable infrastructure projects at an ever-bigger scale year after year may be difficult, given an already large base. Future additional infrastructure-related spend is thus unlikely to provide >2% of GDP a year in fiscal stimulus impulse.

China still needs more infrastructure, but future fiscal stimulus impulse is unlikely to exceed 2% of GDP a year.

…and a modest trade rebound. Consumption to face headwinds

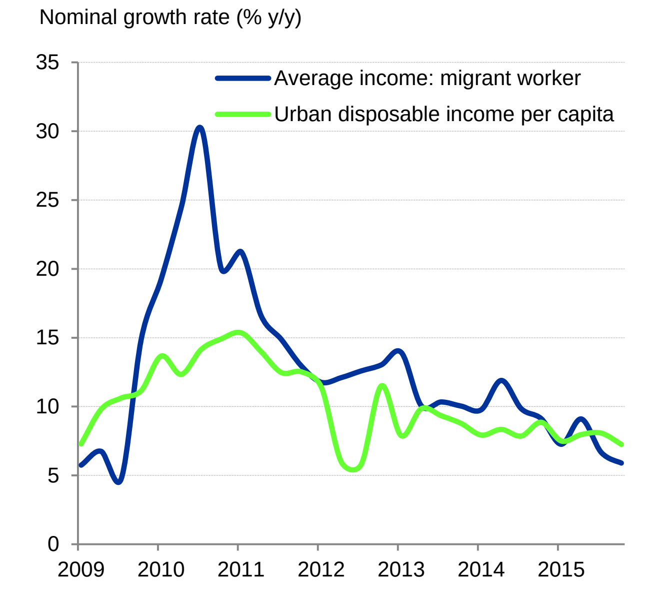
We expect a mild pickup in China's exports in 2017, on modestly firmer US and global growth. World trade is expected to recover from the past two years of weakness, but any uplift for China may be less pronounced than usual as global import elasticity has declined, and protectionism is on the rise. Domestic demand is expected to shift towards public infrastructure and services at the margin, which may further lower China's import elasticity. We expect China's real trade volumes to rise only modestly in 2017, with net exports contributing to 0.2% of GDP growth in 2017 and 2018.

Net trade to provide only marginal support to 2017-2018 growth.

Both employment and consumption will face continued headwinds in 2017 and 2018, as consumption growth slows from 8% in 2016 to 7.2% in 2017 and 6.6% in 2018. Consumption this year has been helped by a resilient labour market, thanks to rapid services growth and a property rally that helped to boost durable and auto sales. We expect employment and wage growth to soften further as the economy slows and excess capacity reduction continues. We see greater headwinds for consumption in 2017 in the absence of auto-related tax benefits, and as property sales moderate and oil prices rise. That said, the growing importance of services against the backdrop of continued mining and industrial sector consolidation should lend some support to China's labour market. We also expect government policies to remain supportive of consumption, via additional measures to support SMEs and new business start-ups (e.g. more cutting of red-tape approvals and procedures, further expanding tax relief, establishing more development funds for innovative industries and SMEs, etc.), speed up migrant worker urbanization reform and expand social benefits coverage.

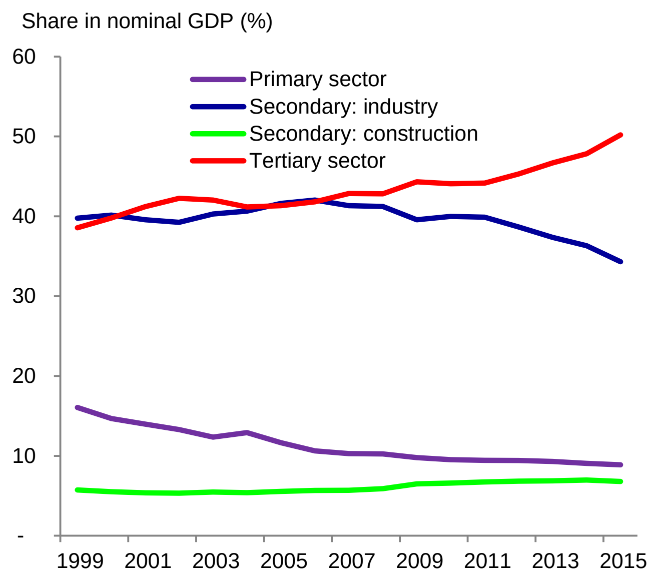
Consumption to face greater headwinds in 2017, but the growing importance of services should lend more support to jobs.

Figure 250: Wage and income growth has slowed



Source: CEIC, UBS estimates

Figure 251: Service sector becoming increasingly important



Source: CEIC, UBS estimates

Mild inflationary pressure and stable monetary policy

Muted inflationary pressure despite stronger global energy and commodity prices. We expect PPI to rise by 1.7% for full-year 2017 (vs. -2% in 2016), printing its highest %y/y readings in Q1 before gradually subsiding. While we expect oil prices to rise and RMB to depreciate further in 2017, domestic commodities prices are unlikely to sustain their recent upward trend as the earlier impact of production cuts ease and base effect fades, remaining at the same levels or weakening somewhat. CPI inflation is expected to **edge up to 2.1% in 2017 before weakening to 1.8%** in 2018. Food CPI should be more subdued next year as the hog cycle enters a downtrend, as the transmission of higher PPI to CPI remains weak, limited by ongoing electricity and transport price controls. Even in the case of a much sharper oil price increase, CPI is expected to stay below 3% over the next two years due to limited pass-through.

Even if global oil prices were to rise more sharply, CPI should still stay below 3% through 2018.

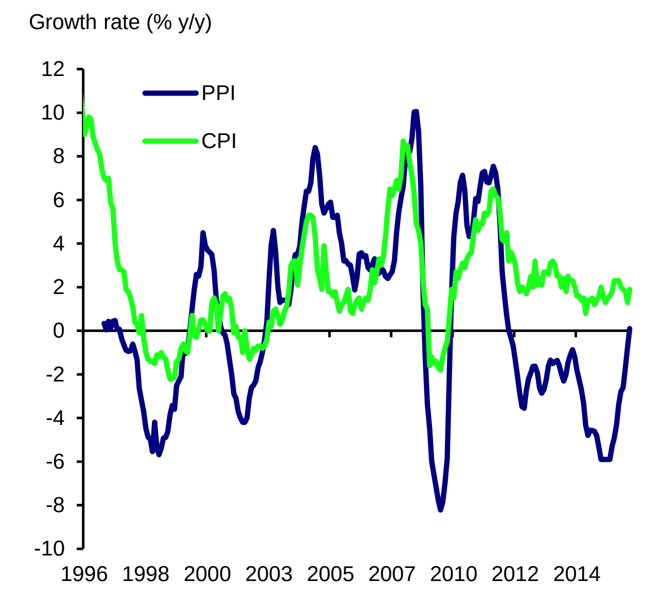
We expect monetary policy to say stable in 2017, with no rate cuts in the next two years. Although growth is expected to slow, real debt servicing costs have come down significantly, reducing the need for further rate cuts. Meanwhile, the need to deal with RMB depreciation and capital outflow pressures and avoid fuelling asset bubbles should prevent the PBC from cutting rates. We **expect the PBC to remain reluctant to lower RRR** to avoid sending any strong easing signals, preferring to use other liquidity facilities instead to keep interbank rates stable and liquidity supportive of growth through 2018.

We see no rate and limited RRR cuts over the next two years.

Credit is unlikely to be tightened significantly despite periodic shifts towards risk control. The government recently emphasized the need to contain asset price bubbles and potential financial risks, signalling a mild shift toward slower credit growth. However, we think that its commitment to achieving a 6.5% GDP growth target will require continued rapid credit expansion, so that whenever growth threatens to slow too much, credit will likely be eased. We expect overall credit growth – captured by total social financing (TSF) adjusted for local government bonds – to grow close to 15% in 2017 before slowing to 13.5% in 2018, down from almost 16% in 2016 but still far above nominal GDP growth. M2, an increasingly inadequate measure in light of financial deepening, is expected to slow from 12% in 2016 to 11% in 2017.

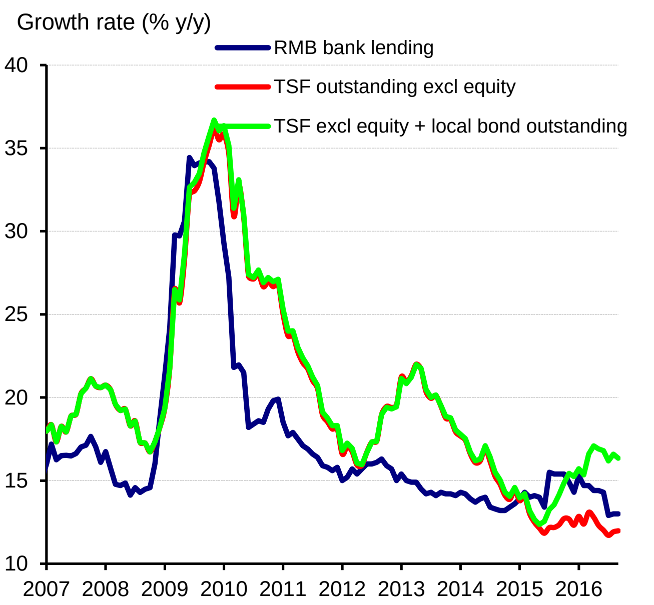
Government's commitment to its growth target means that Chinese credit growth will likely stay far above nominal GDP growth.

Figure 252: Pass-through from PPI to CPI inflation has been muted in recent years



Source: CEIC, UBS estimates

Figure 253: Overall credit (as measured by TSF excl. equity + local government bonds) is running at 16.3%



Source: CEIC, UBS estimates

RMB should depreciate modestly amid outflow pressures

An expected Fed rate hike, shrinking current account surplus and persistent capital outflows to fan depreciation pressures on the RMB. We see China's current account surplus narrowing to 1.3% in 2017 and 1.2% in 2018, from 3.1% in 2015 and 1.9% in 2016, on the back of a stable trade surplus but widening services and income deficits, leaving a smaller buffer against capital outflows. We expect China's services and income deficits to rise given: 1) the Fed and PBC's diverging policy directions; 2) increased diversification by Chinese corporates and

Current account buffer against capital outflows to further shrink on the widening services and income deficits.

households' into foreign assets; 3) China's ongoing "going out" strategy and RMB internationalization; and 4) increased expectations for RMB depreciation.

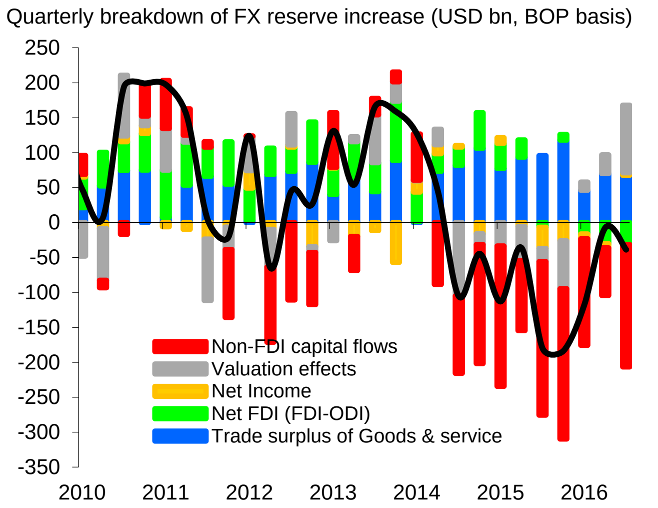
We expect USDCNY to be trading at 7.2 at end-2017 and 7.5 at end-2018 Post US election, market expectations of US fiscal stimulus has pushed up both US treasury yields and USD strength, while a December Fed rate hike is still expected. EM currencies have weakened and will likely weaken further in 2017. At this stage, we think that China may allow the CNY to follow the basket, allowing for slightly more depreciation against the USD ahead of December's Fed rate hike, and likely higher pressure from the new US administration on currency next year. Despite higher depreciation pressures, we think that the government will try to and can manage the process in a gradual manner for multiple reasons: 1) China's government tends to be risk-averse, especially so during a period of leadership transition. Large exchange-rate movements may trigger a sudden loss of confidence and so increase the risk of capital market volatility; 2) any impact from the resumption of the Fed rate hike cycle on China's currency and outflows should be less than before, thanks to tighter outflow controls today, and the Fed's likely much more gradual path of hiking; 3) there is wider recognition today that China does not intend to depreciate the RMB aggressively to promote growth and can mostly control outflows/manage depreciation pressures; and 4) a significant portion of carry-trade has unwound and China's FX debt has declined, lessening one key source of earlier outflow pressures. Meanwhile, the country has opened more channels for capital inflows, and global exposure to Chinese assets remains tiny.

Government will continue to manage the RMB in 2017, allowing for a gradual 5-6% depreciation against USD.

China may allow for faster RMB appreciation, either if an event triggers a collapse of major currencies against the USD (not our baseline forecast) or if capital outflows were to shoot up to new record highs again for a period of time. Conversely, the RMB may also hold up stronger than expected if the USD weakens from here. Our baseline forecast is for headline FX reserves to **decline to $2.8 trillion by end-2017 and $2.5 trillion by end-2018**.

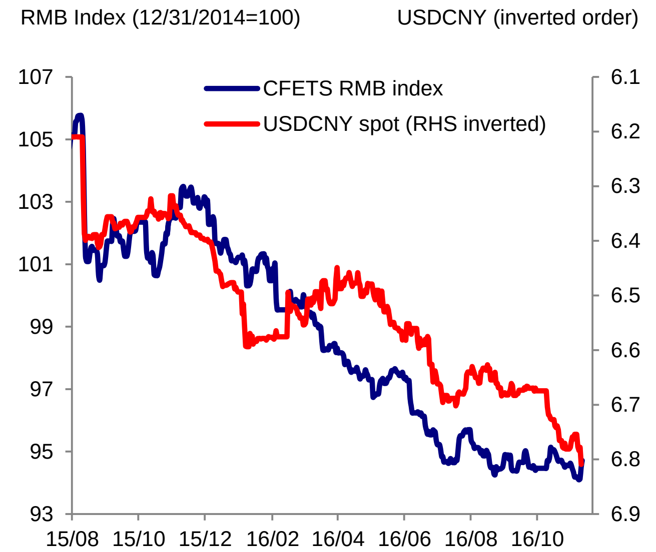
Faster USDCNY depreciation is possible under two scenarios.

Figure 254: Capital outflows have declined since the end of last year



Source: CEIC, UBS estimates

Figure 255: RMB has depreciated both against USD and the trade weighted basket this year



Source: Bloomberg, UBS estimates

More restructuring is needed for corporate profit growth and investment revival

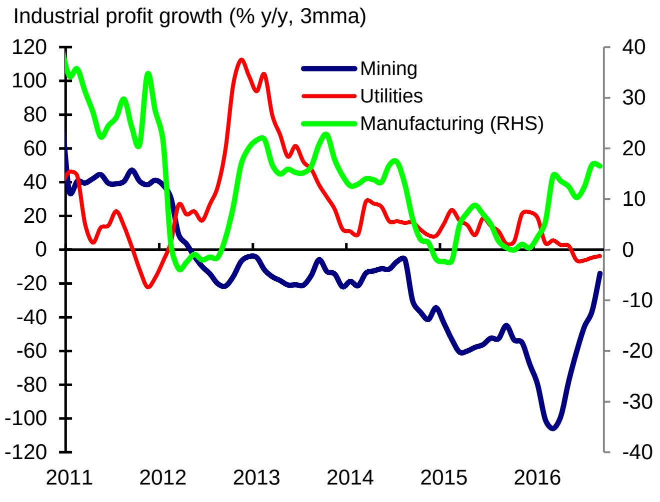
Progress has been made in excess capacity reduction and corporate restructuring. The government made capacity reduction a key task for 2016, especially for the coal and steel sector. Efforts accelerated in Q3, including the shutting down of excess capacities, a ban on new capacity build, and financial incentives to localities to retire excess capacities. But **the most impactful measure this year has been strict production cuts,** especially in the coal sector, which together with earlier production suspensions and destocking on the back of falling prices, helped to change the demand-supply balance in the coal and related sectors, leading to a sharp rebound in coal in other raw material prices.

Supply-side reforms saw progress in 2016, but mostly via strict production cuts.

Without more actual closures or a stronger underlying demand recovery, this year's industrial profit and PPI gains are unlikely to last through 2017. Supply cuts, demand stabilization (thanks to infrastructure and a property rebound), and the global oil price recovery all helped to drive up China's commodity and material prices this year. These developments boosted industrial profits, especially in the coal and heavy industrial sector, helping to ease cash-flow constraints. However, excess capacity remains and may be brought back by the recent price surge, especially as overall demand is expected to grow only modestly. While the recovery in industrial revenue and profits this year helped to stabilize private investment after its earlier sharp deceleration, sustained corporate earnings and profit recovery is critical for private investment fundamentals to strengthen. This requires deeper excess capacity reduction and corporate restructuring.

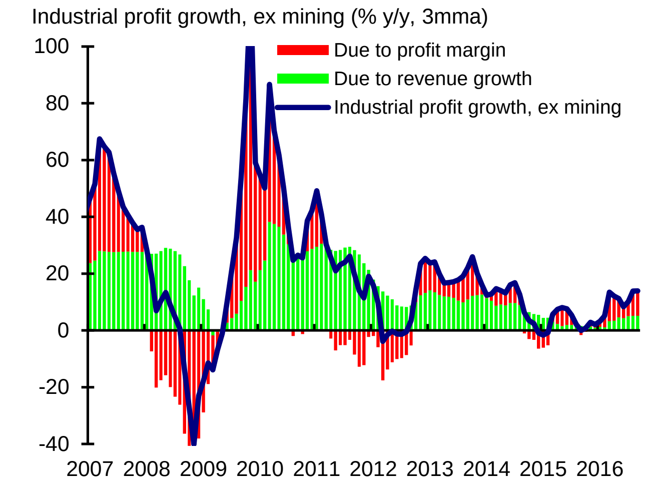
2016's industrial profit and PPI gains are unlikely to be sustained without more actual facility closures or a stronger underlying demand recovery.

Figure 256: Industrial profit growth rebounded in 2016 after two years of deterioration…



Source: CEIC, UBS estimates

Figure 257: … thanks to an improvement in both profit margin and revenue growth



Source: CEIC, UBS estimates

Debt and financial risks to continue in the medium term

Notwithstanding the recent growth stabilization, China's ballooning debt remains a key concern for investors. We estimate that total non-financial sector debt stood close to 260% of GDP (What Are the Real Problems with China's Debt?) at end-2015, with corporate debt about 160% of GDP. The continuation of rapid credit growth backed this year's property rebound and government-backed infrastructure investment, to underpin overall growth this year. What worries investors most about China's debt is its rapid increase and diminishing

What worries investors most about China's debt is its rapid increase and diminishing effectiveness.

effectiveness; a growing share of debt has been used to finance non-productive real estate sector or industrial sectors where assets are not effectively deployed, leading to a decline in returns. Less-efficient SOEs and "zombie" companies also continued to take a disproportionally bigger share of China's financial resources.

Efforts to contain rising leverage and restructure debt have been made this past year. First, local government debt swaps have helped to reduce their debt-servicing burden significantly and associated pace of NPL formation. Second, corporates have been encouraged to tap the booming credit market to refinance their old debt. Third, banks have been encouraged to speed up bad debt disposal, including through securitization and debt-equity swaps. Fourth, many banks have raised more capital in the past couple of years. Meanwhile, real interest rates have fallen thanks to both declining nominal rates and easing deflationary pressures. In addition, to contain the rapid expansion of shadow credit, the authorities have tightened some relevant financial regulations, especially on shadow lending via channel-type products. That said, the implementation of these measures has been both gradual and mild.

Government has tried to contain leverage increase and restructure debt in multiple ways this year…

However, a priority on growth means that leverage will continue to rise. The Chinese government typically tries to tighten credit whenever its growth target looks achievable and asset bubbles pose a real threat, but this also changes whenever growth threatens to slow too much. To achieve their targeted growth rate of 6.5% of GDP, Chinese authorities will have to allow overall credit to grow by 14-15% in 2017. This means that financial regulations are unlikely to be tightened too sharply, and China's overall debt-GDP ratio may approach 300% by end-2017.

... but efforts to tighten credit tend to stop whenever growth threatens to slow too much.

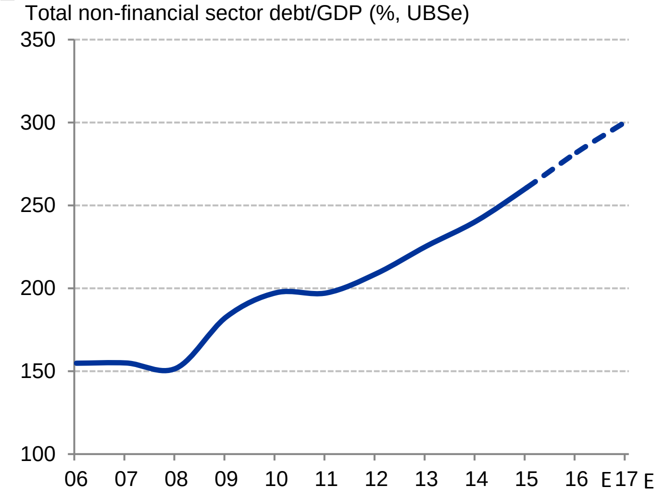
We do not think China is on the brink of a systemic debt crisis. Notwithstanding China's rising debt and related issues, we still don't see an imminent financial/banking crisis whereby a sharp and disorderly deleverage is triggered by a liquidity crunch. China's debt is predominantly financed by domestic savings that are largely channelled through the banking system, due to its less-developed capital markets and capital controls. This ensures that Chinese banks' LDR ratios remain low (even if including WMPs), and are less affected by market liquidity pressures. Government ownership of/control over banks and a central bank that's always standing at the ready also helps to shore up depositor confidence in the banking system, helping to reduce the risk of liquidity events.

Though its debt/GDP ratio may approach 300% by end-2017, China is not on the brink of a systemic debt crisis…

Rise of shadow credit and capital outflows are the two biggest risks to financial stability. Shadow credit's share of overall credit has risen from 10% in 2006 to 33% in 2015, accounting for nearly 80% of GDP. It has a more complex and less stable funding structure, making it much harder for the government to identify and manage any liquidity issues quickly. Persistent large capital outflows meanwhile would reduce China's domestic liquidity buffer, increase financial market volatility, and hurt confidence, making it harder to maintain financial stability.

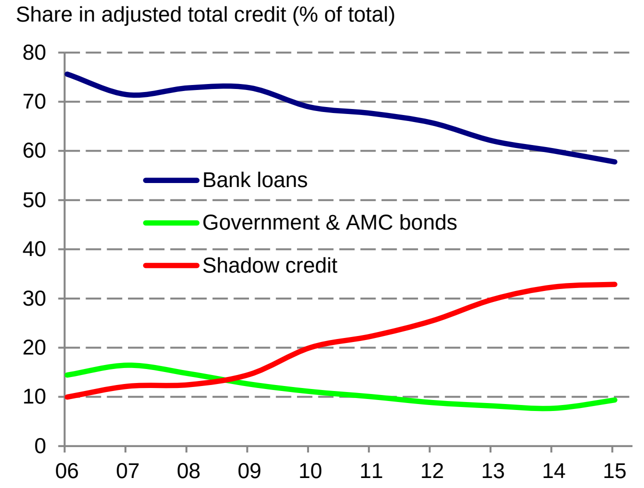
… but the rise of shadow credit and capital outflows pose the biggest risks to financial stability.

Figure 258: China's non-financial sector debt looks set to top 300% of GDP by end-2017



Source: CEIC, UBS estimates

Figure 259: The rise of Chinese shadow credit



Source: CEIC, UBS estimates

Risks to our forecast

Upside and downside risks to our forecasts are broadly balanced.

Risks to our forecast are broadly balanced. On the upside, property-cooling measures may not be effective and property sales and construction could stay strong for longer than expected; the recent surge in property and material prices could stall restructuring to encourage more investment in related sectors; and policy support may be stronger in a leadership transition year with all levels of governments keeping growth a top priority. Exports could be slightly stronger if the US enacts a fiscal stimulus package but does not implement anti-trade and anti-Chinese export measures. In the upside scenario, fixed investment will likely be stronger than in 2016, helping to push GDP growth to 6.8% in 2017; CPI inflation will likely be above 2.5%, prompting the PBC to tighten liquidity conditions somewhat and keep the 7-day repo rate higher at about 2.5%.

2017 GDP could stay at 6.8% in our upside scenario, or slip to 6% or less in our downside scenario.

On the downside, property sales could decelerate more sharply because of policy tightening and/or a sudden reversal of sentiment, given that much demand has already been brought forward; infrastructure investment may also come in short despite the government's intent and ample fiscal capacity, due to physical constraints on its search for investable projects; private and corporate investment may weaken further due to a lack of progress in structural reforms; and finally, global growth and external demand may disappoint given the uncertainties in major economies and rising protectionism. For China, there is an added risk that the new US administration may intensify pressure on the RMB and impose import tariffs on Chinese goods. In addition, the resumption of large capital outflows could lead to financial market volatility and make the authority's efforts to support growth more difficult. In the downside scenario, GDP growth could slip to 6% or below, CPI inflation may drop to 1.8%, and credit conditions may be eased further. While the PBC may still not cut benchmark rates, the 7-day repo rate may be allowed to go lower towards 2%.

For the RMB, increased trade protectionism against China, including a US imposition of tariffs on Chinese goods, would hurt China's exports and raise depreciation pressures on the currency. In addition, in reaction to any tariffs imposed against China, the RMB might be allowed to depreciate a bit faster. However, more hawkish US rhetoric on the RMB without an actual imposition of tariffs might yield the opposite result, especially if the USD does not strengthen much more. The RMB exchange rate will also depend on 1) the US Fed's rate hike trajectory, and 2) the size of China's capital outflows.

Imposition of US tariffs on Chinese goods could see the RMB depreciate a bit faster, but just hawkish US rhetoric alone may do the opposite.

China	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	48,930	54,037	59,524	64,397	68,551	73,729	79,546	85,161
GDP, USD bn	7,573	8,560	9,608	10,484	11,008	11,009	11,283	11,587
GDP per capita, USD	5,623	6,322	7,060	7,665	7,860	7,976	8,133	8,311
Real GDP growth, %	9.5	7.9	7.8	7.3	6.9	6.7	6.4	6.0
Total consumption, % y/y	11.9	8.9	7.9	7.5	8.0	8.0	7.2	6.6
Gross fixed capital formation, % y/y	8.8	9.1	9.3	6.5	6.3	6.2	5.9	5.3
Exports, % y/y	14.3	4.8	4.2	7.8	1.8	1.9	2.6	2.6
Imports, % y/y	18.9	5.8	5.7	7.3	1.1	3.0	2.3	2.4
Unemployment rate, %	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1
Industrial Production (%)	13.7	10.8	9.7	8.2	6.0	5.9	5.7	5.3
Prices, interest rates and money								
CPI inflation, % y/y (average)	5.4	2.6	2.6	2.0	1.4	1.9	2.1	1.8
CPI inflation, % y/y (year-end)	4.1	2.5	2.5	1.5	1.6	1.9	2.0	1.9
Broad money M2, % y/y (end-year)	13.6	13.8	13.6	12.2	13.3	12.0	11.0	11.0
Domestic private credit, % y/y	18.3	19.4	18.0	14.6	15.2	15.9	14.9	13.5
Domestic bank credit/GDP	140.6	149.1	155.7	167.2	194.4	209.0	221.8	234.5
1-year deposit rate, % (year-end)	3.5	3.0	3.0	2.8	1.5	1.5	1.5	1.5
10 year bond yield, % (year-end)	3.5	3.6	4.6	3.6	2.8	2.7	2.6	2.4
USD/RMB (year-end)	6.29	6.23	6.05	6.21	6.49	6.90	7.20	7.50
Fiscal accounts								
General government budget balance, % GDP	-1.1	-1.6	-1.9	-1.8	-3.4	-4.0	-4.0	-4.0
Revenue, % GDP	21.5	22.0	22.0	22.1	22.2	22.2	22.1	22.0
Expenditure, % GDP	22.6	23.6	23.8	23.8	25.7	26.2	26.1	26.0
of which interest expenditure, % GDP	0.5	0.5	0.5	0.6	0.5	0.6	0.6	0.7
Primary balance, % GDP	-0.6	-1.1	-1.3	-1.2	-2.9	-3.4	-3.4	-3.3
Public sector debt (gross),% GDP	15.1	14.6	14.8	15.0	15.7	16.4	16.8	17.4
of which domestic public debt,% GDP	14.6	14.2	14.4	14.7	15.4	16.1	16.5	17.2
of which external public debt, % GDP	0.5	0.4	0.4	0.3	0.3	0.3	0.3	0.2
% domestic public debt held by non-residents	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Public debt held by the central bank, % GDP	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Balance of payments								
Trade balance, USD bn	228.7	311.6	359.0	435.0	567.0	541.5	542.3	583.3
Exports, USD bn	1807.8	1973.5	2148.6	2243.8	2142.8	2022.8	2053.1	2094.2
Imports, USD bn	1579.1	1661.9	1789.6	1808.7	1575.8	1481.2	1510.8	1510.8
Current account balance, USD bn	136.1	215.4	148.2	277.4	330.6	208.4	146.2	133.4
as % of GDP	1.8	2.5	1.5	2.6	3.0	1.9	1.3	1.2
Foreign direct investment (net), USD bn	231.7	176.3	218.0	145.0	62.1	-42.4	-94.8	-146.1
Total FX reserves, USD bn	3234.1	3368.3	3862.2	3883.1	3390.6	3140.2	2860.2	2560.2
Foreign exchange reserves excl gold, USD bn	3181.1	3311.6	3821.3	3843.0	3330.4	3080.0	2800.0	2500.0
Total FX reserves, % GDP	42.7	39.3	40.2	37.0	30.8	28.3	25.2	22.1
Total external debt, % GDP	9.2	8.6	9.0	17.0	12.9	12.5	11.9	11.2
Net International Investment Position, % GDP	22.3	21.8	20.8	15.3	14.5	16.5	16.9	16.7
Credit ratings								
Moody's	Aa3	Aa3	Aa3	Aa3	Aa3	Aa3	N/A	N/A
S&P	AA-	AA-	AA-	AA-	AA-	AA-	N/A	N/A
Fitch	A+	A+	A+	A+	A+	A+	N/A	N/A

Source: CEIC, Haver and UBS forecasts.

Note: Statistical coverage of China's external debts changed in 2014, to include RMB-denominated external debt.

Duncan Wooldridge
Economist
duncan.wooldridge@ubs.com
+852-2971-6046

Edward Teather
Economist
edward.teather@ubs.com
+65-6495-5965

Daiju Aoki
Economist
daiju.aoki@ubs.com
+81-3-5208-7454

Silvia Liu
Economist
silvia.liu@ubs.com
+852-2971-8121

Alice Fulwood
Associate Economist
alice.fulwood@ubs.com
+65-6495-3085

Asia

2017-18 Outlook: Domestic debt overhang and stagnant exports to persist

PIVOTAL QUESTIONS

Q: Will Asian growth pick up next year?
Unlikely. Domestic demand should remain sluggish under the weight of high domestic debt and we expect only a marginal improvement in the volume of exports. India is the outlier.

Q: Will Asia implement aggressive fiscal stimulus next year?
It doesn't look like it. Asian fiscal policy is reactive, not proactive. Most government statements are consistent with flat budget deficits and flat fiscal impulses.

Q: Will Asian central banks lean against the Fed?
Asian central banks are unlikely to hike with the US Fed. Policy divergence with the US should mean Asian currencies slip against the dollar. What changes here, though, is inflation is likely to drift higher rather than lower and that means more rate cuts are unlikely next year.

Q: Will exports recover?
Yes and no. USD nominal exports should return to positive growth rate, but the volume of exports is likely to remain 70% below pre-crisis trend growth. Trump's election poses upside risk if US fiscal stimulus ramps up and downside risk if he raises tariffs on trade partners.

UBS VIEW

Real GDP growth to slow to 5.9% in 2017 from an estimated 6.1% this year. The region is in the advanced stages of a credit bubble, where diminishing marginal benefits to increasing debt occur. Global debt overhang is also a headwind to trade. Weighted headline inflation should pick up assuming oil averages USD60 and that means rates are unlikely to be cut further.

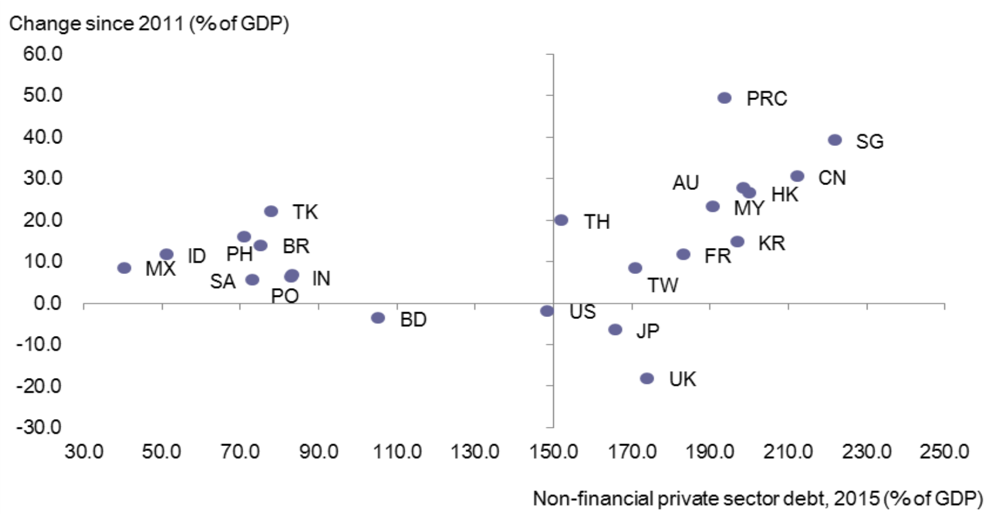
EVIDENCE

Domestic cycle is about debt-fuelled property and construction. Domestic demand is struggling to maintain momentum now that Asia has the highest private debt ratio in the world and had the largest increase since 2011. It's not just China. Debt is low in India, Indonesia, and the Philippines. However, for the rest of Asia private debt ranges from 150% of GDP to well over 200%.

WHAT'S PRICED IN?

Consensus generally believes growth will improve modestly; whereas we argue growth will slow. In part, this is because forecasters underestimate the headwinds from debt.

Asia has seen the biggest build-up in private sector debt the last five years



Source: Haver, BIS, CEIC and UBS calculations

Asia: The greatest debt story of all time

- **Debt overhang means sluggish exports and domestic demand continue**
- **Oil prices to push inflation higher; rate cycle gets out of sync with US**

Non-Japan Asia private sector debt is now the highest in the world and it's not just China.

Debtopia remains the dominant theme for Asia. Asia has relied heavily on debt-fuelled domestic demand to drive economic growth in the face of stagnant volume of exports after the global financial crisis. Note that private sector debt in Asia ex-Japan has risen to 173% of GDP and is now the highest in the world for any major region. Furthermore, it's not just China. Non-China Asia's private sector debt has hit 144% of GDP. The truth is that leverage is only low in India, Indonesia, and the Philippines. Outside of those financial deepening stories one finds private sector debt ranges anywhere from a "low" of 150% to well over 200% of GDP. Private sector leverage is likely to rise further next year, but as we argued a few years ago increased domestic leverage should result in diminishing marginal benefits to economic growth. At the macro level this suggests a fall in the return on assets reflecting the fact that the asset side of the balance sheet grows faster than nominal income alongside debt liabilities. The paradox is that most of Asia is relying on assets (at least in nominal terms) growing faster than economies to stabilize economic growth. This puts trend growth at risk a few years out.

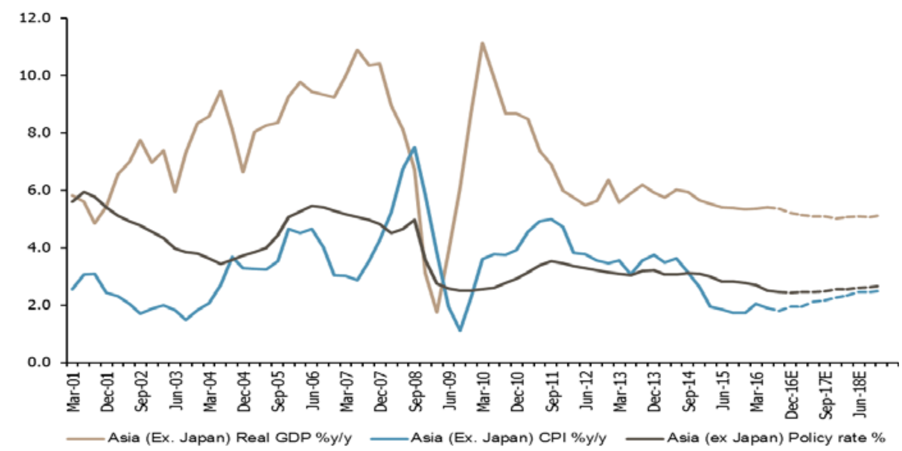
For the first time since 2011 inflation appears set to rise and the Asian rate policy is poised to decouple from Fed policy. That should result in weaker Asian currencies against the US dollar.

So what changes next year, if anything? First, we expect Asian consumer prices to accelerate modestly on average next year for the first time since 2011. This primarily reflects the UBS assumption that Brent oil prices average USD60 per barrel in 2017, up 30% y/y. This would limit the scope for further rate cuts across the region unlike previous years when inflation was decelerating sharply. Second, consistent with the assumption of higher oil prices and relatively stable commodity prices, we expect USD nominal exports to grow +5% in 2017, versus an estimated -4% in 2016. This would mark the first positive nominal growth rate in two years. However, we expect the volume of exports to improve less dramatically, because they are primarily a function of the global capex cycle and most importantly the global private sector debt cycle. Growing populism and protectionism also reduces the probability of major trade agreements that could help raise global trade. We expect low-single-digit growth for the volume of exports, which would remain some 70% below the pre-crisis trend. That is consistent with a large capacity overhang in manufacturing for the region as a whole. The good news is that this excess capacity should limit the upside for inflation even with the higher oil prices UBS expects. Third, UBS expects the US Fed to raise rates 50bps next year. This will likely leave the average Asian central bank on hold next year; however, this means that Asia's rate policy will increasingly become out of sync with the US. We expect this to cause currency weakness in the region on average, with large current account currencies in north Asia and Thailand holding up better than current account deficit economies such as Indonesia and India.

Asian fiscal policy is reactive, not proactive. Most governments do not appear set to ramp up stimulus unless growth slows sharply.

Will Asian governments finally open the fiscal floodgates to drive economies? Historically, fiscal policy in Asia has been reactive, not pro-active. If growth were to slow sharply from here, then, yes, Asian governments have the capacity to aggressively ramp up fiscal spending and probably would. However, so far the current sluggish growth trend has not been enough to provoke a strong fiscal policy stimulus in the region. Asian government announcements are consistent with flat fiscal balances and fiscal impulses for next year. That could change by 2018 or 2019, but the average Asian government doesn't appear ready to load the fiscal bazooka just yet. Where fiscal policy is more interesting is that infrastructure spending should be stable in a world of weak top-line growth.

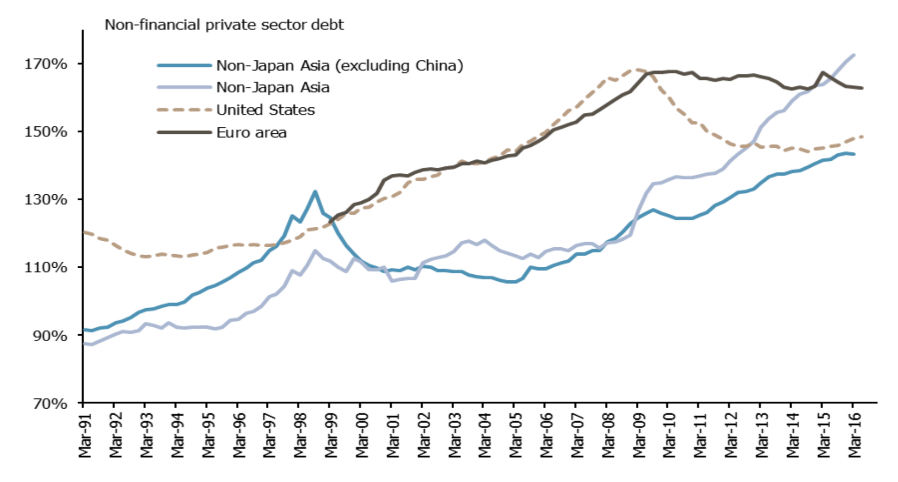
Figure 260: Macro outlook for Asia ex-Japan**



Source: CEIC, UBS estimates **Inflation and policy rates are simple averages

We expect growth to slow but inflation to pick up in 2017 on higher oil prices. This combination suggests that while Asian central banks might not follow the Fed to hike, the room for them to cut has also become more limited.

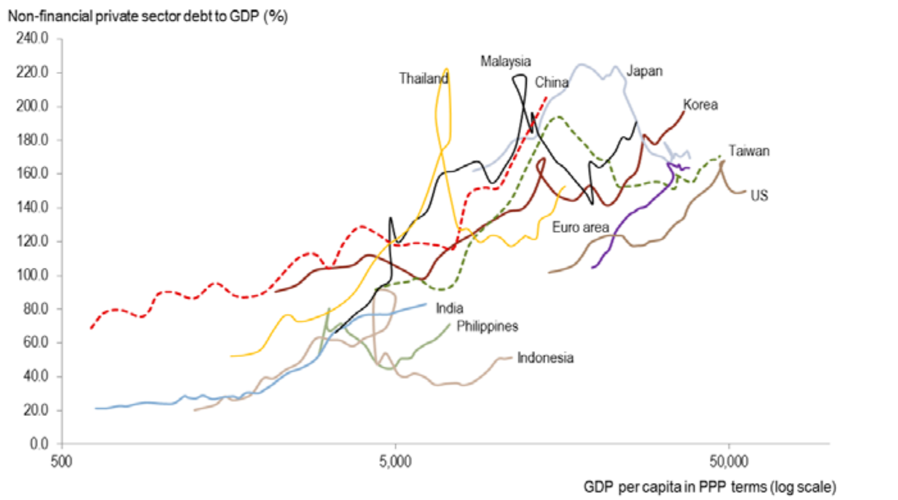
Figure 261: Private non-financial sector debt



Source: Haver, IMF, CEIC and UBS calculations.

Asia now has the highest private-sector debt ratio in the world. Under high leverage, domestic demand is struggling to maintain momentum.

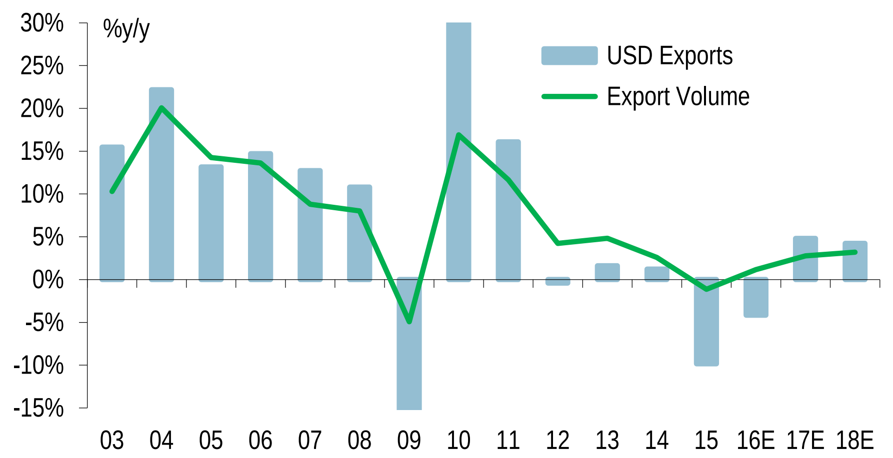
Figure 262: Asia's debt expansion and growth mojo



Source: Haver, IMF, CEIC and UBS calculations.

Debt is low in India, Indonesia and the Philippines. But for the rest of Asia, the private-sector debt ratio ranges from 150% of GDP to well over 200%. Private debt is losing its mojo, with the steep upward slope of this chart indicating diminishing marginal benefits of additional leverage.

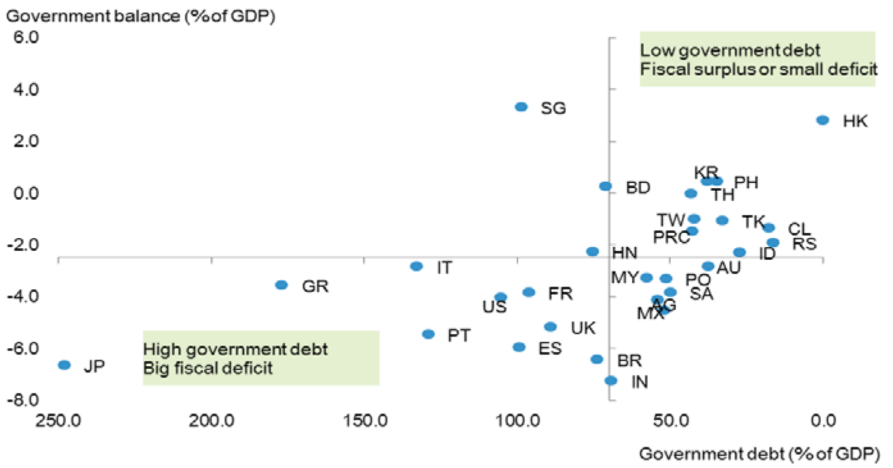
Figure 263: Asian export growth**



Source: CEIC, UBS estimates **export volumes are for goods and services on a national account basis, USD exports are on customs basis.

USD exports should resume positive growth in 2017, reflecting predominately the increase in export prices as we project oil prices to be 30% higher next year. But the improvement in export volumes should be less pronounced.

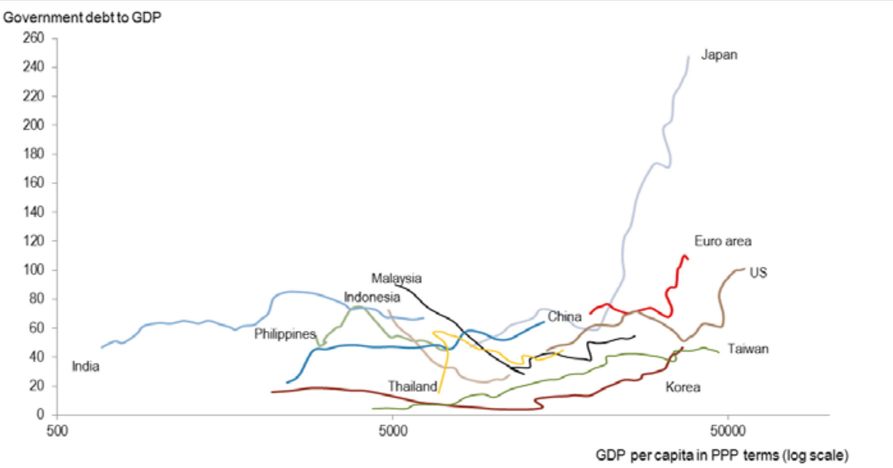
Figure 264: Asia has fiscal fire-power if needed**



Source: Haver, IMF, CEIC and UBS calculations. **average for 2013-2015

Asian governments are in a relatively sound position, given low government debt. But Asian fiscal policy tends to be reactive, not proactive. We do not expect aggressive fiscal stimulus next year. Most government statements are consistent with flat budget deficits and flat fiscal impulses.

Figure 265: Government debt and per capita income



Source: CEIC, Haver, UBS estimates

However, a rise in Asian government debt should be expected in the years ahead, even if not in 2017. A rise in government debt has played an important role in offsetting deleveraging pressures in other economies once their private-sector debt expansions reversed. Some element of this is on the horizon for non-Japan Asia, in our opinion.

Asia snapshot

	Real Growth (%y/y)				Consumer prices (%y/y)				Industrial production (%y/y)			
	2015	2016F	2017F	2018F	2015	2016F	2017F	2018F	2015	2016F	2017F	2018F
Asia (ex. Japan)	**6.2**	**6.1**	**5.9**	**5.8**	**2.4**	**2.5**	**2.8**	**2.8**	**5.6**	**5.7**	**5.5**	**5.6**
Asia (ex. Japan & China)	**5.4**	**5.4**	**5.4**	**5.7**	**3.5**	**3.2**	**3.5**	**3.9**	**5.2**	**5.5**	**5.4**	**5.9**
China	6.9	6.7	6.4	6.0	1.4	1.9	2.1	1.8	6.0	5.9	5.7	5.3
HK	2.4	1.1	1.3	1.4	2.5	2.2	1.8	1.8	-1.5	-0.5	-1.0	-1.0
India	7.6	7.4	7.6	7.8	4.9	4.8	4.5	4.9	9.3	8.3	8.0	8.5
Indonesia	4.8	5.0	4.8	5.2	6.4	3.5	4.5	5.1	4.8	4.7	4.7	5.2
Japan	0.5	0.5	0.8	0.9	0.8	-0.3	0.5	0.6	-1.2	0.0	2.3	1.1
Malaysia	5.0	3.8	3.4	3.7	2.1	2.1	2.7	2.8	4.9	2.6	2.6	3.6
Philippines	5.9	6.6	5.6	6.0	1.4	1.7	2.9	3.2	5.7	6.8	5.6	6.0
Singapore	2.0	1.1	1.4	2.0	-0.5	-0.6	0.7	1.1	-5.2	-0.2	-1.2	2.0
Korea	2.6	2.8	2.6	2.5	0.7	0.9	1.8	1.7	1.6	3.4	2.8	1.9
Taiwan	0.6	1.6	1.0	1.8	-0.3	1.2	1.5	1.1	-1.7	1.1	0.6	1.3
Thailand	2.8	3.1	2.5	3.1	-0.9	0.2	1.4	1.7	0.3	1.0	2.4	2.9

	Current account (% of GDP)				Exchange rate (LC per $, EOP)				Policy rate (%p.a. end period)			
	2015	2016F	2017F	2018F	Current	2016F	2017F	2018F	Current	2016F	2017F	2018F
Asia (ex. Japan)	**3.4**	**2.7**	**2.0**	**1.7**	--	--	--	--	**2.8**	**2.8**	**2.9**	**2.9**
Asia (ex. Japan & China)	**4.0**	**4.1**	**3.3**	**2.7**	--	--	--	--	**4.3**	**4.3**	**4.4**	**4.6**
China	3.0	1.9	1.3	1.2	6.8	6.9	7.2	7.5	1.50	1.50	1.50	1.50
HK	3.1	2.8	1.4	1.3	7.76	7.80	7.80	7.80	0.65	1.00	1.60	2.10
India	-1.1	-0.6	-1.1	-1.7	66.4	67.5	73.0	75.0	6.25	6.25	6.25	6.25
Indonesia	-2.1	-2.1	-2.8	-3.0	13,593	13,500	14,500	15,000	4.75	4.50	5.00	5.75
Japan	3.3	3.6	3.4	3.2	106.8	107.0	110.0	110.0	-0.05	-0.10	-0.10	-0.10
Malaysia	3.0	0.9	1.3	1.6	4.3	4.3	4.6	4.6	3.00	3.00	2.50	2.50
Philippines	2.6	0.8	0.3	-1.3	48.7	48.0	51.0	55.0	3.00	3.00	3.50	4.00
Singapore	19.8	26.4	30.6	32.1	1.40	1.41	1.45	1.45	0.87	1.00	1.75	2.25
Korea	7.7	7.0	6.1	5.5	1,166	1,160	1,200	1,250	1.25	1.25	1.25	0.75
Taiwan	14.5	14.4	12.8	12.0	31.6	32.3	33.5	34.0	1.38	1.38	1.13	1.13
Thailand	8.1	10.5	8.1	7.1	35.1	35.0	36.0	37.0	1.50	1.25	1.25	1.75

Data source: CEIC, Haver and UBS calculations. All Aggregate series use Nominal GDP PPP weightings except for current account we use nominal USD weightings.

Hong Kong

- **HK is muddling through as its monetary headwinds temporarily ease.**
- **But we expect growth to remain subdued in 2017 and 2018.**

Hong Kong's macro outlook is driven by two key moving parts: monetary conditions—the function of domestic interest rates and HKD exchange rate (which is pegged to the USD at a fixed rate)—and the global macro backdrop, particularly relating to China. Monetary conditions in HK have tightened from effective HKD appreciation and rising US rates expectations since 2015. This, plus heightened concerns on China in 2H15, had until late 2Q16 caused domestic growth to visibly slow and property prices to drop.

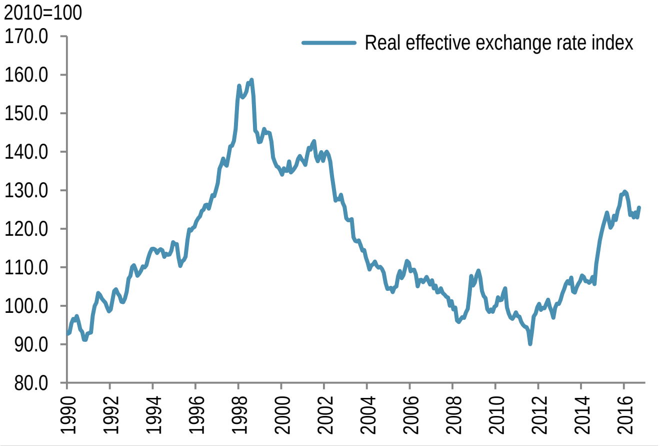
But the stabilization in monetary conditions since 2H16 has allowed the city to temporarily muddle through. Strong USD (and thus HKD) has been the biggest headwind since 2015 by undermining HK's cost competitiveness. The good news is the USD retreated somewhat in 3Q16, allowing the HKD to stabilize in real exchange rate terms during 2H16. Expectations for US rates hikes have also been scaled back after the 'Brexit' vote in late June. Lower rates for longer is positive for HK, where private leverage is high and the economy is sensitive to interest rates.

Monetary conditions have stabilized a bit since 2Q16, as HKD appreciation stalls and expectations for US rate hikes are scaled back.

While Hong Kong's near-term macro has become less bad, we don't expect much recovery ahead. Growth is likely to remain subdued and chug along an L-shaped path in 2017/18. Structurally, HK is still being squeezed by a weaker China but tighter US monetary policy. And we doubt cyclical demand will improve significantly. The retail and hospitability sectors, being the most cost-sensitive, have been the hardest hit since 2015, so some might expect these sectors to recover and contribute the biggest delta to any growth improvement going forward. We doubt that will be the case. While these sectors are indeed finding a floor, as the supply sides become more favourable (lower domestic costs and a less distorted structure) and the relative HKD appreciation pauses, any recovery thereafter still critically hinges on better end-demand. However, tourist spending is still hindered heavily by continued RMB depreciation and tighter rather than looser Chinese visa policy. We do expect domestic spending to improve in 2017, if the wealth effects from property turn more constructive, but only marginally so.

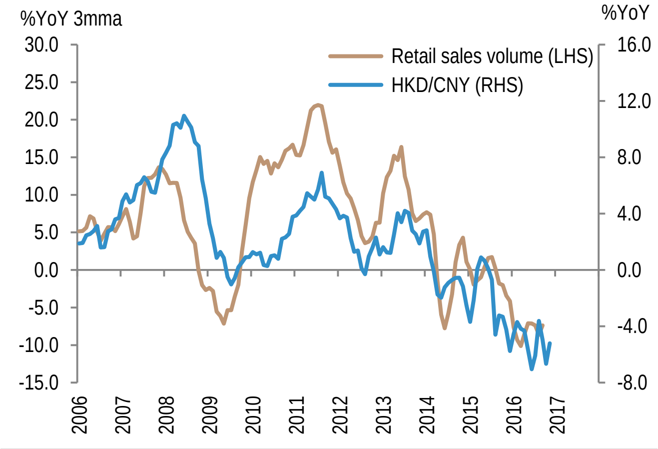
Growth should remain subdued in 2017/18. Structurally, Hong Kong is squeezed by easing Chinese growth but tightening US monetary policy.

Figure 266: HKD REER has moved sideways since 2Q16



Source: CEIC, BIS and UBS calculations. The REER index is compiled by the BIS

Figure 267: RMB depreciation still a drag on the retail sector



Source: CEIC and UBS calculations.

Hong Kong	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	1,934	2,037	2,138	2,258	2,397	2,468	2,518	2,568
GDP, USD bn	250	263	276	291	309	317	323	329
GDP per capita, USD	35,089	36,594	38,170	40,072	42,222	42,995	43,385	43,938
Real GDP growth, %	4.8	1.7	3.1	2.7	2.4	1.1	1.3	1.4
Private consumption, % y/y	8.4	4.1	4.6	3.3	4.7	1.0	1.7	1.6
Government consumption, % y/y	2.5	3.6	2.7	3.0	3.4	3.2	1.7	1.6
Gross Fixed Capital formation, % y/y	10.2	6.8	2.6	-0.1	-2.0	-3.3	1.6	1.6
Exports, % y/y	3.9	1.9	6.2	0.9	-1.5	-0.4	1.6	1.1
Imports, % y/y	4.6	2.9	6.6	1.0	-1.9	-0.4	1.9	1.1
Unemployment rate, %	3.5	3.3	3.4	3.2	3.3	3.5	3.7	3.9
Industrial Production (%)	0.7	-0.8	0.1	-0.4	-1.5	-0.5	-1.0	-1.0
Prices, interest rates and money								
CPI inflation, % y/y (average)	5.3	4.7	4.0	3.5	2.5	2.2	1.8	1.8
CPI inflation, % y/y (year-end)	6.4	3.8	3.9	3.1	2.3	1.6	2.0	1.6
Broad money M3, % y/y (end-year)	4.6	12.1	5.7	9.0	10.4	7.3	6.5	5.0
Domestic private credit, % y/y	12.5	7.0	10.6	13.5	6.3	6.5	5.0	4.0
Domestic bank credit/GDP	173.7	176.6	186.1	200.0	200.2	207.1	213.2	217.4
3M HIBOR, % (end-year)	0.38	0.40	0.38	0.38	0.39	1.00	1.60	2.10
10 year bond yield, % (year-end)	1.45	0.60	2.29	1.86	1.56	1.30	1.85	2.30
USD/HKD (year-end)	7.77	7.75	7.75	7.76	7.75	7.80	7.80	7.80
Fiscal accounts								
General government budget balance, % GDP	3.8	3.2	1.0	3.7	1.3	0.5	-0.3	-0.9
Revenue, % GDP	22.6	21.7	21.3	21.2	19.1	20.2	20.4	20.4
Expenditure, % GDP	18.8	18.5	20.3	17.5	17.8	19.7	20.7	21.3
of which interest expenditure, % GDP	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Primary balance, % GDP	3.8	3.2	1.0	3.7	1.3	0.5	-0.3	-0.9
Public sector debt (gross),% GDP	0.6	0.5	0.5	0.1	0.1	0.6	0.6	0.6
of which domestic public debt, % GDP	0.6	0.5	0.5	0.1	0.1	0.6	0.6	0.6
of which external public debt,% GDP	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
% domestic public debt held by non-residents	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Public debt held by the central bank, % GDP	34.1	32.5	35.2	33.4	34.6	39.0	38.3	37.5
Balance of payments								
Trade balance, USD bn	-54.8	-61.6	-64.8	-70.9	-57.1	-53.6	-61.6	-62.9
Exports, USD bn	429.2	443.1	459.2	474.0	465.5	452.2	463.4	472.8
Imports, USD bn	484.0	504.7	524.1	544.9	522.6	505.7	525.0	535.6
Current account balance, USD bn	13.8	4.1	4.2	3.8	9.6	9.0	4.6	4.2
as % of GDP	5.5	1.6	1.5	1.3	3.1	2.8	1.4	1.3
Foreign direct investment (net), USD bn	0.2	-13.2	-6.5	-11.1	119.8	10.3	-3.0	-2.0
Total FX reserves, USD bn	285.4	317.3	311.2	328.5	358.8	363.0	365.0	367.0
Foreign exchange reserves excl gold, USD bn	285.3	317.2	311.1	328.4	358.8	362.9	364.9	366.9
Total FX reserves, % GDP	114.4	120.8	112.9	112.8	116.0	114.4	113.1	111.5
Total external debt, % GDP	395.4	392.1	420.9	446.8	421.5	401.1	397.2	389.4
Net International Investment Position, % GDP	285.5	274.5	274.9	298.9	316.6	352.5	355.5	358.3
Credit ratings								
Moody's	Aa1	Aa1	Aa1	Aa1	Aa1	Aa1	N/A	N/A
S&P	AAA	AAA	AAA	AAA	AAA	AAA	N/A	N/A
Fitch	AA+	AA+	AA+	AA+	AA+	AA+	N/A	N/A

Source: CEIC, Haver and UBS forecasts.

Note: For inflation, we use underlying inflation (CPI excluding the one-off government measures). Public-sector debt refers to general government debt only. It is negligible in HK as the city enjoys high fiscal reserves and has persistently run fiscal surpluses. Public debt held by the central bank refers to outstanding Exchange Fund papers issued by the HKMA when inflows into HKD were strong. High external debt in HK largely reflects Hong Kong's status as an international financial centre. Hong Kong's domestic sectors have little external leverage

India

- **Growth accelerates as balance sheet repair gets under way**
- **Policy mix of looser money, tight fiscal unchanged in FY18; shift in FY19**

Balance sheet repair and election themes could vie for investor attention this year

Balance sheet repair will be a key issue in FY 2017-18, with attention shifting to the possibility of looser fiscal policy ahead of the 2019 election late in the year. With FY 2016-17 having been the year of recognising non-performing assets, 2017-18 and 2018-19 promise to be years of balance sheet clean-up – a process in which India has a head start on other Asian countries.

We expect India's economy to accelerate in FY 2017-18, bucking the regional trend.

We expect India's real GDP to grow 7.6% in FY 2017-18 after a below-consensus 7.4% in FY 2016-17. After years of consolidation, we expect the investment share of GDP to come close to bottoming out as balance sheets improve. Constrained by domestic rather than international regulation, India (ex-IT services exports) is at less risk from protectionism, but exports should not provide much of a lift to GDP due to subdued external demand. However, the note demonetization scheme, while positive for formalization of the economy, adds to near-term growth uncertainty.

Inflation dynamics turn less benign

Higher oil prices (we project Brent oil to average USD 60/brl in CY 2017) should put upward pressure on inflation. The impact on retail fuel prices may be smoothed by government policy while the disinflationary impact of the depressed credit cycle and lower food price inflation should provide an offset in early FY 2017-18. However, we expect headline inflation to accelerate into 2018-19. We project an average of 4.5% CPI inflation in FY 2017-18 and 4.9% in FY 2018-19. Our projections do not include the impact of the 7th Pay Commission allowances for public housing – which could technically lift the CPI inflation rate by 100-150bps for a period over the next two years.

A shift in policy direction

As such, the next two years promise a shift in the policy mix from fiscal consolidation and monetary policy easing. We expect FY 2017-18 to be the last year of fiscal consolidation towards the deficit target set at 3.0% of GDP. The introduction of GST in FY 2017-18, a potential long-term positive for tax system and economic efficiency, could imply some volatility in growth around the time of introduction but is not expected to impact inflation or revenues in the near term. In 2018-19 we expect the central government deficit to widen to 3.5% of GDP as policy is loosened ahead of the 2019 general election.

RBI rates on hold in 2017. Fall in real rates implies upward pressure on USDINR

We doubt the RBI will tighten policy next year to offset the rise in CPI inflation due to oil, GST or public housing allowances. Indeed, the rupee note demonetarisation scheme could result in lower market rates. A combination of higher Fed rates and evidence of unwelcome persistence of inflation above the RBI's 4% +/-2ppt target mid-point should also keep the RBI on hold in FY 2018-19. The willingness to put up with higher inflation combined with higher Fed rates, plus a wider current account deficit on higher oil prices and investment, implies some weakness in the rupee foreign exchange rate – we assume USDINR rises to 73 by end FY 2017-18.

Alternative scenario: looser policy = stronger growth and weaker FX

Under our baseline scenario, policy is supportive of growth but does not generate a significant boost. An alternative scenario (20% chance) is that the government adopts a more stimulatory stance. A widening of the Union fiscal deficit to 4.0% of GDP in FY 2018-19 might boost real GDP growth to 8.0-8.5%. However, as this would push the general government deficit (including state governments) back towards 8% of GDP, the yield curve would likely steepen, and especially if RBI policy is accommodative. Moreover, the INR could fall an additional 3-6% against the USD as the current account widens to a more uncomfortable level.

India	11/12	12/13	13/14	14/15	15/16	16/17F	17/18F	18/19F
Economic Activity and Employment								
GDP, local currency bn	87,360	99,513	112,728	124,882	135,761	151,922	170,640	193,894
GDP, USD bn	1,827	1,831	1,868	2,043	2,076	2,265	2,384	2,594
GDP per capita, USD	1,520	1,501	1,512	1,633	1,640	1,767	1,839	1,978
Real GDP growth, %	5.5	5.6	6.6	7.2	7.6	7.4	7.6	7.8
Private consumption, % y/y	9.3	5.3	6.8	6.2	7.4	7.7	8.2	8.4
Government consumption, % y/y	6.9	0.5	0.4	12.8	2.2	9.3	7.0	8.0
Gross Fixed Capital formation, % y/y	12.3	4.9	3.4	4.9	3.9	3.3	7.0	8.0
Exports, % y/y	15.6	6.7	7.8	1.7	-5.2	1.5	4.5	4.5
Imports, % y/y	21.1	6.0	-8.2	0.8	-2.8	-1.7	5.0	5.5
Unemployment rate, %	9.8	8.5	8.2	3.6	3.6	3.6	3.6	3.6
Manufacturing, % y/y	7.4	6.0	5.6	5.5	9.3	8.3	8.0	8.5
Prices, interest rates and money								
CPI inflation, % y/y (average)	9.2	9.9	9.4	5.9	4.9	4.8	4.5	4.9
CPI inflation, % y/y (year-end)	9.0	9.4	8.2	5.3	4.8	4.3	4.8	4.9
Broad Money M3, % y/y (end-year)	16.1	13.5	13.6	13.4	10.9	15.0	15.0	20.0
Domestic private credit, % y/y	16.8	14.0	14.2	10.7	10.2	12.0	15.0	20.0
Domestic bank credit/GDP	54.4	54.5	54.8	54.7	55.3	55.4	56.7	59.9
Repo rate, % (end-year)	8.50	8.00	7.75	8.00	6.75	6.25	6.25	6.25
10 year bond yield, % (year-end)	8.5	8.2	8.8	7.9	8.1	6.5	6.8	7.3
USD/INR (year-end)	53.0	54.9	61.9	63.0	66.2	67.5	73.0	75.0
Fiscal accounts								
General government budget balance, % GDP	-5.9	-4.9	-4.5	-4.1	-3.9	-3.5	-3.0	-3.5
Revenue, % GDP	8.6	8.8	9.0	8.8	8.8	9.1	9.5	9.8
Expenditure, % GDP	14.5	13.8	13.5	12.9	12.7	12.6	12.5	13.3
of which interest expenditure, % GDP	3.4	3.4	3.6	0.0	0.0	3.2	3.2	3.2
Primary balance, % GDP	-2.8	-1.8	-1.1	-0.9	-0.7	-0.3	0.2	-0.3
Public sector debt (gross),% GDP	47.8	47.6	47.1	46.7	47.5	46.3	44.6	43.1
of which domestic public debt, % GDP	43.7	44.0	43.5	43.5	44.2	43.0	41.3	39.8
of which external public debt,% GDP	4.1	3.7	3.7	3.2	3.3	3.3	3.3	3.3
% domestic public debt held by non-residents	0.9	1.6	1.7	3.7	3.7	3.7	3.8	3.9
Public debt held by the central bank, % GDP	6.8	7.2	6.6	4.2	4.5	5.1	4.8	4.4
Balance of payments								
Trade balance, USD bn	-183.4	-190.3	-135.8	-137.7	-118.4	-103.1	-119.2	-136.9
Exports, USD bn	306.0	300.4	314.4	310.3	262.0	262.0	275.1	290.2
Imports, USD bn	489.3	490.7	450.2	448.0	380.4	365.1	394.4	427.1
Current account balance, USD bn	-78.2	-88.2	-32.4	-26.8	-22.2	-14.1	-27.2	-44.9
as % of GDP	-4.3	-4.8	-1.7	-1.3	-1.1	-0.6	-1.1	-1.7
Foreign direct investment (net), USD bn	22.1	19.8	21.6	31.3	36.0	36.0	40.0	50.0
Total FX reserves, USD bn	260.1	259.7	276.4	317.3	336.1	326.1	336.1	336.1
Foreign exchange reserves excl gold, USD bn	233.0	234.0	254.8	298.3	316.0	306.0	316.0	316.0
Total FX reserves, % GDP	14.2	14.2	14.8	15.5	16.2	14.4	14.1	13.0
Total external debt, % GDP	19.7	22.4	23.9	23.2	23.4	20.8	21.0	20.4
Net International Investment Position, % GDP	-14.5	-17.8	-18.2	-17.8	-17.4	-16.6	-16.9	-17.2
Credit ratings								
Moody's	Baa3	Baa3	Baa3	Baa3	Baa3	Baa3	N/A	N/A
S&P	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	N/A	N/A
Fitch	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	N/A	N/A

Source: CEIC, Haver and UBS forecasts.
Note: India's fiscal year begins in April. All data is fiscal year, except Interest rate and exchange rate.
Note: General government balance reflects Union Budget only (States not included)
Note: Manufacturing is as in national accounts data
Note: Measuring Indian labour market activity is fraught with difficulty. Labour market data presented here is based on ILO estimates.

Indonesia

- **Another year of economic adjustment in Indonesia**
- **Easy monetary policy settings and end to Amnesty flows to weaken IDR**

Another year of economic adjustment

We believe 2017 will be another year of adjustment for Indonesia's economy, with 2018 looking better. We project real GDP growth of 4.8% in 2017 and 5.2% in 2018. Still subdued growth in 2017 is a non-consensus view. We expect that growth outcome, combined with a less favourable rate differential with the US and a wider current account deficit, to depress the rupiah during 2017.

Balance sheet repair in 2017 to set stage for improvement in growth in 2018

Although credit growth has clearly slowed to cyclically low levels, the level of investment spending and specifically construction investment remains unusually elevated relative to GDP. The easy-money and elevated commodity price environment which drove construction activity up as a share of an economy has receded. We also note the rise in NPLs in recent quarters – with the implication that resources were misallocated during the prior years' credit expansion. It follows that some adjustment or balance sheet repair is likely before growth can sustainably reaccelerate. Our non-consensus view of subdued growth in 2017 is heavily based on the notion that the balance sheet clean-up is at an early stage. As the repair and adjustment process continues, cyclical growth prospects should improve – which is why we expect an improvement in real GDP growth in 2018.

Limited room for fiscal impulse

Additionally, after fiscal stimulus and easier monetary policy settings in 2016 we expect no further widening of the fiscal deficit. The government's stated intention to stay within the legislated deficit limit of 3% of GDP implies a reduced fiscal impulse (defined as the change in the fiscal deficit). The end of the Tax Amnesty in March 2017 implies a waning of Tax Amnesty Revenues from circa 1.0ppts of GDP in 2016 to 0.2-0.4ppts in 2017, but the rise in Brent oil prices to USD 60 a barrel that UBS projects in 2017 should go some way to offsetting this, with oil and gas revenues rising by around 0.4ppts of GDP. On balance we expect the impulse to growth from fiscal policy to weaken after a positive impulse in H1 2016.

One more policy rate cut, to be reversed within 12 months

Bank Indonesia's space for policy action will likely be curtailed by higher oil prices. A slow response of government-administered retail prices to the rise in oil prices may limit the rise in inflation in 2017, but as the increase in oil prices looks more persistent, inflation may accelerate in the second half of the year and into 2018. That process may add to post Tax-Amnesty currency weakness and drive the central bank to raise policy rates. We expect policy rates to be cut 25bps one more time in 2016 but increased 50bps in H2 2017 and a further 75bps in 2018.

Recent IDR strength likely to reverse (unless coal prices remain elevated)

Unlike most Asian countries, higher energy prices in general should be positive for Indonesia's terms of trade – all else equal. However, Indonesia is a coal exporter and a net oil and gas importer. The sharp rise in coal prices during 2016 will improve the trade balance through early 2017, but UBS analysts believe the coal price increase to be a temporary function of Chinese government policy. As such Indonesia could face an increase in oil prices and decline in coal prices in late 2017 and into 2018 – an uncomfortable combination for the current account balance. This, and a moderation of recent years' import compression, leads us to project the current account deficit to average 2% of GDP in H2 2016 but 2.7% in 2017 and 3.0% in 2018. That, an end to Tax Amnesty-related flows, and a deteriorating real rate gap with the US also promise to weigh on the rupiah after a period of strength over the last year. We project USDIDR 14500 at end 2017. If coal prices prove more resilient, then the rupiah could be stronger than we currently project.

Indonesia	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	7,831,726	8,615,705	9,546,134	10,565,817	11,540,790	12,462,135	13,627,989	15,026,254
GDP, USD bn	892	918	913	890	862	937	978	1,023
GDP per capita, USD	3,686	3,742	3,671	3,527	3,373	3,623	3,741	3,873
Real GDP growth, %	6.2	6.0	5.6	5.0	4.8	5.0	4.8	5.2
Private consumption, % y/y	5.1	5.5	5.5	5.3	4.8	5.1	4.9	5.2
Government consumption, % y/y	5.5	4.5	6.7	1.2	5.4	1.8	4.4	5.3
Gross Fixed Capital formation, % y/y	8.9	9.1	5.0	4.6	5.1	4.5	4.6	4.6
Exports, % y/y	14.8	1.6	4.2	1.0	-2.0	-2.3	2.7	4.0
Imports, % y/y	15.0	8.0	1.9	2.2	-5.8	-2.9	3.0	3.8
Unemployment rate, %	7.5	6.1	6.2	5.9	6.2	6.5	6.7	6.7
Industrial Production (%)	4.1	4.1	6.0	4.8	4.8	4.7	4.7	5.2
Prices, interest rates and money								
CPI inflation, % y/y (average)	5.3	4.0	6.4	6.4	6.4	3.5	4.5	5.1
CPI inflation, % y/y (year-end)	3.8	3.7	8.1	8.4	3.4	3.3	5.4	4.6
Broad Money M2, % y/y (end-year)	16.4	15.0	12.8	11.9	9.0	7.3	13.5	17.5
Domestic private credit, % y/y	25.9	22.3	20.0	12.6	9.6	7.9	11.5	16.5
Domestic bank credit/GDP	28.4	31.8	34.8	35.1	35.4	35.6	37.0	39.7
7 Day Reverse Repo, % (end-year)	N/A	N/A	N/A	N/A	N/A	4.50	5.00	5.75
10 year bond yield, % (year-end)	6.0	5.1	8.7	7.9	8.8	7.0	7.5	8.0
USD/IDR (year-end)	9,068	9,670	12,189	12,440	13,795	13,500	14,500	15,000
Fiscal accounts								
General government budget balance, % GDP	-1.1	-1.8	-2.2	-2.1	-2.6	-2.8	-2.8	-2.3
Revenue, % GDP	15.5	15.5	15.1	14.7	13.1	12.5	12.5	13.0
Expenditure, % GDP	16.5	17.3	17.3	16.8	15.7	15.3	15.3	15.3
of which interest expenditure, % GDP	1.2	1.2	1.2	1.3	1.4	1.3	1.3	1.3
Primary balance, % GDP	0.1	-0.6	-1.0	-0.9	-1.2	-1.5	-1.5	-1.0
Public sector debt (gross),% GDP	22.9	22.7	24.6	24.4	27.0	27.6	28.8	28.8
of which domestic public debt, % GDP	12.5	12.4	13.0	13.7	14.8	16.0	16.9	17.6
of which external public debt,% GDP	10.4	10.2	11.6	10.7	12.2	11.6	11.9	11.2
% domestic public debt held by non-residents	30.8	33.0	32.5	38.1	38.2	39.0	39.0	39.0
Public debt held by the central bank, % GDP	3.3	2.9	2.6	2.2	2.1	1.9	1.8	1.6
Balance of payments								
Trade balance, USD bn	26.1	-1.7	-4.1	-2.2	7.7	5.8	-1.2	-4.3
Exports, USD bn	203.5	190.0	182.6	176.0	150.4	139.6	145.6	151.1
Imports, USD bn	177.4	191.7	186.6	178.2	142.7	133.8	146.8	155.5
Current account balance, USD bn	1.7	-24.4	-29.1	-27.5	-17.7	-20.0	-26.9	-31.0
as % of GDP	0.2	-2.7	-3.2	-3.1	-2.1	-2.1	-2.8	-3.0
Foreign direct investment (net), USD bn	11.5	13.7	12.2	14.7	10.6	10.0	10.0	10.0
Total FX reserves, USD bn	103.4	105.3	92.9	105.5	100.1	115.9	110.9	110.9
Foreign exchange reserves excl gold, USD bn	99.8	101.4	89.8	102.5	97.4	113.3	108.3	108.3
Total FX reserves, % GDP	11.6	11.5	10.2	11.9	11.6	12.4	11.3	10.8
Total external debt, % GDP	25.3	27.5	29.1	33.0	36.0	36.3	36.8	37.1
Net International Investment Position, % GDP	-35.7	-39.3	-40.7	-43.2	-42.5	-41.2	-42.2	-43.4
Credit ratings								
Moody's	Ba1	Baa3	Baa3	Baa3	Baa3	Baa3	N/A	N/A
S&P	BB+	BB+	BB+	BB+	BB+	BB+	N/A	N/A
Fitch	BBB-	BBB-	BBB-	BBB-	BBB-	BBB-	N/A	N/A

Source: CEIC, Haver and UBS forecasts.
Note: Indonesia changed its policy rate to the 7-day repo rate in August 2016. Previous policy rate was a 1-year rate and thus not directly comparable with current policy rate.

Japan

- **Japanese economic and political outlook for 2017–18**

We estimate that GDP will continue to expand slightly faster than the potential growth rate of 0.6% (+0.7% in 2017, +0.8% in 2018). Domestic demand will drive growth (mainly consumption and government spending). In particular, growth is being powered more by non-manufacturing and services than by the manufacturing sector. The services industry index is rising consistently, mainly thanks to areas such as services for seniors, leisure and sports (Figure 268).

Hitherto the stock market has frequently focused on political events and exchange rates, such as surprises under Abenomics and BoJ quantitative easing (QE). We continue to believe reforms to entrenched regulations and steady yen depreciation will be needed, but we think it will become easier for companies and households to spend for the medium to long term as interest/exchange rates and the political situation stabilize. We believe investors will look more closely at specific areas of growth and expenditure in Japan from here on. Our 14 September 2016 Macro Keys report, Economic and political 'stability and change': Abenomics, changes in industry and labour, NIRP discusses the key points to watch in Japan's economic and political landscape.

In consumption we flag a spending revival in mid- to low-income bracket

We expect consumption to pick up gradually from +0.1% in 2016 to +0.5% in 2017 and +0.8% in 2018 (consumption accounts for about 60% of GDP). We attribute weak consumption hitherto to five factors: (1) dull wage growth; (2) rising food prices (up about 3% yoy in 2015, up a further 1% or so in 2016); (3) uncertainty over social security (rising trend in savings rate by younger population cohort); (4) increased burden on seniors due to social security reforms; and (5) the negative wealth effect (household financial assets down around ¥30trn or 6% of GDP over the year due to yen strength, falling share prices). However, there is support from growth of around 2–3% yoy in total wages thanks to rising employment (Figure 269); though with average growth per capita stalled at around +0.5%) and as a return to stable forex halts the climb in food prices, which have a strong inverse correlation with consumer sentiment. We cannot expect consumption to be so strong that household savings rates also fall in younger age-bands, but higher wages earned by working women and seniors should provide a tailwind for some consumer goods.

The BoJ's negative interest rate policy (NIRP) has started to lead to clear recovery in durable goods consumption and house purchases, although there is no visible evidence that total consumption has risen. There are some concerns about excessive housing investment, but we do not expect oversupply in large cities such as Tokyo, which are seeing a sustained population influx. Please refer to our 12 October 2016 report by our real estate analyst Toshihiko Okino: Japan Lesson: Real Estate Recording new profit highs as business models change.

In capex we highlight private sector labour-saving investment

On the other hand, we estimate that private sector capital expenditure growth will remain very gentle at around +1% yoy. Industrial production (a leading indicator for capex) correlates closely with real exports, and with export volume growth set to remain modest (we forecast export growth of +2% in 2017, +1.1% in 2018), we do not envisage any great expansion in domestic capex. Rather, we highlight the fact that labour-saving investment has started to take off in industries in which women and seniors cannot make up for shortages. In particular, the value of robot shipments to industries such as food products, chemicals, and precision equipment has risen to match record-high levels (Figure 270). Signs of the labour force participation rate by women/seniors approaching a ceiling, or developments such as a sustained rise in the minimum wage or upward pressure on non-regular employees' wages from the labour shortage will likely prompt labour-saving investment in non-manufacturing/services as well. For further details about growth in investment in robots please see our 22 June 2016 Macro Keys report Fuse lit for Japanese corporate investment in robots. R&D investment will also more easily attract attention as it starts to be booked in GDP capex statistics. We think we can look for government support for R&D investment as well.

Will inflation take hold once more?

We think 2% growth in the economy and prices will be hard to achieve at the overall macro level. A 2% rise in prices requires a corporate savings rate of about -5% of GDP (Figure 271). However, in industries and specific areas aligned with structural change, such as some durable goods and the services sector, growth continues while prices are also rising clearly. We estimate that core CPI will climb to +0.5% yoy by the end of 2017 (+0.3% on average for the year) and +0.7% yoy by the end of 2018 (average: +0.6%). We believe Japan will chart a course that cannot be called either deflation or inflation, but that will involve diversified growth and inflation as some areas see expansion while others experience contraction — a picture we term 'diversifying inflation'. A key feature since the start of Abenomics is that the proportion of goods and services with rising prices has climbed to 60%, consistently at broadly the same level as in the period of economic recovery prior to the economic shock triggered by the Lehman Brothers collapse (July 2008). On the other hand, the proportion of goods and services with falling prices has climbed to around 30%, even now. We envisage overall price growth of 0.5–1% yoy or so at best from here on, given the falling population in younger age bands and weak trade, possibly not providing an adequate inflation rate. However, there are plenty of categories in which prices are rising consistently because of the new structure of industry, such as consumption by seniors and spending on services, and we think the picture of 'diversifying inflation' with its mix of rising and falling prices for different goods and services will continue.

What will happen to The Three Arrows of Abenomics?

We think PM Abe will put more effort into diplomacy and constitutional reforms, and we believe key policy areas to focus on will be those in which steady reforms are progressing, rather than catalysts that would substantially move markets. For example, we envisage further expansion in female, senior and foreign workers, and labour force participation rates are likely to rise to 70% for women and at least 28% for seniors over 65 (Figure 272). The government is also actively seeking to attract foreign workers under a different framework from its immigration policy, including adopting the world's fastest green-card, supporting an increase in foreign workers at Japanese companies, and bringing in foreign IT human resources. The number of foreign workers rose by 120,000 people to a total of 908,000 in 2015 (around 1.4% of the labour force), and should reach 2,408,000 in 2025 (3.4% of the labour force) if growth continues at a rate of 150,000 people a year. Turning to privatization policies, we can look for PFIs to progress in water utility services and ports. We expect to see enhanced tax breaks and subsidies for investment in the Internet of Things (IoT), artificial intelligence (AI) and robots as the Fourth Industrial Revolution. We envisage advances in Fintech and the sharing economy. Proposed casino legislation should also be enacted by the Ordinary Diet in 2017. Corporate governance remains an important theme, but Japanese companies' ROE distribution is gradually shifting (Figure 273).

The BoJ has introduced yield curve control, looking to prolong monetary easing. Our view is that short-term interest rates will be kept at -0.1% and the 10-year yield will be held to zero in 2017-18, so long as conditions do not deteriorate to the point of recession. We believe the focus will be more on any slowdown in the pace of JGB purchases from the current ¥80trn a year. It will be the end of 2018 before depositary financial institutions reach their minimum JGB holding ratio levels, and the BoJ will no longer be able to maintain the current pace of JGB purchasing. We estimate that purchasing will be scaled back to ¥70trn or so in April 2017 and around ¥60trn in April 2018. The BoJ might also raise its 10-year yield target if prices rise more strongly than we expect. Be that as it may, we cannot look for BoJ policies to weaken the yen, and we therefore focus on industries that stand to benefit from sustained low interest rates (for example, consumer durables and housing).

Expectations pinned on the BoJ are fading, but hopes of fiscal expansion are growing in some quarters. We envisage a supplementary budget of around ¥5trn in FY17, but this would represent an increase of only ¥900bn from FY16, and is therefore unlikely to be enough to substantially change trends in the economy (we estimate that public investment growth will expand from -0.1% in 2016 to +3.7% in 2017 and +2.7% in 2018). However, there may be greater upside than downside, given PM Abe's stance and proponents of fiscal expansion in leading LDP positions. On the other hand, if fiscal expansion fails to encourage corporate investment, the impact will likely prove only transient, merely pushing up the corporate savings rate in the balance between investment and savings.

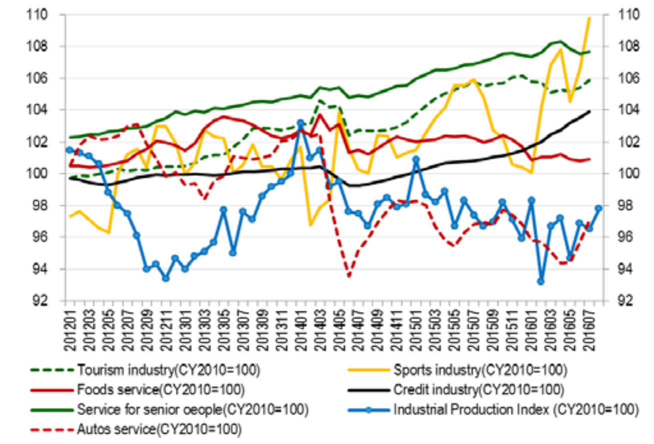
Key political events

Approval rates remain high for the LDP and Abe Cabinet, and the December 2018 Lower House election is likely to be brought forward to avoid an election in the run-up to the 2020 Tokyo Olympic Games. We think November 2017 is a likely date, marking the last Lower House election of PM Abe's term in office (likely to be extended to September 2021). However, election issues will include the sustainability of Abenomics and amending the constitution, rather than large-scale reforms.

Changes in BoJ policy board personnel will also be closely watched. Two board members will reach the end of their terms of office in July 2017 (Takahiro Sato, Takahide Kiuchi). They are opposed to the current yield curve control, and we think the personnel change will actually enhance the current policy regime. In March 2018 two vice governors are due to step down, followed by Governor Haruhiko Kuroda in April. We do not expect Mr. Kuroda to be reappointed, but neither do we envisage any great change in the monetary policy framework. In our main scenario we do not expect any bold changes, such as moves towards foreign bond buying or helicopter money in monetary policy, or gearing up commitment through changes in the Bank of Japan Law.

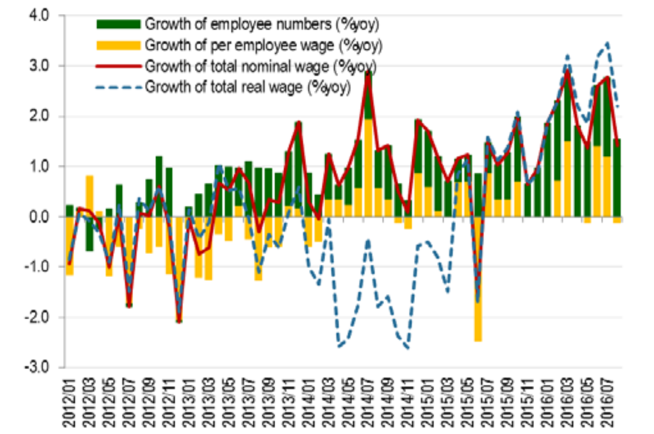
We can look for progress in trade and investment agreements in 2017-18. The TPP is awaiting US ratification, but Japan may accelerate talks on other trade and investment agreements, such as the FTA with the EU (negotiations under way since 2012, aiming to reach agreement by the end of 2016), and FTA talks with China and South Korea. This is because it is easier to reflect the will of economic and business entities such as the Japan Business Federation and Japan Association of Corporate Executives under a stable administration. Expanding FTAs not only benefits the manufacturing sector by scrapping tariffs but also provides a major boost to efforts by domestic demand-driven industries to expand overseas (such as retail, food, infrastructure and banking).

Figure 268: Services Economic Activity Index and Industrial Production Index



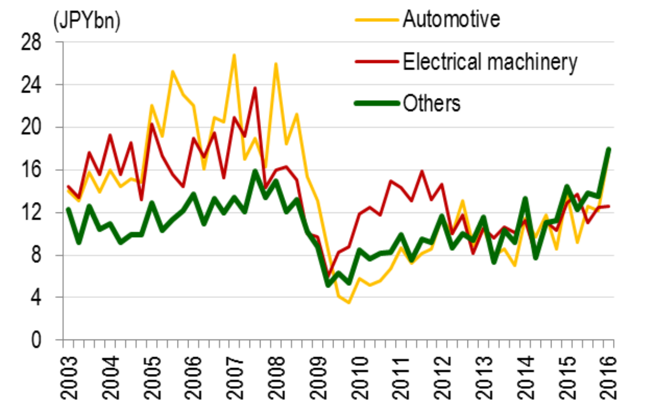
Source: Ministry of Economy, Trade and Industry, UBS

Figure 269: Total nominal wage growth continues to accelerate



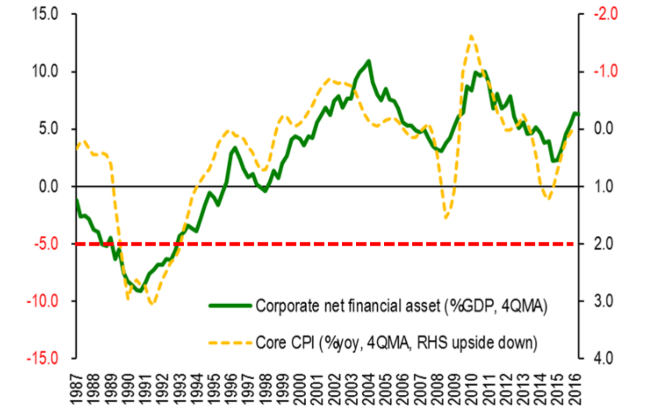
Source: Ministry of Health, Labour, and Welfare, UBS

Figure 270: Domestic robot market – value of shipments by industry



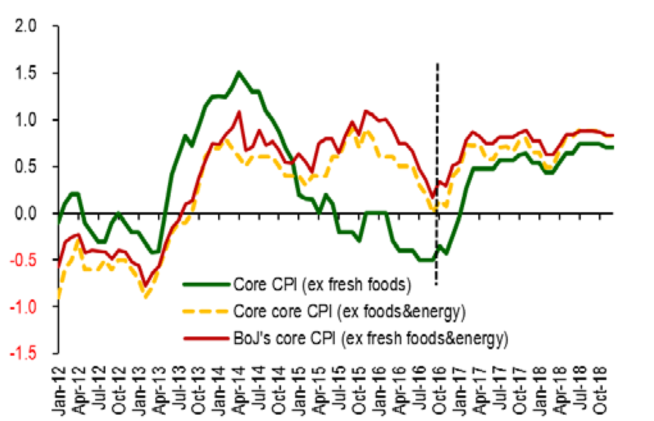
Source: Japan Robot Association, UBS, Note: Other industries include metals, machinery, precision equipment, groceries/beverages/tobacco/feedstuff, chemical products (such as pharmaceuticals and cosmetics), and plastic products

Figure 271: Corporate savings rate and core CPI



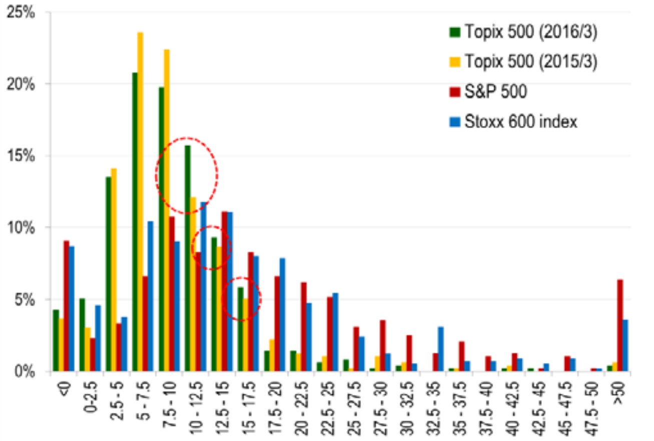
Source: Bank of Japan, Ministry of Internal Affairs and Communications, Cabinet Office, UBS

Figure 272: Price growth forecasts



Source: Ministry of Internal Affairs and Communications, Bank of Japan, UBS

Figure 273: ROE distribution clearly starting to shift



Source: Bloomberg, UBS

Japan	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	471,579	475,332	479,084	486,871	499,211	505,886	515,144	526,015
GDP, USD bn	5,918	5,934	4,890	4,571	4,127	4,818	4,683	4,697
GDP per capita, USD	46,310	46,545	38,418	35,971	32,469	37,981	36,999	37,196
Real GDP growth, %	-0.5	1.7	1.4	0.0	0.5	0.5	0.8	0.9
Private consumption, % y/y	0.3	2.3	1.7	-0.9	-1.2	0.1	0.5	0.8
Government consumption, % y/y	1.2	1.7	1.9	0.1	1.2	2.0	0.8	0.8
Gross Fixed Capital formation, % y/y	1.4	3.4	2.5	1.3	0.0	0.9	1.6	1.3
Exports, % y/y	-0.4	-0.2	1.2	8.3	2.8	-1.1	2.2	2.1
Imports, % y/y	5.9	5.3	3.1	7.2	0.3	-0.8	2.1	2.0
Unemployment rate, %	4.2	4.0	3.4	3.2	3.1	3.1	3.0	2.8
Industrial Production (%)	-2.8	0.6	-0.8	2.1	-1.2	0.0	2.3	1.1
Prices, interest rates and money								
CPI inflation, % y/y (average)	-0.3	-0.1	0.3	2.8	0.8	-0.3	0.5	0.6
CPI inflation, % y/y (year-end)	-0.2	-0.2	1.7	2.4	0.1	-0.1	0.5	0.7
Broad Money M2, % y/y (end-year)	3.1	2.6	4.2	3.6	3.1	2.3	2.7	3.2
Domestic private credit, % y/y	1.2	3.5	4.4	3.7	3.6	2.9	2.8	2.8
Domestic bank credit/GDP	138.4	143.7	143.8	146.6	148.4	150.5	152.5	154.4
Uncollateralized Overnight, % (end-year)	0.08	0.08	0.07	0.07	0.04	-0.10	-0.10	-0.10
10 year bond yield, % (year-end)	0.99	0.80	0.74	0.33	0.27	-0.10	0.00	0.00
USD/Yen (year-end)	77.6	86.3	105.4	119.8	120.4	107.0	110.0	110.0
Fiscal accounts								
General government budget balance, % GDP	-9.8	-8.8	-8.5	-6.2	-5.5	-5.4	-5.5	-4.1
Revenue, % GDP	30.8	31.1	32.1	33.6	32.4	33.6	34.3	35.2
Expenditure, % GDP	40.6	39.8	40.6	39.8	37.9	39.0	39.7	39.3
of which interest expenditure, % GDP	2.1	2.2	2.2	2.3	2.0	1.8	1.7	1.6
Primary balance, % GDP	-7.7	-6.6	-6.3	-3.9	-3.5	-3.6	-3.7	-2.5
Public sector debt (gross),% GDP	227.0	237.7	239.7	246.4	248.7	253.0	257.2	261.3
of which domestic public debt, % GDP	226.6	237.3	239.2	246.0	248.3	252.6	256.8	260.8
of which external public debt,% GDP	0.4	0.4	0.5	0.5	0.5	0.5	0.5	0.5
% domestic public debt held by non-residents	6.8	7.1	6.8	7.9	8.6	8.9	9.3	9.7
Public debt held by the central bank, % GDP	18.8	27.0	41.7	56.1	72.8	87.5	101.7	115.5
Balance of payments								
Trade balance, USD bn	-4.1	-53.5	-89.9	-98.9	-5.2	43.2	43.7	39.8
Exports, USD bn	789.2	776.5	695.0	699.9	621.9	650.3	701.8	749.2
Imports, USD bn	793.4	830.0	784.9	798.8	627.1	607.1	658.1	709.4
Current account balance, USD bn	130.4	59.7	45.7	36.7	135.6	175.7	157.2	149.9
as % of GDP	2.2	1.0	0.9	0.8	3.3	3.6	3.4	3.2
Foreign direct investment (net), USD bn	116.7	117.3	146.0	118.5	130.9	139.9	132.0	116.4
Total FX reserves, USD bn	1295.8	1268.1	1266.8	1260.5	1233.2	1236.7	1244.1	1251.3
Foreign exchange reserves excl gold, USD bn	1258.2	1227.2	1237.3	1231.0	1207.1	1210.6	1218.0	1225.1
Total FX reserves, % GDP	21.9	21.4	25.9	27.6	29.9	26.4	24.7	23.3
Total external debt, % GDP	51.3	54.9	62.0	67.6	71.1	72.4	73.6	74.9
Net International Investment Position, % GDP	56.4	63.0	68.0	74.6	68.0	68.9	69.6	69.9
Credit ratings								
Moody's	Aa3	Aa3	A1	A1	A1	A1	N/A	N/A
S&P	AA-	AA-	AA-	AA-	A+	A+	N/A	N/A
Fitch	AA	A+	A+	A+	A	A	N/A	N/A

Source: CEIC, Haver and UBS forecasts.

Korea

- **Growth to trend lower; inflation to trend higher**
- **Rates on hold in 2017; cuts resume in 2018**

Economic growth appears confined to 2.5-3.0% unless global trade recovers meaningfully or perhaps Korea implements an aggressive fiscal stimulus. Both seem unlikely.

Korea's economy should slow. It's easy to see considering the outlook for exports and domestic demand. First, gross exports are equivalent to 46% of GDP and the outlook for exports is poor, because a) global debt overhang hinders global trade and b) China is Korea's most important trade partner and appears to be suffering diminishing marginal benefits of increasing leverage to sustain its economy. Our base case is for export volumes of 2-3%y/y versus a long-term average of roughly 12%. Capacity utilization has fallen every year since 2011 from a high of 82% down to 70% in 2016, which implies a need for industrial consolidation. This has begun already in the shipbuilding sector, but other industrial sectors may need to follow.

Construction and housing were the backbone of domestic demand in 2016, but we expect this support to fade noticeably in 2H17 and 2018 as excess housing supply rises.

But then what has kept Korea out of recession? The answer has been housing and construction since late-2014. Will that continue? Perhaps, but we think less so in 2017, and by 2018 we expect construction and housing to be a drag on the economy. Remember that in mid-2014 the government relaxed regulations and cut rates to encourage the housing market and construction. Household debt surged, permits for housing construction climbed, unsold houses fell and house prices climbed. In 2016 we estimate construction contributed 50% of GDP growth as high housing orders from 2014-2015 translated into construction activity. However, based on orders and permits, our construction team expects new housing supply to average 750k units in 2017 and 2018, when implied incremental demand is expected to be only 470k. That should result in excess supply. Indeed, unsold housing units bottomed at 28k units in April 2015, but have recently climbed to 61k. That's not a disaster in the near term, but excess supply should progressively expand and weigh on the housing market, construction, and consumption on the horizon. Furthermore, increasing household debt to disposable income has been central to this story since mid-2014 and this has now risen to 165% of disposable income.

The longer-term direction for rates is still probably down, but a number of near-term factors are likely to keep the Bank of Korea on hold in 2017.

This is where our story becomes a bit anti-consensus. We think the Bank of Korea will remain on hold until early 2018. The BoK consistently cut rates in recent years as growth and inflation fell below target due to weak exports, demographics, and high private sector debt. However, UBS assumes that oil prices increase 30% next year and that should push consumer price inflation above 2% by 3Q17 before the upward delta stabilizes in 4Q17 and 2018. We doubt the BoK will cut rates into accelerating inflation during the first three quarters of 2017. Second, government statements increasingly signal growing uneasiness with household debt and speculative activity in some areas. Third, the economy should still benefit from the current momentum in construction in 1H17, before fading more noticeably toward the end of next year. The probability of a rate cut rises in late 2017, but remember that Korea holds its presidential election on 20 December 2017 and it will probably want to side-step that. But by early 2018, rate cuts are our base case once more. As for fiscal policy the government's five-year plan aims to restrain spending at 3.5% y/y (below nominal GDP) and gradually reduce the budget deficit. This may well need to change to keep GDP above 2.5% along with lower rates beyond 2017.

Korea	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	1,332,681	1,377,457	1,429,445	1,486,079	1,558,592	1,632,540	1,697,862	1,766,802
GDP, USD bn	1,204	1,223	1,306	1,411	1,378	1,414	1,436	1,450
GDP per capita, USD	24,185	24,461	26,002	27,993	27,226	27,824	28,136	28,300
Real GDP growth, %	3.7	2.3	2.9	3.3	2.6	2.8	2.6	2.5
Private consumption, % y/y	2.9	1.9	1.9	1.7	2.2	2.5	2.1	1.8
Government consumption, % y/y	2.2	3.4	3.3	3.0	3.4	3.9	3.6	4.2
Gross Fixed Capital formation, % y/y	0.8	-0.5	3.3	3.4	3.8	5.1	4.6	2.0
Exports, % y/y	15.1	5.1	4.3	2.0	0.8	1.8	2.2	2.2
Imports, % y/y	14.3	2.4	1.7	1.5	3.2	3.0	2.4	2.2
Unemployment rate, %	3.4	3.2	3.1	3.5	3.6	3.8	3.9	4.0
Industrial Production (%)	3.3	1.2	1.8	1.4	1.6	3.4	2.8	1.9
Prices, interest rates and money								
CPI inflation, % y/y (average)	4.0	2.2	1.3	1.3	0.7	0.9	1.8	1.7
CPI inflation, % y/y (year-end)	4.2	1.4	1.1	0.8	1.3	1.1	1.8	1.6
Broad money M2, % y/y (end-year)	5.5	4.8	4.6	8.1	8.2	7.0	8.0	8.0
Domestic private credit, % y/y	8.1	5.3	5.0	6.4	7.4	7.0	6.0	5.0
Domestic bank credit/GDP	182.3	185.7	187.9	192.4	197.0	199.0	201.0	202.0
Base rate, % (end-year)	3.25	2.75	2.50	2.00	1.50	1.25	1.25	0.75
10 year bond yield, % (year-end)	3.81	3.13	3.65	2.68	2.18	1.80	2.10	2.20
USD/KRW (year-end)	1,153	1,071	1,055	1,099	1,172	1,160	1,200	1,250
Fiscal accounts								
General government budget balance, % GDP	-1.0	-1.0	-1.3	-2.0	-2.4	-2.0	-2.0	-1.9
Revenue, % GDP	21.9	22.6	22.0	21.6	21.8	22.2	22.2	22.2
Expenditure, % GDP	20.5	21.3	21.0	21.0	21.8	21.6	21.6	21.4
of which interest expenditure, % GDP	1.1	1.0	0.9	0.9	0.9	0.9	0.8	0.8
Primary balance, % GDP	2.5	2.4	1.9	1.5	0.9	1.5	1.5	1.6
Public sector debt (gross),% GDP	30.2	30.9	32.5	33.9	35.7	39.5	40.2	40.9
of which domestic public debt, % GDP	29.5	30.3	31.9	33.4	35.2	34.8	35.7	36.4
of which external public debt,% GDP	4.4	5.0	4.8	4.8	4.7	4.7	4.5	4.5
% domestic public debt held by non-residents	14.1	14.8	14.4	13.1	12.3	11.0	10.0	9.0
Public debt held by the central bank, % GDP	2.5	2.6	2.3	2.2	2.0	1.8	1.7	1.6
Balance of payments								
Trade balance, USD bn	30.8	28.3	44.0	47.2	90.3	91.6	80.5	74.4
Exports, USD bn	555.2	547.9	559.6	572.7	526.8	492.4	511.6	529.7
Imports, USD bn	524.4	519.6	515.6	525.5	436.5	400.7	431.0	455.3
Current account balance, USD bn	18.7	50.8	81.1	84.4	105.9	99.0	87.0	80.0
as % of GDP	1.5	4.2	6.2	6.0	7.7	7.0	6.1	5.5
Foreign direct investment (net), USD bn	-19.9	-21.1	-15.6	-18.8	-22.6	-20.0	-19.0	-18.0
Total FX reserves, USD bn	306.4	327.0	346.5	363.6	368.0	378.0	375.0	375.0
Foreign exchange reserves excl gold, USD bn	304.2	323.2	341.7	358.8	363.2	369.0	366.0	366.0
Total FX reserves, % GDP	25.5	26.7	26.5	25.8	26.7	26.6	25.3	25.1
Total external debt, % GDP	33.2	33.4	32.4	30.1	28.7	28.0	28.0	28.0
Net International Investment Position, % GDP	-6.7	-7.7	-2.9	6.2	14.2	14.0	14.0	14.0
Credit ratings								
Moody's	A1	Aa3	Aa3	Aa3	Aa2	Aa2	N/A	N/A
S&P	A	A+	A+	A+	AA-	AA	N/A	N/A
Fitch	A+	AA-	AA-	AA-	AA-	AA-	N/A	N/A

Source: CEIC, Haver and UBS forecasts. Notes: Domestic bank credit to GDP is private non-financial sector debt. Gov't budget balance is on a consolidated basis excluding social security funds. Public sector debt is for general government only.

Malaysia

- **Growth to trough as easier policy helps growth accelerate in 2018**
- **The ringgit to depreciate in 2017 before stabilising in 2018**

Growth to trough in 2017 as fiscal policy helps lift growth in 2018

We believe there is still some pain to come for Malaysia. Globally, growth is not accelerating from 2017 into 2018 – as such, domestic dynamics are key for the trajectory of the Malaysian economy. Here the picture still looks weak. The credit cycle continues to wind down, credit growth has continued to slip in 2016, and private domestic demand remains sluggish. With monetary policy only just beginning to be eased, and tight fiscal policy likely to remain a drag on the economy, the outlook for the first half of 2017 is weak. A shift in policy could help to drive a pick-up in 2018. Currency volatility could prompt a RRR cut, or other liquidity measures. We see room for two further 25bps rate cuts from BNM in 2017, which should begin to stimulate lending in the second half. Meanwhile, if oil prices recover as UBS expects, there may be a little more wiggle room (between 0.5-1.0ppts of GDP) in the budget for 2018 – allowing government spending to pick up ahead of the next election, which must be called by August 2018. We forecast real GDP growth of 3.4% and 3.7% in 2017 and 2018, respectively.

Inflation to accelerate as oil prices rise.

Given our forecast for rising oil prices, we anticipate inflation will also rise – although the acceleration in Malaysia should be smaller than elsewhere due to base-effects from GST. We forecast average inflation to rise from 2.1% in 2016 to 2.7% in 2017 and 2.8% in 2018. BNM does not have an explicit inflation target – but its forecast range for 2016 was 2.0-3.0%. Inflation of close to 3.0% is likely at the high end of what BNM is comfortable with, and this could prompt policy action. However, because we expect below-potential growth in 2017 and 2018, we don't look for BNM to begin hiking until after 2018.

Current account to maintain a narrow surplus

Malaysia's current account surplus evaporated as oil prices fell, and the energy balance (gas + oil + coal) halved – a return to higher oil prices should yield a (lagged) return to a slightly larger current account cushion. The energy balance is set to rise from USD 2bn (now) to USD 4bn by the end of 2018. This helps to lift the current account balance to 1.3% of GDP in 2017 and 1.5% of GDP in 2018, after just 0.9% of GDP in 2016.

Some further weakness before the ringgit stabilises in 2018

The ringgit weakened significantly in 2015, and has proven volatile in 2016. We expect further depreciation in 2017 as rate cycles diverge at BNM and the Fed, but rising oil prices should help to stem rapid depreciation. The currency should exhibit more stability in 2018 as oil prices continue to climb, and real GDP growth accelerates. We forecast USDMYR at 4.60 at year-end 2017 and 2018.

A Patronomics boost?

The upside risks to our outlook stem largely from foreign sources – as Malaysia's economy could gain from increased competition for soft power in the region. "Patronomics" looks to be driving greater infrastructure investment into 2018, with bidding for the HSR link from Singapore to Kuala Lumpur (KL) likely to be hotly contested by China and Japan (among others), while a new KL-Kelantan line was recently awarded to China. These dynamics could help to spur investment in Malaysia. Elsewhere, the chance that the TPP could be passed in the lame duck session of the U.S. Congress, or at all under President Trump, seems very low. TPP would likely have been a boon for Malaysia's investment climate, as it reduces both tariffs and non-tariff barriers to trade, improving the appeal of manufacturing in Malaysia – but it was always a (positive) risk case and is not factored into our economic projections.

Malaysia	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	912	971	1,019	1,106	1,157	1,219	1,305	1,403
GDP, USD bn	298	314	323	338	296	296	296	305
GDP per capita, USD	10,253	10,653	10,704	11,008	9,502	9,361	9,229	9,398
Real GDP growth, %	5.3	5.5	4.7	6.0	5.0	3.8	3.4	3.7
Private consumption, % y/y	6.9	8.3	7.2	7.0	6.0	6.3	4.5	4.7
Government consumption, % y/y	14.2	5.4	5.8	4.3	4.4	3.8	0.6	6.0
Gross Fixed Capital formation, % y/y	6.4	19.0	8.1	4.8	3.7	2.5	3.2	3.3
Exports, % y/y	4.2	-1.7	0.3	5.0	0.6	-1.7	1.7	2.2
Imports, % y/y	6.3	2.9	1.7	4.0	1.2	-0.3	1.5	3.8
Unemployment rate, %	3.1	3.0	3.2	2.9	3.2	3.5	3.8	4.0
Industrial Production (%)	5.4	4.4	3.4	6.2	4.9	2.6	2.6	3.6
Prices, interest rates and money								
CPI inflation, % y/y (average)	3.2	1.7	2.1	3.1	2.1	2.1	2.7	2.8
CPI inflation, % y/y (year-end)	3.0	1.2	3.2	2.7	2.7	1.7	2.5	2.9
Broad money M3, % y/y (end-year)	14.3	9.0	7.3	7.0	2.6	2.4	4.8	5.0
Domestic private credit, % y/y	12.4	12.1	10.2	9.3	8.6	5.8	5.0	5.0
Domestic bank credit/GDP	110.1	114.1	120.3	121.1	124.9	125.4	123.0	120.2
Overnight policy rate, % (end-year)	3.00	3.00	3.00	3.25	3.25	3.00	2.50	2.50
10 year bond yield, % (year-end)	3.69	3.47	4.11	4.11	4.18	3.60	3.60	3.80
MYR/USD (year-end)	3.18	3.06	3.28	3.50	4.29	4.30	4.60	4.60
Fiscal accounts								
General government budget balance, % GDP	-4.7	-4.3	-3.8	-3.4	-3.2	-3.5	-3.0	-3.0
Revenue, % GDP	20.3	21.4	21.0	19.9	18.9	17.4	16.9	17.0
Expenditure, % GDP	25.0	25.7	24.8	23.3	22.2	20.9	19.9	20.0
of which interest expenditure, % GDP	1.9	2.0	2.0	2.0	2.1	2.1	1.8	1.7
Primary balance, % GDP	-2.7	-2.3	-1.7	-1.3	-1.1	-1.4	-1.2	-1.3
Public sector debt (gross),% GDP	61.5	65.3	64.7	62.0	60.5	60.0	59.5	58.8
of which domestic public debt, % GDP	48.0	49.9	51.4	51.2	52.7	45.3	45.7	45.9
of which external public debt,% GDP	13.4	15.4	15.6	15.2	17.1	14.8	13.8	12.8
% domestic public debt held by non-residents	48.7	48.2	45.8	36.5	36.8	37.0	37.0	37.0
Public debt held by the central bank, % GDP	69.3	71.1	72.6	72.4	73.9	66.5	66.9	67.2
Balance of payments								
Trade balance, USD bn	40.4	30.9	22.5	25.3	23.1	15.9	17.9	20.0
Exports, USD bn	228.2	227.6	228.4	233.8	198.6	184.1	200.1	212.2
Imports, USD bn	187.7	196.7	205.9	208.5	175.6	168.2	182.1	192.2
Current account balance, USD bn	32.5	16.3	11.2	14.8	9.0	2.7	3.9	4.8
as % of GDP	10.9	5.2	3.5	4.4	3.0	0.9	1.3	1.6
Foreign direct investment (net), USD bn	-3.1	-7.9	4.5	-9.3	0.9	1.0	1.0	1.0
Total FX reserves, USD bn	133.6	139.7	134.9	115.9	95.3	95.3	95.3	95.3
Foreign exchange reserves excl gold, USD bn	131.8	137.8	133.5	114.6	94.0	94.0	94.0	94.0
Total FX reserves, % GDP	44.9	44.4	41.7	34.3	32.2	32.2	32.2	31.2
Total external debt, % GDP	58.9	62.0	68.4	67.6	72.1	73.0	74.0	75.0
Net International Investment Position, % GDP	4.0	-1.8	-4.6	-1.6	9.5	10.4	11.8	13.3
Credit ratings								
Moody's	A3	A3	A3	A3	A3	A3	N/A	N/A
S&P	A-	A-	A-	A-	A-	A-	N/A	N/A
Fitch	A-	A-	A-	A-	A-	A-	N/A	N/A

Source: CEIC, Haver and UBS forecasts.

Philippines

- **Growth to dip in 2017 before infrastructure lifts growth in 2018**
- **Peso to exhibit weakness, as the current account balance narrows**

Growth to dip in 2017 as domestic demand slows.

Growth in the Philippines is set to slow, having accelerated sharply in 2016. So far 2016 has seen extremely strong domestic demand and, in particular, booming investment growth delivered better-than-expected real GDP growth. The drivers of this boom were likely election-related spending (including a large fiscal impulse) and loose monetary conditions that fuelled credit growth. We expect both of these to reverse in 2017 as deficit projections show a smaller fiscal impulse, and global monetary conditions tighten. We forecast real GDP growth of 5.6% and 6.0% yoy in 2017 and 2018, respectively.

Fiscal policy to provide a boost, but probably not until 2018.

Ahead of the election in May 2016 the fiscal deficit widened sharply – from just 0.9% of GDP in 2015 to 2.7% of GDP (seasonally adjusted) in Q2 2016. This provided a sizeable fiscal impulse (defined as the year-on-year change in the fiscal deficit) to spur growth. The government forecasts fiscal deficits of 3.0% of GDP in both 2017 and 2018 – as such there is little fiscal impulse coming through in 2017 (and none in 2018). But, the new administration has set its focus on big infrastructure projects (including those part-financed by the private sector, or even by foreign governments). This could allow fiscal policy to be more supportive of growth than the deficit implies. We doubt that this boost will come as early as 2017 – infrastructure projects tend to be plagued by delays – but better traction on public projects could lift growth in 2018. There remains a risk that spending will front-run revenue raising – resulting in a higher deficit (and fiscal impulse) than forecast over the next two years.

A depleted current account balance – and a deficit in 2018.

The current account in the Philippines has deteriorated sharply over the past four quarters, as growth has accelerated. On the year, the current account balance was 4.3ppts of GDP lower in Q2 2016, falling into a small deficit in seasonally-adjusted terms. We anticipate a recovery in the current account balance from this low – looking for a small surplus of 0.3% of GDP in 2017 as weaker domestic demand curbs import growth, but we expect acceleration in growth in 2018 and rising oil prices to induce a deficit of 1.3% of GDP in 2018. Political relations with the next U.S. President as well as U.S. fiscal and trade policy more generally are potential swing factors for Philippine goods and services exports.

Inflation accelerates – prompting policy rate hikes.

Inflation has remained fairly benign in the Philippines, a consequence of the disinflationary pressures of falling oil prices. This is likely to change in 2017 as UBS expects oil prices to rebound to average \$60 a barrel in 2017 and \$70 a barrel in 2018. This should push up headline inflation in the Philippines, to above 3.0% in 2018. While this is within the BSP's target band of 3.0% ± 1.0%, in the context of rising global rates (and a worse external balance) this should encourage rate hikes from BSP. We look for BSP to raise rates by 50 bps in 2017 and by 50 bps in 2018, following the Fed.

Peso to experience some "catch-up" weakness in 2017 and 2018.

These dynamics are likely to induce currency weakness. We expect growth to slow in the Philippines – while the external balance has deteriorated, removing a buffer to global capital flows as the Fed is due to raise rates. Rising inflation and higher oil prices should also hurt the Philippines, as it is a net oil importer. We look for USDPHP at 51.0 in 2017 and 55.0 in 2018.

Philippines	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	9,708	10,561	11,538	12,645	13,307	14,394	15,578	16,958
GDP, USD bn	224	250	272	285	293	305	317	318
GDP per capita, USD	2,372	2,603	2,788	2,873	2,905	2,980	3,055	3,023
Real GDP growth, %	3.7	6.7	7.1	6.2	5.9	6.6	5.6	6.0
Private consumption, % y/y	5.6	6.6	5.6	5.5	6.3	7.1	5.6	5.7
Government consumption, % y/y	2.1	15.5	5.0	3.3	7.8	10.0	7.0	4.1
Gross Fixed Capital formation, % y/y	-1.9	10.8	11.8	6.2	15.2	22.6	8.1	8.8
Exports, % y/y	-2.5	8.6	-1.0	11.7	9.0	4.1	4.7	7.4
Imports, % y/y	-0.6	5.6	4.4	9.3	14.0	12.6	5.0	8.0
Unemployment rate, %	7.0	7.0	7.1	6.8	6.3	6.8	6.8	6.8
Industrial Production (%)	4.7	5.4	10.1	8.3	5.7	6.8	5.6	6.0
Prices, interest rates and money								
CPI inflation, % y/y (average)	4.7	3.2	2.9	4.2	1.4	1.7	2.9	3.2
CPI inflation, % y/y (year-end)	4.2	3.0	4.1	2.7	1.5	2.0	2.8	3.6
Broad Money M2, % y/y (end-year)	7.1	9.6	32.2	11.6	9.7	12.6	11.0	11.0
Domestic private credit, % y/y	16.2	14.1	17.3	19.6	12.4	13.8	10.0	8.0
Domestic bank credit/GDP	37.7	39.0	41.3	46.1	49.1	51.6	52.5	52.1
Reverse Repurchase Rate, % (end-year)	4.50	3.50	3.50	4.00	4.00	3.00	3.50	4.00
10 year bond yield, % (year-end)	5.4	4.5	3.4	3.9	4.0	4.0	4.5	5.0
USD/PHP (year-end)	43.9	41.2	44.4	44.6	47.2	48.0	51.0	55.0
Fiscal accounts								
General government budget balance, % GDP	-2.0	-2.3	-1.4	-0.6	-0.9	-2.6	-3.0	-2.9
Revenue, % GDP	14.0	14.5	14.9	15.1	15.8	15.7	16.5	17.0
Expenditure, % GDP	16.0	16.8	16.3	15.7	16.8	18.3	19.5	19.9
of which interest expenditure, % GDP	2.9	3.0	2.8	2.5	2.3	2.1	2.1	2.0
Primary balance, % GDP	0.8	0.7	1.4	2.0	1.4	-0.5	-0.9	-0.9
Public sector debt (gross),% GDP	51.0	51.5	49.2	45.4	44.7	44.4	44.5	44.7
of which domestic public debt, % GDP	29.6	32.8	32.4	30.2	29.2	32.3	33.2	33.7
of which external public debt,% GDP	20.7	18.1	14.5	13.8	13.1	12.1	11.4	11.0
% domestic public debt held by non-residents	N/A	N/A	N/A	30.6	30.3	30.0	30.0	30.0
Public debt held by the central bank, % GDP	2.5	2.1	1.9	1.8	1.7	1.6	1.5	1.5
Balance of payments								
Trade balance, USD bn	-12.2	-10.0	-5.7	-3.3	-12.2	-22.8	-26.3	-33.0
Exports, USD bn	48.3	52.1	56.7	62.1	58.8	56.3	59.1	63.3
Imports, USD bn	60.5	62.1	62.4	65.4	71.1	79.1	85.4	96.2
Current account balance, USD bn	5.6	7.0	11.4	10.8	7.7	2.6	0.9	-4.2
as % of GDP	2.5	2.8	4.2	3.8	2.6	0.8	0.3	-1.3
Foreign direct investment (net), USD bn	0.3	1.0	-0.1	1.0	-0.1	2.0	2.0	2.0
Total FX reserves, USD bn	75.3	83.8	83.2	79.5	80.7	85.7	87.7	89.7
Foreign exchange reserves excl gold, USD bn	67.3	73.5	75.7	72.1	74.0	79.0	81.0	83.0
Total FX reserves, % GDP	33.6	33.5	30.6	27.9	27.6	28.1	27.6	28.2
Total external debt, % GDP	33.7	32.0	28.9	27.3	26.5	23.6	22.1	22.0
Net International Investment Position, % GDP	-10.3	-16.3	-13.2	-14.4	-9.9	-9.1	-8.8	-10.1
Credit ratings								
Moody's	Ba2	Ba1	Baa3	Baa2	Baa2	Baa2	N/A	N/A
S&P	BB	BB+	BBB-	BBB	BBB	BBB	N/A	N/A
Fitch	BB+	BB+	BBB-	BBB-	BBB-	BBB-	N/A	N/A

Source: CEIC, Haver and UBS forecasts.

Singapore

- **Growth to remain weak, no major policy stimulus by govt. or MAS**
- **Balance sheet clean-up in 2017 could help growth improve in 2018**

We expect no major stimulus effort; growth momentum likely to remain weak

Singapore's growth momentum is likely to remain weak. We believe hopes for a major stimulus effort on the part of the authorities will be disappointed. We project real GDP growth of 1.4% in 2017 and 2.0% in 2018 after 1.1% this year. Global trade volumes are expected to remain depressed and Singapore is arguably more exposed than most to any protectionist policies on the part of a Trump Presidency. Moreover, the credit cycle both in the region and Singapore appears to be entering balance sheet repair phase. None of these dynamics are good for Singapore as a regional trade and finance hub. However, the recognition of malinvestments at home and abroad should enable Singaporean households and firms to continue the process of balance sheet repair. That promises cleaner balance sheets and a better growth outcome in 2018. Also, fiscal stimulus under the new U.S. President might lift Singapore's open economy more than most.

Higher rates to catalyse balance sheet repair, but no recession

So far the most obvious areas of capital misallocation are in the offshore oil and gas supply sectors (evidenced by NPLs) and the property market (evidenced by falling prices and rentals). However, the decline in the profit share of GDP and slackening of the labour market suggests the scale of economic adjustment needed probably goes beyond those sectors. We expect this adjustment to become more obvious in 2017, not least because higher SGD interest rates (imported from USD markets) should incentivise a more efficient use of capital. That adjustment process should keep growth weak and push unemployment higher but, absent a significant external shock, not tip the economy into recession for full year 2017.

MAS policy on hold

As such, while we do expect growth to be below trend, we doubt it will be sufficiently below trend to prompt MAS policy easing. The MAS' exchange rate policy is at an unusual juncture because the slope of the SGD Nominal Effective Exchange Rate (S$NEER) policy band was set to flat in April 2016. Because of the implications for Singapore's financial system, we believe that the MAS is highly unlikely to set the policy bank to a negative slope or adjust the mid-point of the band lower in small increments. At the same time economic conditions do not seem to warrant a significant (2ppts) change in the mid-point of the policy band.

Our simple model of MAS behaviour attributes changes in exchange-rate policy to variations in official projections of the output gap (a measure of excess capacity) and inflation. If inflation recovers as we, consensus and the MAS expects on higher oil prices and a less negative drag on services prices from budgetary policy measures, then the output gap would have to widen almost 2ppts of GDP to induce a significant adjustment to the mid-point of the policy band. Such a move in official estimates of the output gap would likely require negative growth in 2017 as a whole. This is possible, but not our base case.

Government to support economy, but, absent a recession, no major stimulus effort

Likewise the government is likely to continue supporting the economy through policy and stimulus at the margin. However, as with the MAS, government commentary implies a large stimulus package aimed at boosting growth 1-2ppts seems unlikely unless the economy falls into a meaningful recession.

SGD to fall against USD

Nonetheless, if US rates rise and unemployment rates trend higher, as we expect, financial market participants will probably flirt with the idea that MAS may loosen policy via a meaningful step down in the mid-point of the S$NEER policy band. On these grounds we project USDSGD to rise to 1.45 by end 2017.

Singapore	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	346	361	376	388	402	402	407	415
GDP, USD bn	275	289	300	306	293	293	289	290
GDP per capita, USD	53,127	54,479	55,636	56,016	52,894	52,021	50,547	50,108
Real GDP growth, %	6.2	3.7	4.7	3.3	2.0	1.1	1.4	2.0
Private consumption, % y/y	4.3	3.5	3.1	2.2	4.5	3.0	1.6	1.8
Government consumption, % y/y	-3.1	-1.9	11.1	-0.1	6.6	7.5	4.0	4.0
Gross Fixed Capital formation, % y/y	5.2	8.3	5.7	-2.6	-1.0	0.2	1.0	1.7
Exports, % y/y	5.6	1.8	4.8	4.3	2.5	1.6	2.4	2.8
Imports, % y/y	4.0	3.0	4.5	3.9	2.1	1.8	1.9	3.1
Unemployment rate, %	2.0	2.0	1.9	2.0	1.9	2.2	3.6	3.4
Industrial Production, % y/y	7.9	0.3	1.5	2.8	-5.2	-0.2	-1.2	2.0
Prices, interest rates and money								
CPI inflation, % y/y (average)	5.2	4.6	2.4	1.0	-0.5	-0.6	0.7	1.1
CPI inflation, % y/y (year-end)	5.5	4.3	1.5	-0.1	-0.6	-0.1	0.7	1.3
Broad money M2, % y/y (end-year)	10.0	7.2	4.3	3.3	1.5	6.0	5.0	5.0
Domestic private credit, % y/y	30.3	16.7	17.0	5.7	-1.2	1.0	2.0	2.0
Domestic bank credit/GDP	121.5	135.7	152.8	156.4	149.0	150.8	151.7	151.8
3M SIBOR SGD, % (end-year)	0.4	0.4	0.4	0.5	1.2	1.0	1.8	2.3
10 year bond yield, % (year-end)	1.6	1.3	2.6	2.3	2.6	2.0	2.6	2.8
SGD/USD (year-end)	1.30	1.22	1.27	1.32	1.41	1.41	1.45	1.45
Fiscal accounts								
General government budget balance, % GDP	1.3	1.9	1.4	1.1	-0.7	-1.1	-1.0	-1.0
Revenue, % GDP	14.6	15.3	15.1	15.5	16.1	16.9	17.0	17.0
Expenditure, % GDP	13.3	13.5	13.7	14.4	16.8	18.0	18.0	18.0
of which interest expenditure, % GDP	-1.1	-0.8	-1.3	-0.7	-1.9	-3.7	-3.7	-3.7
Primary balance, % GDP	N/A	0.8	0.0	-0.6	-3.1	-2.9	-2.8	-2.8
Public sector debt (gross),% GDP	102.3	106.5	103.9	99.8	104.7	112.4	118.2	115.9
of which domestic public debt, % GDP	102.3	106.5	103.9	99.8	104.7	112.4	118.2	115.9
of which external public debt,% GDP	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
% domestic public debt held by non-residents	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Public debt held by the central bank, % GDP	0.6	0.7	0.8	0.7	0.8	0.8	0.7	0.7
Balance of payments								
Trade balance, USD bn	44.3	27.6	33.9	39.0	49.8	39.7	48.1	56.3
Exports, USD bn	409.0	407.5	407.1	405.1	346.5	329.9	354.0	378.0
Imports, USD bn	364.7	379.9	373.1	366.1	296.6	290.2	305.8	321.7
Current account balance, USD bn	62.8	52.4	53.8	53.5	57.9	77.0	87.0	92.0
as % of GDP	22.8	18.1	17.9	17.5	19.8	26.3	30.1	31.7
Foreign direct investment (net), USD bn	-16.9	-38.8	-26.5	-29.4	-29.8	-30.0	-30.0	-30.0
Total FX reserves, USD bn	238.2	259.3	273.1	257.1	247.8	247.8	247.8	247.8
Foreign exchange reserves excl gold, USD bn	238.0	259.1	272.9	256.8	247.6	247.6	247.6	247.6
Total FX reserves, % GDP	86.5	89.6	90.9	83.9	84.6	84.6	85.8	85.3
Total external debt, % GDP	432.1	421.0	448.1	456.4	441.8	442.8	436.7	428.3
Net International Investment Position, % GDP	200.3	198.4	203.7	196.6	209.7	212.5	225.8	235.5
Credit ratings								
Moody's	Aaa	Aaa	Aaa	Aaa	Aaa	Aaa	N/A	N/A
S&P	AAA	AAA	AAA	AAA	AAA	AAA	N/A	N/A
Fitch	AAA	AAA	AAA	AAA	AAA	AAA	N/A	N/A

Source: CEIC, Haver and UBS forecasts.
Note: Government fiscal budget is Fiscal Year April-March. Debt is calendar year-end. General government balance represents operational revenue and expenditure only. Primary budget balance is based on IMF calculation and derived from overall government balance excluding investment revenue and interest expense. MAS uses the exchange rate, not interest rates, as its policy tool.

Taiwan

- **We expect real GDP to slip back to around 1%y/y in 2017.**
- **Headline inflation should edge up next year on higher oil prices.**

We expect growth to slip in 2017 as the positive tech product and inventory cycles peak towards late 2016

A better tech product cycle and a more favourable manufacturing inventory cycle are driving the moderate cyclical improvement currently under way in Taiwan. USD exports marginally expanded 0.2%y/y and industrial production grew 4.1% y/y in 3Q16. Real GDP growth is on track to expand 1.5-2.0% this year (UBS: 1.6% y/y; consensus: 1.0%), up from 0.6% in 2015. However, as the boosts from the positive tech product and inventory cycles increasingly fade by late 2016/early 2017, Taiwan might lose steam again.

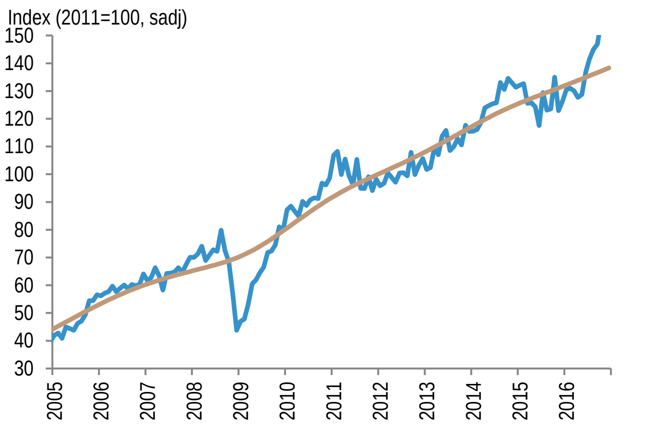
Tech is driving the export improvement since 2Q16; but tech shipments are already growing above trend

The launch of Apple iPhone 7 is driving the rebound in exports since 2Q16. Tech exports (mostly semiconductors) have increased on average 7% y/y in USD terms and 11% y/y in real terms since 2Q. However, real tech shipments have already been expanding above trend and this is unlikely to be sustained (see figure below). Manufacturing inventories are falling and this bodes well for current production. Industrial production will likely accelerate further in 4Q16 to a high-single-digit year-on-year pace, a rate that nevertheless generally marks the cyclical peak in Taiwan's manufacturing cycle post the GFC. In other words, the room for further pick-up in production should be limited beyond 4Q16. A sustained export and manufacturing recovery hinges on end-demand improving. However, end-demand will likely remain soft, given excess capacity in China and the absence of a decent CAPEX recovery in DM. Contrary to consensus, which expects growth to accelerate next year, we expect real GDP in Taiwan to slip back to around 1% y/y in 2017.

Headline inflation to increase on higher energy prices

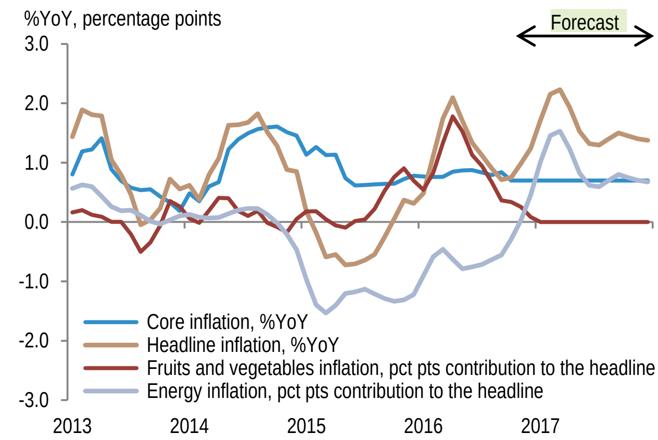
Headline CPI could increase in 2017 on higher oil prices. Falling energy inflation has partially offset the jump in vegetable prices in 2016 when extreme cold weather in early 2016 caused vegetable prices to spike. The opposite should happen next year (see figure below). While vegetable prices might normalize, this should be more than offset by rising energy inflation, so we expect headline inflation to increase to 1.5% y/y in 2017. Despite higher inflation, we think the CBC will be biased to cut rates if growth weakens in line with our expectations in 2H17.

Figure 274: Tech exports already growing above trend



Source: CEIC and UBS calculations. Real tech exports: exports of electronic components deflated by export price of electrical machinery. Trend is calculated using HP filter. Tech accounts for 1/3 of total exports in Taiwan.

Figure 275: Inflation to rise on higher oil prices in 2017



Source: CEIC and UBS calculations. Based on UBS Brent oil price forecasts at USD45.3 barrel for 2016 and USD60 for 2017. Core is defined as CPI excluding energy and vegetables. CPI weights: energy (6.75%); vegetables (4.2%)

Taiwan	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	14,312	14,687	15,231	16,097	16,688	16,940	17,194	17,675
GDP, USD bn	486	496	512	530	523	522	513	520
GDP per capita, USD	21,017	21,384	22,013	22,755	22,402	22,309	21,897	22,143
Real GDP growth, %	3.8	2.1	2.2	3.9	0.6	1.6	1.0	1.8
Private consumption, % y/y	3.1	1.8	2.3	3.3	2.3	1.8	1.5	1.6
Government consumption, % y/y	2.0	2.2	-0.8	3.6	-0.3	2.4	1.0	1.2
Gross Fixed Capital formation, % y/y	-1.1	-2.6	5.3	1.8	1.2	-0.6	-0.7	0.8
Exports, % y/y	4.2	0.4	3.5	5.9	-0.2	1.1	0.4	1.1
Imports, % y/y	-0.5	-1.8	3.4	5.7	0.9	0.8	0.3	0.6
Unemployment rate, %	4.2	4.2	4.1	3.8	3.9	4.0	3.8	4.0
Industrial Production (%)	4.4	-0.2	0.7	6.4	-1.7	1.1	0.6	1.3
Prices, interest rates and money								
CPI inflation, % y/y (average)	1.4	1.9	0.8	1.2	-0.3	1.2	1.5	1.1
CPI inflation, % y/y (year-end)	2.0	1.6	0.3	0.6	0.1	1.0	1.3	1.3
Broad money M2, % y/y (end-year)	4.8	3.5	5.8	6.1	5.8	4.6	4.3	5.0
Domestic private credit, % y/y	6.3	4.0	5.7	6.2	5.0	5.2	4.8	5.4
Domestic bank credit/GDP	146.5	147.4	147.1	145.8	145.5	148.5	151.0	152.4
CBC Rediscount rate, % (end-year)	1.88	1.88	1.88	1.88	1.63	1.38	1.13	1.13
10 year bond yield, % (year-end)	1.29	1.15	1.68	1.61	1.03	1.20	1.50	1.75
USD/TWD (year-end)	30.3	29.1	30.0	31.7	33.1	32.3	33.5	34.0
Fiscal accounts								
General government budget balance, % GDP	-2.1	-2.4	-1.4	-0.9	0.1	-0.2	-0.3	-0.4
Revenue, % GDP	16.1	15.8	16.1	15.6	16.0	16.0	16.1	16.0
Expenditure, % GDP	18.3	18.2	17.5	16.4	15.9	16.2	16.4	16.4
of which interest expenditure, % GDP	0.5	0.5	0.6	0.6	0.5	0.3	0.4	0.5
Primary balance, % GDP	-1.6	-2.0	-0.8	-0.2	0.6	0.1	0.2	0.1
Public sector debt (gross),% GDP	45.6	46.6	45.5	44.2	43.0	42.8	42.6	41.9
of which domestic public debt, % GDP	45.6	46.6	45.5	44.2	43.0	42.8	42.6	41.9
of which external public debt,% GDP	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
% domestic public debt held by non-residents	2.0	1.4	0.9	0.8	0.5	0.5	0.4	0.3
Public debt held by the central bank, % GDP	46.7	45.2	44.9	44.1	45.2	45.5	44.8	43.6
Balance of payments								
Trade balance, USD bn	24.9	29.1	33.4	38.2	48.1	50.1	44.2	40.6
Exports, USD bn	312.9	306.4	311.4	320.1	285.3	276.0	292.6	302.3
Imports, USD bn	288.1	277.3	278.0	281.8	237.2	225.9	248.4	261.7
Current account balance, USD bn	37.9	44.1	51.8	61.9	75.8	75.1	65.6	62.2
as % of GDP	7.8	8.9	10.1	11.7	14.5	14.4	12.8	12.0
Foreign direct investment (net), USD bn	-14.7	-9.9	-10.7	-9.9	-12.3	-10.4	-11.5	-10.0
Total FX reserves, USD bn	385.5	403.2	416.8	419.0	426.0	438.0	440.0	443.0
Foreign exchange reserves excl gold, USD bn	380.5	397.9	411.7	414.1	421.4	433.4	435.4	438.4
Total FX reserves, % GDP	79.4	81.3	81.5	79.0	81.5	83.9	85.7	85.2
Total external debt, % GDP	25.2	26.3	33.2	33.5	30.2	30.6	30.1	30.2
Net International Investment Position, % GDP	147.4	160.9	169.6	176.3	200.5	209.7	218.6	224.3
Credit ratings								
Moody's	Aa3	Aa3	Aa3	Aa3	Aa3	Aa3	N/A	N/A
S&P	AA-	AA-	AA-	AA-	AA-	AA-	N/A	N/A
Fitch	A+	A+	A+	A+	A+	AA-	N/A	N/A

Source: CEIC, Haver and UBS forecasts.

Note: Public sector debt refers to total debt (loans plus bonds) incurred by the general government because of fiscal deficits. Public debt held by the central bank refers to outstanding CDs issued for monetary policy/sterilization purpose

Thailand

- **Growth to slow in 2017 as positive impulses fade**
- **Improved balance sheets to help growth recover in 2018**

Below-consensus growth forecast for 2017

Our below-consensus growth forecast of 2.5% for 2017 envisages that recent positives impulses wane while the drag from the credit cycle on growth persists. The rise in the NPL ratio in recent quarters following a credit boom in 2010-2014 suggests a misallocation of capital and a need for balance sheet adjustment. Ultimately that process should be good for growth. In 2018, as balance sheets are progressively cleaned up, we project real GDP growth to re-accelerate to circa 3%.

Official projections suggest a fading fiscal impulse, but this could change ahead of elections

Politics and fiscal policy is a key source of uncertainty in our projections. It is possible that long-awaited infrastructure spending by the military-backed government ahead of an end 2017 election could support growth. It is also possible that uncertainty in the bureaucracy around political leadership post a long-anticipated election slows down public investment activity. Projections by the Public Debt Management Office suggest that after providing a meaningful impulse in late 2015 and early 2016, the incremental impulse to growth from deficit spending should wane in 2017 and 2018. We take this as our base-case scenario.

Policy rates close to bottoming out

The boost to growth from BoT policy should also be limited. We do believe policy rates may be edged lower in late 2016 or early 2017 on the grounds of low inflation and disappointing growth. However, the BoT does not appear keen to ease policy due to concerns over financial stability. As with several other economies in the region, interest rates in Thailand are probably close to their lows. We project policy rate increases in 2018.

Private investment to remain subdued

Low interest rates and public infrastructure spending – if it proceeds as planned – should be positives for private investment. So could a close-to-double-digit recovery in export growth (not our base case). However, in addition to signals from NPL data that some balance sheet repair is necessary, private businesses may also choose to postpone investment until the change in political leadership is clearer. The military government has proposed elections in late 2017. Following the passing of His Majesty the King, the election roadmap was confirmed, but delays or changes in plans are still possible. We expect private investment growth to remain subdued.

Agriculture to improve, but impact limited by contribution to GDP

More positively the agricultural sector (9% of GDP, 35-40% of employment) should contribute to growth in 2017 after contracting 4% in 2015 due to poor weather conditions. That in turn should help consumption – but only at the margin given the modest contribution of agriculture to GDP. Consumption activity may also be supported by the end of debt repayments associated with the first-time car buyer scheme in 2012 – although the availability of new credit and the willingness to borrow may be curtailed by still-high household debt levels more generally.

Current account surplus to support THB

Conversely, tourism growth could become a less positive contributor to consumption following a tightening up of rules for Chinese tour groups. Nevertheless, tourism, subdued private investment and the moderate expansion in credit all promise to keep Thailand's current account surplus elevated. Risks to competitiveness from being outside TPP are also reduced post the U.S. election – although U.S. policy could still impact Thai trade. We project the surplus to remain in the 5-10% of GDP range in 2017 and 2018 – even with the rise in oil prices. The baht should continue to be somewhat less volatile than peer currencies as a result – although that may add to pressure on the BoT to ease policy one last time.

Thailand	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	11,300	12,349	12,901	13,132	13,534	14,093	14,646	15,336
GDP, USD bn	371	398	420	405	395	401	411	416
GDP per capita, USD	5,789	6,169	6,487	6,212	6,013	6,081	6,223	6,285
Real GDP growth, %	0.8	7.2	2.7	0.8	2.8	3.1	2.5	3.1
Private consumption, % y/y	1.8	6.7	1.0	0.6	2.1	3.0	2.1	2.7
Government consumption, % y/y	3.4	6.8	2.5	2.1	2.2	3.4	3.6	2.8
Gross Fixed Capital formation, % y/y	4.9	10.7	-1.0	-2.4	4.7	3.7	3.4	3.6
Exports, % y/y	9.2	4.9	2.6	0.2	0.2	2.3	1.4	3.3
Imports, % y/y	12.3	5.6	1.5	-5.3	-0.3	-0.9	3.1	3.6
Unemployment rate, %	0.7	0.7	0.7	0.8	0.9	1.1	1.6	1.8
Industrial Production (%)	-7.5	10.6	2.4	-5.2	0.3	1.0	2.4	2.9
Prices, interest rates and money								
CPI inflation, % y/y (average)	3.8	3.0	2.2	1.9	-0.9	0.2	1.4	1.7
CPI inflation, % y/y (year-end)	3.5	3.6	1.7	0.6	-0.9	0.7	1.5	1.8
Broad Money, % y/y (end-year)	15.1	10.4	7.3	4.7	4.4	4.0	4.0	4.0
Domestic private credit, % y/y	17.0	14.6	9.6	5.1	4.9	4.3	4.0	4.0
Domestic bank credit/GDP	86.6	91.3	95.7	98.0	97.7	97.8	98.2	97.7
One-Day Repurchase, % (end-year)	3.25	2.75	2.25	2.00	1.50	1.25	1.25	1.75
10 year bond yield, % (year-end)	3.3	3.5	3.9	2.6	2.5	2.3	2.5	2.8
USD/THB (year-end)	31.7	30.6	32.8	33.0	36.1	35.0	36.0	37.0
Fiscal accounts								
General government budget balance, % GDP	-2.5	-2.7	-1.9	-2.9	-2.9	-2.8	-3.0	-2.5
Revenue, % GDP	16.6	16.8	16.8	15.9	16.5	17.3	17.0	17.5
Expenditure, % GDP	19.2	19.5	18.7	18.8	19.4	20.1	20.0	20.0
of which interest expenditure, % GDP	1.2	1.2	1.1	1.1	1.0	1.0	1.0	1.1
Primary balance, % GDP	-1.3	-1.5	-0.8	-1.8	-1.9	-1.8	-2.0	-1.4
Public sector debt (gross),% GDP	27.3	28.5	29.7	30.1	32.6	33.1	34.8	36.0
of which domestic public debt, % GDP	26.9	28.1	29.1	29.5	32.0	32.5	34.2	35.4
of which external public debt,% GDP	0.4	0.4	0.5	0.6	0.6	0.6	0.6	0.6
% domestic public debt held by non-residents	11.5	16.4	17.4	18.3	14.2	13.6	13.6	13.6
Public debt held by the central bank, % GDP	2.5	2.4	1.9	1.7	2.0	2.0	2.0	2.0
Balance of payments								
Trade balance, USD bn	-6.2	-20.0	-21.9	-0.2	11.7	19.8	15.1	11.6
Exports, USD bn	222.6	229.1	228.5	227.5	214.4	213.8	221.8	230.1
Imports, USD bn	228.8	249.1	250.4	227.7	202.7	194.0	206.7	218.5
Current account balance, USD bn	9.4	-1.6	-4.8	15.1	32.1	42.3	33.2	29.7
as % of GDP	2.5	-0.4	-1.2	3.7	8.1	10.5	8.1	7.1
Foreign direct investment (net), USD bn	-4.7	-1.4	3.8	-0.8	4.0	-12.0	-4.0	0.0
Total FX reserves, USD bn	175.1	181.6	167.3	157.1	156.5	156.5	156.5	156.5
Foreign exchange reserves excl gold, USD bn	167.4	173.3	161.3	151.3	151.3	151.3	151.3	151.3
Total FX reserves, % GDP	47.2	45.7	39.8	38.8	39.6	39.0	38.1	37.6
Total external debt, % GDP	28.1	32.9	33.8	35.0	33.3	33.4	33.1	33.2
Net International Investment Position, % GDP	-11.1	-20.4	-16.6	-24.0	-10.9	-0.2	7.9	14.9
Credit ratings								
Moody's	Baa1	Baa1	Baa1	Baa1	Baa1	Baa1	N/A	N/A
S&P	BBB+	BBB+	BBB+	BBB+	BBB+	BBB+	N/A	N/A
Fitch	BBB	BBB	BBB+	BBB+	BBB+	BBB+	N/A	N/A

Source: CEIC, Haver and UBS forecasts.
Note: Fiscal budget are Fiscal Year October-September. Government debt numbers are calendar year end. General government balance shows central government cash balance only

Scott Haslem
Economist
scott.haslem@ubs.com
+61-2-9324-3663

George Tharenou
Economist
george.tharenou@ubs.com
+61-2-9324-3520

Jim Xu
Associate Economist
jim.xu@ubs.com
+61-2-9324-2665

Australia & New Zealand

Australasia Outlook 2017-2018

UBS Research THESIS MAP **Fading commodity headwinds for Australia and New Zealand**

PIVOTAL QUESTIONS

Q: Does an improved commodity outlook point to better growth and steady policy rates?

Yes. Better hard (Australia) and soft (New Zealand) commodity prices, if sustained, reverse the past few years' negative income shock for the Australasian economies, underpinning a modestly higher path ahead for inflation. Rising coal and iron ore prices – as the mining capex collapse ends – should combine to lift Australia's growth through 2017, with the RBA remaining on hold at 1.5%. The recent 40% gain in dairy prices should support still solid (but moderately slower) NZ growth, as prior strong construction and migration growth drivers fade ahead, leaving the RBNZ on hold at 1.75%.

Q: Do strong construction cycles in both economies present growth risks?

Yes. For Australia, a correction in currently booming multi-story residential work (driving growth in 2017) should drag growth slower through 2018, with risks of a sharper-than-expected downturn. This should be partly offset by improving business capex (on better domestic activity and a fading mining drag). For NZ, the Canterbury construction rebuild has peaked, but is being replaced by firmer activity in Auckland, while housing presents near-term upside risks (strong migration). Past years' rapid house-price gains across Australasia are a medium-term risk (via wealth effects) to the growth outlook.

UBS VIEW

Low rates and better commodity prices support growth, but some slowing into 2018: The end of the mining capex drag, higher commodity prices and net fiscal stimulus should see Australian growth accelerate to 3.0% in 2017, before slowing to 2.8% in 2018 on weaker residential activity and slower consumption (on weaker house-price gains). For NZ, 2016's likely 3.3% pace of growth should slow to a still-firm 2.6% in 2017, before fading construction sees growth slow further to 2.4% in 2018. A drift higher in inflation and firm growth should see the RBA and RBNZ on hold in 2017, beginning rate normalisation in 2018, limiting exchange rate weakness, despite US Fed hikes.

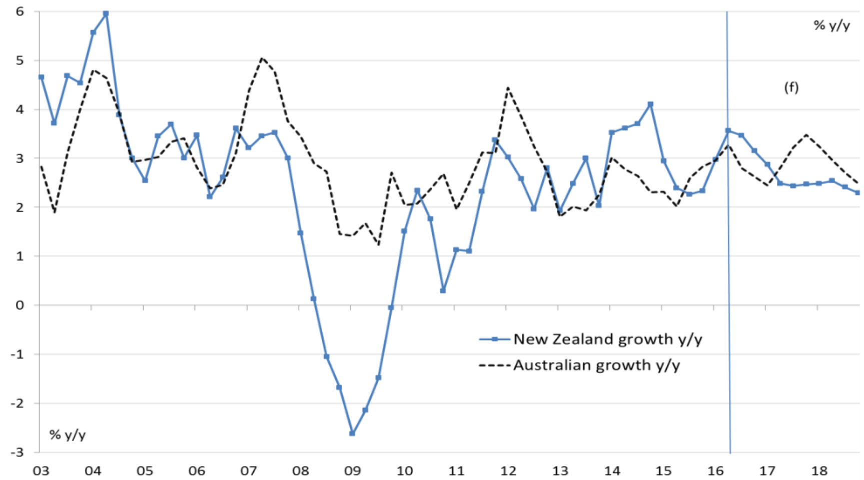
EVIDENCE

There's been a material easing in prior growth headwinds and disinflationary drivers: An improving global backdrop, supporting Australasian trading partner growth, and the part reversal of falling hard (coal and iron ore) and soft (dairy) commodity prices point to firm growth ahead for Australasia. While likely to remain low historically, the drift higher in oil prices also supports a return of inflation to CPI targets, underpinning the start of a likely gradual normalisation of rates in mid/late-18.

WHAT'S PRICED IN?

We are above consensus for growth in Australia but below for NZ. Our steady RBA is non-consensus, but 'on hold' RBNZ in-line: We're above consensus for Australian growth (3.0% vs. 2.8% for 2017), but below consensus for NZ (2.6% vs. 3.0%). Consensus has a further RBA cut in early 2017 (against our 'on hold'), while UBS and consensus sees the RBNZ on hold in 2017 at 1.75%.

Australasian growth outlook



Source: ABS, Statistics NZ, UBS forecasts

Australia

For the past few years, discussions about Australia's outlook have been focused on the headwinds that have been significantly impacting the economy. In particular, the negative income shock from falling commodity prices, the drag from falling capex post the resources boom, as well as the fiscal contraction by the Federal government as it seeks to return its budget to surplus.

Prior headwinds to Australia's growth outlook – commodity, capex and fiscal – have eased

These headwinds, however, appear to have largely eased through 2H16, providing the foundation for a firmer recovery in Australia's domestic economy, which while rebalancing well of late, has been constrained to a subdued pace of growth:

- For commodity prices, while some retracement post their recent spike is anticipated, Australia's commodity prices have rebounded 30% through 2016 (20% in AUD terms), having fallen over 60% from their mid-2011 highs, a significant positive for economy-wide income and earnings.
- For capex, after quadrupling to 8% of GDP by 2012, collapsing resources investment has cost the economy around 2%pts of growth each year in recent years. But with the completion of most of the large capex project by mid-17, total business capex is expected to be flat over the coming year.
- For fiscal policy, while the Federal consolidation from a 2½% of GDP deficit in 2015/16 to surplus by 2020/21 remains on track, recently announced infrastructure spending by the cyclically stronger States of NSW and VIC more than offsets this drag, rendering fiscal policy a net stimulus ahead.

Growth is seen strengthening through 2017…

As such, Australia's growth is forecast to strengthen further to 3.0% in 2017 after 2.9% in 2016, before easing modestly to 2.8% in 2018. More materially, the pace of y/y growth is seen accelerating to 3.5% through 2017 – as the prior headwinds ease – a full 1%pt faster than its forecast exit rate of 2.4% for 2016 (post some 2H16 slowing from Australia's current 3.3% y/y growth). Through 2018, growth is seen retracing somewhat as Australia's booming housing construction cycle hits reverse and the initial impulse from public sector capex fades, with growth forecast to slow to 2.5% by end-18, with risks of a more marked easing.

…led by better domestic activity

Key to Australia's outlook is the expected pick-up in domestic activity. The current 3.3% y/y pace of growth into mid-16 is flattered by the 'pay-off' from the capex boom, with net exports contributing two-thirds of that growth, but domestic demand at a well-below trend ~1% y/y, and private demand half that pace. Looking ahead, we expect a strong recovery in domestic growth to 2½% y/y by end-17, led by both public (4½% y/y) as well as private (1½%) demand, albeit the latter remains below trend. Some slowing in domestic growth is forecast through 2018 to 1¾% y/y, albeit still above mid-16's current 1¼% y/y pace.

A housing correction drags growth slower through 2018

Across sectors in 2017 and 2018, we forecast a net strengthening in private and public capex, but a moderation in consumption growth, while housing activity remains firm in 2017 but moves sharply lower by end-2018:

- The private capex drag is forecast to ease in 2017 to -3.5% y/y from -9% in both 2015 and 2016. This reflects a less material drag from mining (halving to a fall of ~10% y/y) and a modest recovery in non-mining. For 2018, we forecast the first positive year of growth for capex in six years (a modest +1.5% y/y), as mining stabilises, and non-mining capex lifts on better domestic activity and easing commodity price-led cashflow headwinds.

- For housing, multi-story-led construction in Sydney, Melbourne & Brisbane capitals should help housing investment to rise further in 2017 (+3.5% after a ~8% for 2016). But with building approvals now peaking, and activity at historical highs, we forecast a contraction in 2018 (-5.5%). With only 50% of the multi-story build complete, but vacancy rates already rising and rental growth negative, we look for price weakness in 2017. We expect flat house prices across both 2017 & 2018 (after 5% in 2016), albeit with downside risks, while dwelling starts are seen down ~10% each year (205k in 2017 & 180k in 2018, after 228k for 2016), dragging on domestic growth in 2018.
- For private consumption, real growth picked up to 3% y/y in 2016, despite only 2% real income growth, as consumers have modestly drawn down their saving (10% to 8% over the past two years). Improved confidence, led by a better labour market and wealth (particularly house price) gains, have been a key driver. But recent softer trends in the jobs market, led by slower hours worked & full-time jobs growth, with unemployment unlikely to move low enough (5.5% end-17 & 5.3% end-18, from 5.6% currently) to drive wage gains (likely to remain 2-2½% y/y), and weaker house prices ahead, is likely to see consumption retrace toward 2½% y/y across 2017 & 2018.

Fading headwinds signals a pick-up in economy-wide nominal growth…

The fading of the headwinds – commodity, capex & fiscal – that have previously constrained domestic activity signals a pick-up in economy-wide nominal growth. This should see nominal GDP growth rise to 5.5% in 2017, its fastest since 2011, a positive stimulus to fiscal trends and corporate cashflow. While a rising terms of trade (~5% in 2017, first time in six years) is unlikely to be strongly jobs- and capex-supportive, it should see Australia delivering monthly trade surpluses ahead, more than halving the current account deficit to 2.0% of GDP in 2018 from 4.7% in 2015, even given a significant share of resource sector ownership lies offshore.

…pointing to better fiscal and current account deficit trends

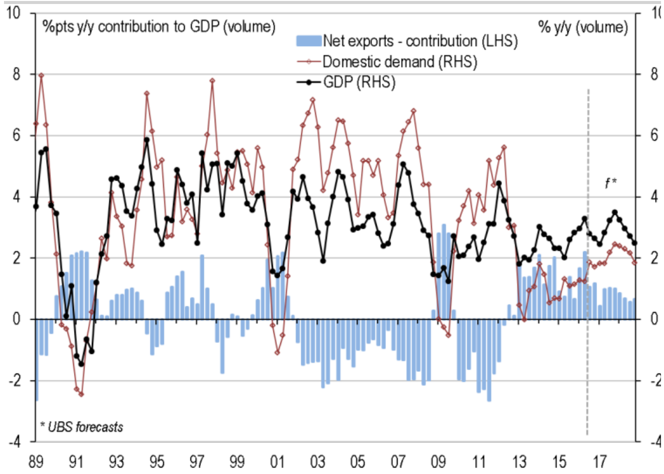
For inflation, notwithstanding our relatively upbeat growth outlook, is expected to stay subdued in the forecast period. Key drivers include heightened competitive pressure in traditional (prior high margin) oligopolistic sectors, more contained government administered pricing, structurally lower wage growth and weakness in housing rents. However, less severe economy-wide income headwinds, and tentative signs of 'steadying' labour earnings, as well as rising oil prices, contribute to a basing and drift higher in inflation from here. We forecast underlying inflation, now 1.5% y/y, to drift steadily but modestly higher and return to the RBA's 2-3% target in early 2018, remaining around 2% throughout 2018.

Despite better growth, inflation stays low and the RBA on hold

For the RBA, ongoing low (but not falling) inflation should see it remain on hold for most of the forecast period, an extended pause at low rates for a central bank that has historically tended to move quickly away from highly accommodative policy settings. On balance, with underlying inflation back in the target in 1H18, rising headline inflation & inflation expectations helped by higher global oil prices, and the likelihood that the US Fed has 'out-hiked' the RBA a handful of times by 2H18, we forecast a start to rate normalisation by the RBA in Q418, with a 25bp hike to 1.75%. However, downside risks to growth via housing, as well as global developments, make this forecast subject to more than the usual uncertainty.

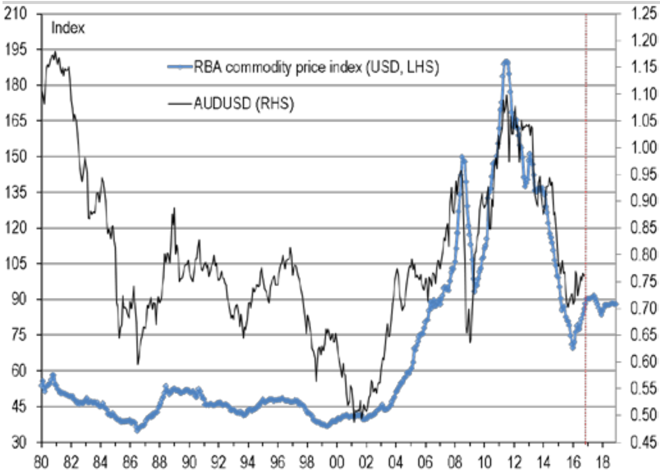
Key external downside risks to Australia's outlook lie in a China hard-landing scenario – a direct impact on real growth – or in political & banking sector risks from Europe – a potential funding headwind for our financial sector. Domestically, downside risks lie in a sharper-than-expected housing correction and prices that undermine consumer sentiment, while upside risks lie in a more vibrant than anticipated response to the recent easing of key commodity & capex headwinds.

Figure 276: We expect growth to accelerate through 2017



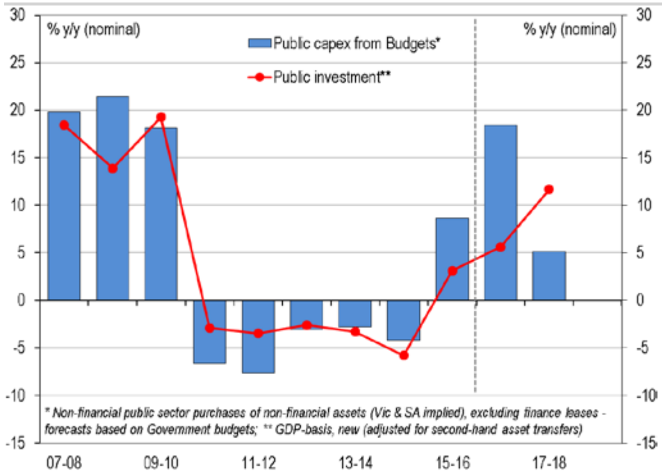
Source: ABS, UBS forecasts

Figure 277: Australia's commodity prices are up 30%



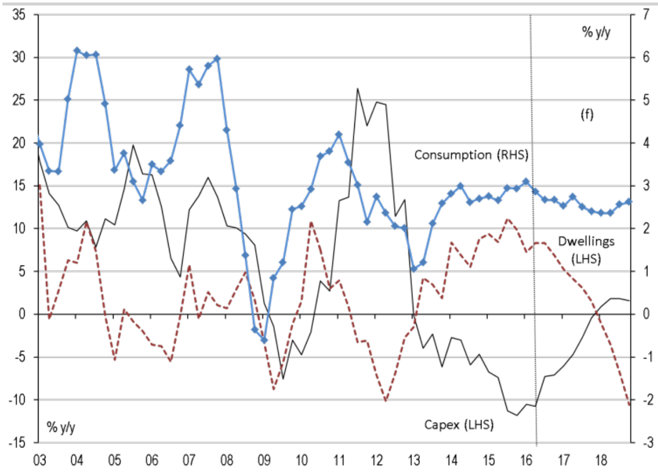
Source: RBA, Factset, UBS forecasts

Figure 278: Public infrastructure capex



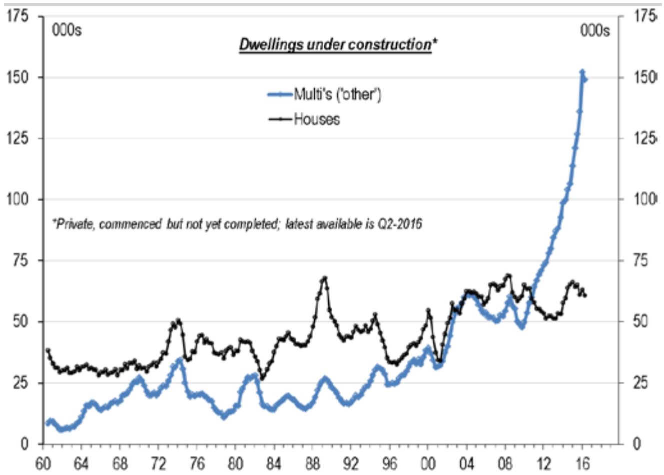
Source: Australian Government Budget Papers, ABS, UBS

Figure 279: Consumption, capex and dwellings %y/y



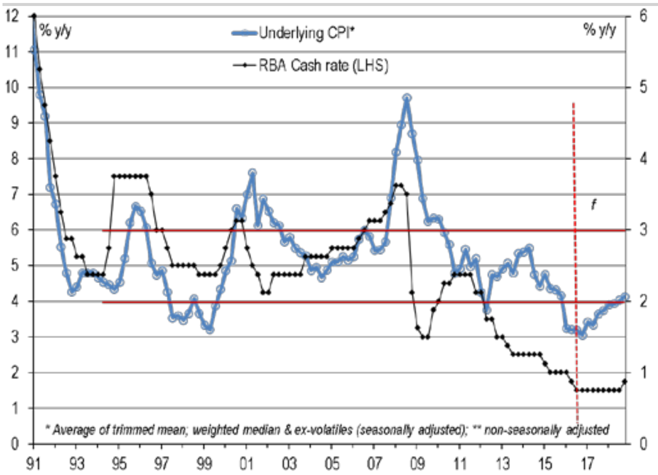
Source: ABS, UBS forecasts

Figure 280: Dwellings under construction



Source: ABS, UBS

Figure 281: Core inflation and RBA cash rate



Source: ABS, RBA, UBS forecasts

Australia	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	1457	1505	1555	1600	1628	1692	1786	1872
GDP, USD bn	1522	1563	1489	1439	1216	1270	1393	1473
GDP per capita, USD	67962	68619	64274	61208	51003	52540	56814	59167
Real GDP growth, %	2.7	3.6	2.0	2.7	2.4	2.9	3.0	2.8
Private consumption, % y/y	3.2	2.3	1.7	2.8	2.8	2.8	2.5	2.5
Government consumption, % y/y	3.6	2.5	1.2	0.6	2.9	4.2	3.0	3.0
Gross Fixed Capital formation, % y/y	6.9	9.2	-1.8	-1.9	-3.9	-3.3	0.2	0.8
Exports, % y/y	0.1	5.8	5.9	6.7	6.0	7.0	5.8	5.0
Imports, % y/y	11.1	6.1	-1.8	-1.7	1.7	0.1	2.2	2.5
Unemployment rate, %	5.1	5.2	5.7	6.1	6.1	5.7	5.6	5.4
Industrial Production, %	1.2	3.4	2.2	4.2	1.8	3.4	1.5	2.0
Prices, interest rates and money								
CPI inflation, % y/y (average)	3.3	1.8	2.4	2.5	1.5	1.2	1.8	2.1
CPI inflation, % y/y (year-end)	3.0	2.2	2.7	1.7	1.7	1.4	1.9	2.1
Broad money M2, % y/y (end-year)	8.1	7.3	6.9	7.2	5.9	5.7	3.6	3.4
Domestic private credit, % y/y	3.2	3.9	3.3	5.0	6.3	6.1	4.0	3.8
Domestic bank credit/GDP	115.2	117.7	121.4	127.3	136.2	139.7	137.4	135.6
Policy rate, % (end-year)	4.25	3.00	2.50	2.50	2.00	1.50	1.50	1.75
10 year bond yield, % (year-end)	3.81	3.28	4.26	2.81	2.96	2.25	2.40	2.65
AUD/USD (year-end)	1.03	1.04	0.89	0.82	0.73	0.78	0.78	0.80
Fiscal accounts								
General government budget balance, % GDP	-3.4	-2.9	-1.2	-3.1	-2.4	-2.4	-2.2	-1.4
Revenue, % GDP	21.4	22.1	23.0	22.7	23.5	23.5	23.9	24.2
Expenditure, % GDP	24.5	24.9	24.1	25.6	25.6	25.8	25.9	25.5
of which interest expenditure, % GDP	0.3	0.4	0.5	0.7	0.7	0.7	0.7	0.7
Primary balance, % GDP	-3.0	-2.5	-0.7	-2.4	-1.7	-1.7	-1.4	-0.7
Public sector debt (gross),% GDP	13.6	15.7	16.9	20.2	22.9	25.9	29.0	30.2
of which domestic public debt, % GDP	9.7	11.5	11.5	13.5	14.8	16.2	17.5	17.4
of which external public debt,% GDP	3.9	4.2	5.4	6.6	8.1	9.6	11.5	12.8
% domestic public debt held by non-residents	71.5	73.3	68.3	67.0	64.7	62.7	60.2	57.7
Balance of payments								
Trade balance, USD bn	12.8	-23.0	-10.0	-8.2	-27.1	-14.7	4.8	11.4
Exports, USD bn	328.2	312.9	305.1	294.4	236.2	240.2	272.7	292.2
Imports, USD bn	315.4	336.0	315.1	302.6	263.4	254.8	267.9	280.8
Current account balance, USD bn	-44.9	-66.2	-50.2	-42.4	-57.5	-38.2	-29.5	-26.9
as % of GDP	-2.9	-4.2	-3.4	-2.9	-4.7	-3.1	-2.1	-1.8
Foreign direct investment (net), USD bn	96.8	142.2	128.0	123.3	113.3			
Total FX reserves, USD bn	46.8	49.1	53.2	53.9	49.3			
Foreign exchange reserves excl gold, USD bn	42.8	44.9	50.1	50.8	46.5			
Total FX reserves, % GDP	3.1	3.1	3.6	3.7	4.1			
Total external debt, % GDP	88.1	91.4	100.9	106.6	117.8			
Net International Investment Position, % GDP	55.0	55.2	54.6	55.0	58.8			
Credit ratings								
Moody's	Aaa	Aaa	Aaa	Aaa	Aaa	Aaa		
S&P	AAA	AAA	AAA	AAA	AAA	AAA		
Fitch	AAA	AAA	AAA	AAA	AAA	AAA		

Source: RBA, UBS

New Zealand

The conversation about New Zealand's economic prospects over the past couple of years has concentrated on the collapse of international prices for dairy, NZ's main export commodity. However, as has been discussed previously, there have been various offsets that resulted in growth out-performing expectations. Non-dairy commodity export prices fared somewhat better than dairy over this period, oil import prices fell, dairy export volumes grew, while record tourist numbers and migrant inflows combined with a booming construction sector to underpin domestic demand growth. But just as the dairy sector outlook brightens, several of these positive drivers are expected to moderate over 2017 and 2018.

Growth has been strong, and should moderate ahead

Looking ahead, we find it difficult to believe the factors that combined to give four consecutive quarters of near 1% q/q growth will be repeated. As such, growth momentum should moderate. There may be some upside risk to our outlook near term, but we remain comfortable with the notion that growth will likely slow over the year ahead. While improving terms of trade should lighten the headwind for the export sector over the forecast horizon, the tapering of construction activity will likely reveal a more modest pace of growth in 2017 and 2018. We forecast NZ growth to slow from 3.3% this year, to 2.6% next year and 2.4% in 2018.

Diary prices have rebounded, tourism and migration near record highs

Global dairy auction prices have rebounded over 40% since mid-July, on account of a better balance between inventories, demand and production. The outlook remains uncertain, but there's been a material improvement in agricultural sector sentiment and we expect sustained ongoing gains to deliver improved pay-outs over the next two seasons. In the other direction, we also expect oil prices to increase gradually over the forecast horizon, such that the terms of trade improve only slowly. Meanwhile, higher airline seat capacity into NZ will likely provide for further growth in tourist numbers near term, but capacity constraints suggest the rate of growth is not sustainable. Moreover, migrant inflows (which have led to record population growth) have likely peaked, with recently announced government policy changes designed to temper arrivals.

General election to be held in 2017

The National Party (led by Prime Minister, John Key) secured a third term (of three years) at the September 2014 election. The next general election will need to be held by mid-November next year. The latest NZ Roy Morgan Poll shows National as the most preferred party on 48%, well ahead of a probable Labour/Greens alliance attracting 38%. On these poll results, National may need the support of the NZ First Party (with 10% support) to form a government. NZ First leader Winston Peters has typically stated the party would talk to the highest-polling party following an election result – NZ First formed a government with National in 1996 and Labour in 2005. If a National-NZ First coalition were to be in government at the end of 2017, the main question would be what concessions NZ First were able to extract in order to agree to support National. These would likely be in areas like migration policy (where NZ First favours tighter rules and fewer migrants) but would most likely leave the major monetary/fiscal policies largely unchanged.

Construction in Canterbury has peaked, but is rising in Auckland

The latest National Construction Pipeline Report suggests that total construction activity will increase 5.4% in calendar 2017, before holding steady in 2018, with activity rising significantly in Auckland over both years but falling in Canterbury from 2017 onwards. Still-low mortgage rates, ongoing high (albeit falling) levels of net migration and the Auckland Unitary Plan all suggest strong building activity lies ahead but that the construction sector will likely fade as a major contributor to growth in 2017 and make no meaningful contribution to growth in 2018.

Private consumption continues to make the largest contribution to growth over the forecast period, underpinned by solid income growth (rising employment plus modest wage growth), while the investment composition shifts away from construction towards business capex as capacity constraints intensify. For 2017 this results in a lift in investment-intensive imports with net exports making a larger growth detraction, while for 2018 the net effect of a fading construction sector contribution is a slower pace of domestic demand growth.

Fiscal balance has improved more rapidly than expected…

Recent years have also been marked by fiscal consolidation being something of a drag on growth. But faster-than-predicted improvement in nominal GDP growth has seen the Government's operating balance move back into surplus last year (0.2% of GDP, 2015) led by a higher tax take (higher provisional taxes bolstering the corporate tax take, while GST was supported by residential investment and tourist spending). Combined with forecast lower expenditure growth ahead, this should deliver a larger 0.7% of GDP surplus for the June 2016 year. Surpluses are expected to increase over the forecast period, with fiscal policy projected to be slightly expansionary in 2017 and close to neutral in 2018.

The current account likely deteriorates moderately in 2017

It has long been anticipated that the current account would deteriorate on the back of weak trading partner growth, falling commodity export prices and rising domestic demand. However, the latest data (for mid-2016) show the deficit at 2.9% of GDP, which compares favourably with the post-1990 average of 3.8%. We don't see the recent stellar performance on export volumes being sustained, while ongoing domestic demand growth should pull in imports. We are assuming that the terms of trade will be flat for the rest of 2016, before gradually improving across 2017 and 2018. Combined with a forecast deterioration in the primary and secondary balances, we see the external deficit worsening to 3.6% of GDP mid-next year, before pulling back to 3.1% by year-end and 3.0% for 2018.

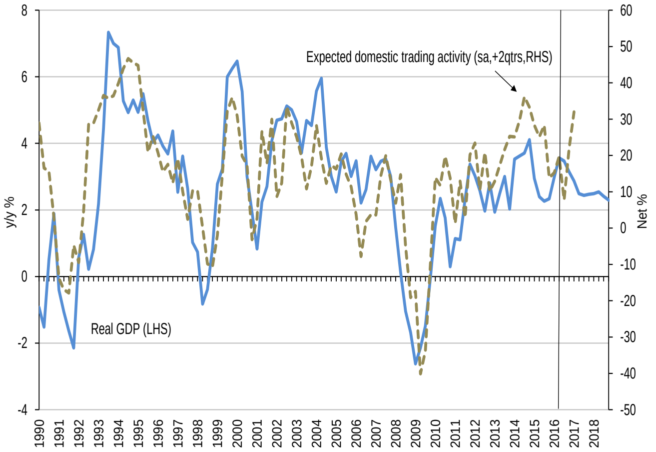
Our forecast track has CPI inflation back within the 1-3% target band by the end of the year (as prior oil/petrol-price falls drop out) and back 'near' the target mid-point by Q3 next year. The forecast rise in inflation is driven most by tradables (less drag), followed by non-tradable-ex-housing (labour-market constraints intensify as unemployment drifts down towards 4½%) and then housing. Our rising inflation forecast is dependent upon our exchange-rate and wage-inflation assumptions. If the exchange rate is stronger than expected and/or wage inflation fails to respond to a tightening labour market, then the risk is that inflation will stay lower and take longer to return to 'near' the target band mid-point.

Inflation is seen back in the target early 2017, and the RBNZ on hold

We see the 10 November OCR cut by the RBNZ to 1.75% as the final move in this easing cycle. However, the Bank will likely leave the door open to easing at this stage but start to move to a more neutral stance when headline inflation moves back into the target band early next year. Provided that inflation returns to near the target mid-point late next year, and the Fed hikes as anticipated over the next two years, we see the RBNZ starting to normalise rates with one move mid-2018 and another in Q418 taking the OCR to 2.25% by that time.

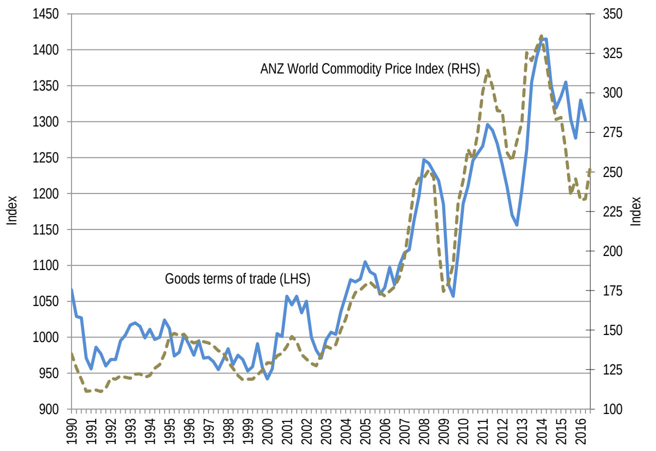
Key external downside risks to NZ's growth outlook involve a China hard-landing and its impact on commodity prices and trading partner growth (Australia especially) or political and banking sector risks from Europe (overseas funding costs). Domestically, political uncertainty surrounding next year's general election could delay business investment decisions, while house-building (largely in Auckland) could exceed expectations, adding to near-term growth.

Figure 282: Real GDP and business sentiment



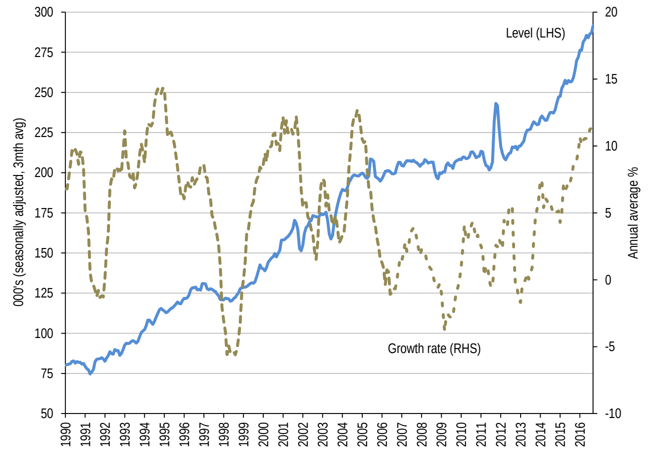
Source: Statistics NZ, NZIER, UBS forecasts

Figure 283: Terms of trade and ANZ World Commodity Price Index



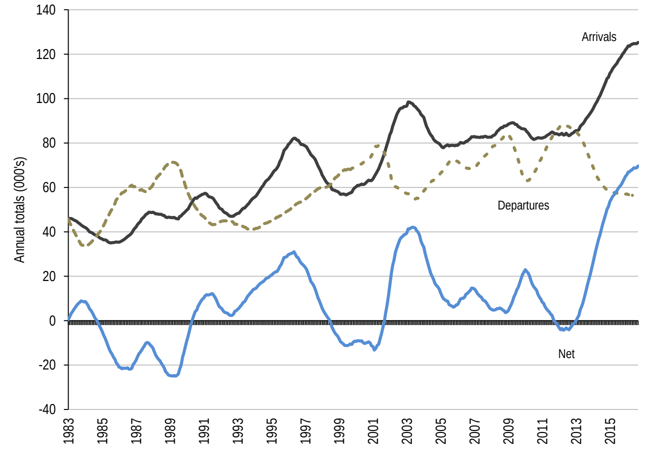
Source: Statistics NZ, ANZ, UBS

Figure 284: Tourism



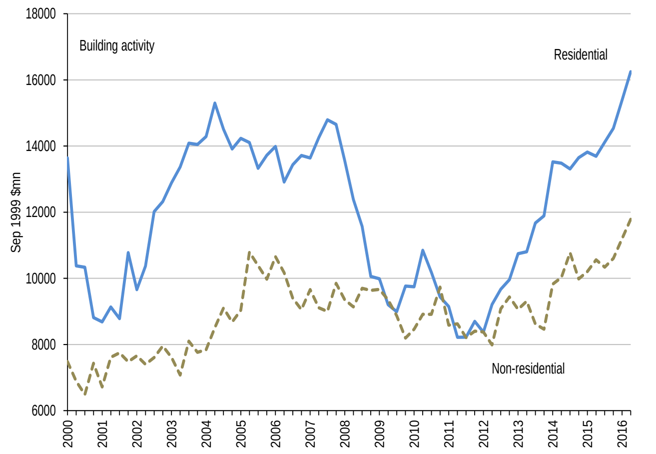
Source: Statistics NZ, UBS

Figure 285: Migration



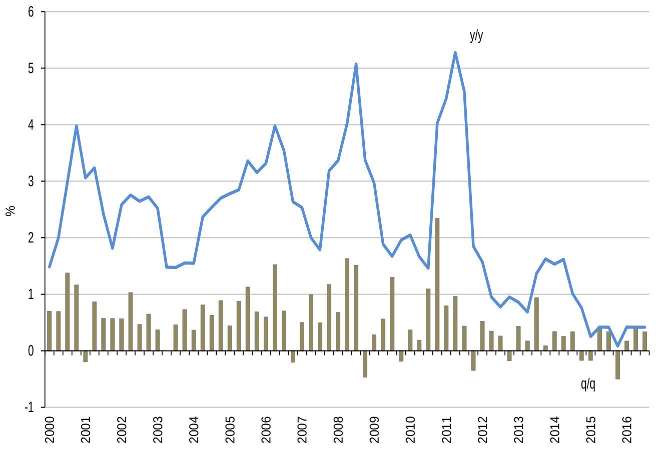
Source: Statistics NZ, UBS

Figure 286: Construction



Source: Statistics NZ, UBS

Figure 287: Inflation



Source: Statistics NZ, UBS

New Zealand	2011	2012	2013	2014	2015	2016F	2017F	2018F
Economic Activity and Employment								
GDP, local currency bn	211	217	227	238	246	257	266	277
GDP, USD bn	167	176	186	198	172	180	184	188
GDP per capita, USD	38071	39778	41768	43775	37349	38162	38503	38744
Real GDP growth, %	2.0	2.6	2.4	3.8	2.5	3.3	2.6	2.4
Private consumption, % y/y	2.6	2.8	2.9	2.7	2.3	3.4	3.0	2.6
Government consumption, % y/y	2.7	-0.4	1.7	2.7	1.9	2.0	2.4	1.5
Gross Fixed Capital formation, % y/y	6.5	6.9	5.1	10.9	2.8	5.2	5.3	3.2
Exports, % y/y	2.6	1.9	0.8	3.0	7.0	3.0	2.1	2.8
Imports, % y/y	7.0	2.8	6.2	7.9	3.7	2.6	4.7	3.1
Unemployment rate, %	6.0	6.4	5.8	5.4	5.4	5.2	4.9	4.6
Industrial Production (%)								
Prices, interest rates and money								
CPI inflation, % y/y (average)	4.0	1.1	1.1	1.2	0.3	0.5	1.6	1.9
CPI inflation, % y/y (year-end)	1.8	0.9	1.6	0.8	0.1	1.1	1.8	2.0
Broad money M2, % y/y (end-year)	15.2	12.5	15.6	10.3	14.2			
Domestic private credit, % y/y	0.9	3.8	4.8	4.6	7.4			
Domestic bank credit/GDP	152.3	153.9	153.2	153.3	159.5			
Policy rate, % (end-year)	2.5	2.5	2.5	3.5	2.5	1.8	1.8	2.3
10 year bond yield, % (year-end)	3.9	3.6	4.8	3.8	3.6	2.7	2.9	3.3
NZD/USD (year-end)	0.77	0.83	0.82	0.78	0.67	0.74	0.75	0.76
Fiscal accounts								
General government budget balance, % GDP	-6.5	-6.9	3.2	1.3	2.4	-2.1	1.5	1.8
Revenue, % GDP	27.8	28.1	29.2	28.5	29.9	30.2	30.1	30.2
Expenditure, % GDP	34.1	32.0	32.0	30.3	30.0	29.4	29.4	29.3
of which interest expenditure, % GDP	1.5	1.7	1.7	1.5	1.6			
Primary balance, % GDP	-8.9	-4.3	-2.0	-1.2	0.2	0.7	0.6	0.9
Public sector debt (gross),% GDP	35.2	37.0	35.6	34.9	35.6	34.5		
of which domestic public debt, % GDP								
of which external public debt,% GDP								
% domestic public debt held by non-residents								
Balance of payments								
Trade balance, USD bn	2.3	0.1	1.0	0.9	-1.6	-1.2	-1.8	-1.1
Exports, USD bn	38.2	37.7	39.7	42.0	34.4	33.7	35.4	37.6
Imports, USD bn	35.9	37.6	38.7	41.1	36.0	34.9	37.3	38.7
Current account balance, USD bn	-4.7	-6.9	-5.9	-6.4	-5.8	-4.8	-5.7	-5.6
as % of GDP	-2.8	-3.9	-3.2	-3.2	-3.4	-2.7	-3.1	-3.0
Foreign direct investment (net), USD bn	1.6	4.1	1.3	2.1	-0.4			
Total FX reserves, USD bn	15.4	14.3	15.2	14.8	13.9			
Foreign exchange reserves excl gold, USD bn								
Total FX reserves, % GDP	9.2	8.2	8.2	7.5	8.1			
Total external debt, % GDP	-69.1	-68.8	-62.7	-59.6	-56.3			
Net International Investment Position, % GDP	-69.0	-70.4	-65.2	-66.3	-62.5			
Credit ratings								
Moody's	Aaa	Aaa	Aaa	Aaa	Aaa	Aaa		
S&P	AA+	AA+	AA+	AA+	AA+	AA+		
Fitch	AA	AA	AA	AA	AA	AA		

Source: NZ, UBS

GLOBAL ECONOMIC RESEARCH			

Arend Kapteyn
Global Head of Economic Research
+44 20 7567 0030531 (arend.kapteyn@ubs.com)

Name	External Tel	Email	Title
Global Economics			
Pierre Lafourcade (New York)	+ 1 203 719 8921	pierre.lafourcade@ubs.com	Senior International Economist
Sophie Constable (London)	+44 20 7568 3105	sophie.constable@ubs.com	Economist / Global Database Manager
Lucy Taylor (London)	+44 20 7568 3217	lucy-m.taylor@ubs.com	Executive Team Assistant, Global Economics
US Economics			
Drew Matus (New York)	+1 212 713 4448	drew.matus@ubs.com	Deputy Chief Economist, US and Canada
Samuel Coffin (New York)	+1 203 719 1252	samuel.coffin@ubs.com	Economist, US
Dave Liang (New York)	+1 203 719 1246	dave.liang@ubs.com	Economist, US
Jessy Moya (New York)	+1 212 713 2471	jessy.moya@ubs.com	Administrative Assistant, US Economics
LatAm Economics			
Rafael de la Fuente (New York)	+1 203 719 7127	rafael.delafuente@ubs.com	Chief Economist, Latin America
Guilherme Loureiro (Sao Paulo)	+55 11 2767 6621	guilherme.loureiro@ubs.com	Senior Economist, Brazil
Thiago Carlos (Sao Paulo)	+55 11 3014 7429	thiago.carlos@ubs.com	Economist, Brazil
Mariano Szafowal (Buenos Aires)	+54 11 43 160311	mariano.szafowal@ubs.com	Economist, Argentina
Australia & New Zealand Economics			
Scott Haslem (Sydney)	+61 2 932 43663	scott.haslem@ubs.com	Chief Economist, Australasia
George Tharenou (Sydney)	+61 2 932 43520	george.tharenou@ubs.com	Economist, Australia
Jim Xu (Sydney)	+61 2 932 42665	jim.xu@ubs.com	Intern, Australia Economics
Robin Clements (Auckland)	+64 33 589 150	robin.clements@ubs.com	Economist, New Zealand
Asia Economics			
Duncan Wooldridge (Hong Kong)	+852 2 971 6046	duncan.wooldridge@ubs.com	Co-Head of Asian Economic Research, Chief Asia Economist
Silvia Liu (Hong Kong)	+852 2 971 8121	silvia.liu@ubs.com	Economist, Hong Kong & Taiwan
Amy Tang (Hong Kong)	+852 2 971 8461	amy.tang@ubs.com	Statistician, Asian Economics
Edward Teather (Singapore)	+65 64 955 965	edward.teather@ubs.com	Senior Economist, ASEAN, India
Alice Fulwood (Singapore)	+65 64 953 085	alice.fulwood@ubs.com	GTP, Asian Economics
Daiju Aoki (Japan)	+81 352 087454	daiju.aoki@ubs.com	Senior Economist, Japan
Isabella Leung (Hong Kong)	+852 2 9718 193	isabella.leung@ubs.com	Production Coordinator/Administrative Assistant, APAC Econ
Natalie Ng (Singapore)	+65 6495 3681	natalie.ng@ubs.com	Administrative Assistant, APAC Economics and Macro Strategy
China Economics			
Tao Wang (Hong Kong)	+852 2 971 7525	wang.tao@ubs.com	Co-Head of Asian Economic Research, Chief China Economist
Donna Kwok (Hong Kong)	+852 371 23160	donna.kwok@ubs.com	Senior Economist, China
Ning Zhang (Hong Kong)	+852 2 971 8135	ning.zhang@ubs.com	Economist, China
Lan Chen (Shanghai)	+86 21 3866 8802	Lan.chen@ubssecurities.com	Economist, China
Jennifer A Zhong (Beijing)	+86 10 5832 8324	jennifer-a.zhong@ubssecurities.com	Associate, China, UBS Securities
Western Europe Economics			
Reinhard Cluse (London)	+44 20 7568 6722	reinhard.cluse@ubs.com	Chief Economist, Europe
Jennifer Aslin (London)	+44 20 7568 6585	jennifer.aslin@ubs.com	Associate Economist
Felix Huefner (Frankfurt)	+49 69 1369 8280	felix.huefner@ubs.com	Senior European Economist, Germany, France and Switzerland
Emerging EMEA Economics			
Gyorgy Kovacs (London)	+44 20 7568 7563	gyorgy.kovacs@ubs.com	Chief Economist, Emerging EMEA
Anna Zadornova (London)	+44 20 7567 4212	anna.zadornova@ubs.com	Economist, Russia, ex-CIS, UAE, Qatar
Business Management			
Marc Altieri (New York)	+1 212 713 3467	marc.altieri@ubs.com	Operating Officer, Macro Strategy and Economics
Maarit Strange (London)	+44 20 7568 8258	maarit.strange@ubs.com	Business Manager, Macro Strategy and Economics

Valuation Method and Risk Statement

Risks include macroeconomic variables (such as GDP growth rates and inflation), economic slowdown, a weakening currency, global economic events, and government policy changes.

Required Disclosures

This report has been prepared by UBS Limited, an affiliate of UBS AG. UBS AG, its subsidiaries, branches and affiliates are referred to herein as UBS.

For information on the ways in which UBS manages conflicts and maintains independence of its research product; historical performance information; and certain additional disclosures concerning UBS research recommendations, please visit www.ubs.com/disclosures. The figures contained in performance charts refer to the past; past performance is not a reliable indicator of future results. Additional information will be made available upon request. UBS Securities Co. Limited is licensed to conduct securities investment consultancy businesses by the China Securities Regulatory Commission. UBS acts or may act as principal in the debt securities (or in related derivatives) that may be the subject of this report. This recommendation was finalized on: 14 November 2016 12:39 AM GMT.

Analyst Certification: Each research analyst primarily responsible for the content of this research report, in whole or in part, certifies that with respect to each security or issuer that the analyst covered in this report: (1) all of the views expressed accurately reflect his or her personal views about those securities or issuers and were prepared in an independent manner, including with respect to UBS, and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by that research analyst in the research report.

UBS Global Credit Strategy and Research: Rating Definitions
UBS ranks potential investment opportunities within non-government fixed income markets and sectors.

<table>
<tr><th colspan="7">Issuer Ratings</th></tr>
<tr><th></th><th>UBS Terminology</th><th>Rating Category[1]</th><th>Time Horizon</th><th>Definition</th><th>Coverage[2]</th><th>IB Services[3]</th></tr>
<tr><td rowspan="3">Credit Outlook</td><td>Positive</td><td>Buy</td><td rowspan="3">Up to 6 months</td><td rowspan="3">UBS' expected trend in a company's creditworthiness</td><td>3%</td><td>67%</td></tr>
<tr><td>Stable</td><td>Hold</td><td>63%</td><td>46%</td></tr>
<tr><td>Negative</td><td>Sell</td><td>34%</td><td>38%</td></tr>
<tr><th></th><th>UBS Terminology</th><th colspan="2">Time Horizon</th><th colspan="3">Definition</th></tr>
<tr><td rowspan="3">Credit Rating</td><td>AAA, AA, A (+/-)</td><td colspan="2" rowspan="3">Up to 12 months</td><td colspan="3" rowspan="3">UBS' assessment of a company's creditworthiness. Credit Ratings are only used in the evaluation of Swiss corporates.</td></tr>
<tr><td>BBB, BB, B (+/-)</td></tr>
<tr><td>CCC, CC, C (+/-)</td></tr>
<tr><th colspan="7">Security Recommendations</th></tr>
<tr><th></th><th>UBS Terminology</th><th colspan="2">Time Horizon</th><th colspan="3">Definition</th></tr>
<tr><td rowspan="3">Bond Recommendation</td><td>Outperform</td><td colspan="2" rowspan="3">Up to 3 months</td><td colspan="3" rowspan="3">A corporate bond's expected relative performance versus a defined reference</td></tr>
<tr><td>Marketperform</td></tr>
<tr><td>Underperform</td></tr>
<tr><th></th><th>UBS Terminology</th><th colspan="2">Time Horizon</th><th colspan="3">Definition</th></tr>
<tr><td rowspan="2">CDS Recommendation</td><td>Buy Protection</td><td colspan="2" rowspan="2">Up to 3 months</td><td colspan="3" rowspan="2">Recommendation to hedge a company's creditworthiness</td></tr>
<tr><td>Sell Protection</td></tr>
</table>

Note: Bond recommendations may be defined as 'Tactical', as in Tactical Outperform or Tactical Underperform, where there is a near term catalyst(s) taken into account.
The UBS credit rating may be modified by the addition of a plus (+) or minus (-) sign where applicable to show relative standing within the major categories.
Source: UBS. Rating allocations are as of 30 September 2016.
1.To satisfy regulatory requirements, we assign Buy, Hold and Sell in our Credit Outlook ratings distribution table for our Issuer Rating system.
2.Percentage of companies under coverage globally within this rating category.
3.Percentage of companies within this rating category for which investment banking (IB) services were provided within the past 12 months.

Company Disclosures

Issuer Name	Credit Rating	Outlook
Argentina[2, 4]	Restricted	Restricted
Brazil[7, 22]	No Rating	No Rating
Canada[7]	No Rating	No Rating
China (Peoples Republic of)[4, 5, 7]	No Rating	No Rating
Colombia	No Rating	No Rating
Czech Republic	No Rating	No Rating
Federal Republic of Germany	No Rating	No Rating
French Republic[2, 4, 5, 7]	No Rating	No Rating
Hellenic Republic[7]	No Rating	No Rating
Hungary	No Rating	No Rating
India[7]	No Rating	No Rating
Indonesia (Republic of)	No Rating	No Rating
Japan[4, 5, 7]	No Rating	No Rating
Kingdom of Spain[4, 7]	No Rating	No Rating
Korea (Republic of)[7]	No Rating	No Rating
Malaysia	No Rating	No Rating
Mexico	No Rating	No Rating
New Zealand[7]	No Rating	No Rating
Philippines (Republic of)[2, 4]	Restricted	Restricted
Poland[5, 7]	No Rating	No Rating
Republic of Italy[2, 4, 5, 7]	No Rating	No Rating
Republic of Kazakhstan[7]	No Rating	No Rating
Russia[4, 5, 7]	No Rating	No Rating
Singapore[5, 7]	No Rating	No Rating
South Africa[7]	No Rating	No Rating
Taiwan[7]	No Rating	No Rating
Thailand (Kingdom of)	No Rating	No Rating
Turkey	No Rating	No Rating
United Arab Emirates[7]	No Rating	No Rating
United Kingdom of Great Britain and Nort[4, 5, 7, 22]	No Rating	No Rating
United States of America[7, 22]	No Rating	No Rating
Venezula	No Rating	No Rating

Source: UBS. Ratings in this table are the most current published ratings prior to this report.

Issuer Name
Brazil[7, 22]
Canada[7]
Chile[7]
China (Peoples Republic of)[4, 5, 7]
Commonwealth of Australia[2, 4, 7]
Czech Republic
Dominion of New Zealand[7]
French Republic[2, 4, 5, 7]
Hong Kong Government International Bond
India (Republic Of)[7]
Japan[4, 5, 7]
Peru (Republic of)
Poland[5, 7]
Republic of Italy[2, 4, 5, 7]
Russia[4, 5, 7]
Singapore[5, 7]
South Africa (Republic of)[7]
Spain[4, 7]
Switzerland[4, 5, 7]
United Arab Emirates[7]
United Kingdom of Great Britain[4, 5, 7, 22]
United States[7, 22]

2. UBS AG, its affiliates or subsidiaries has acted as manager/co-manager in the underwriting or placement of securities of this company/entity or one of its affiliates within the past 12 months.
4. Within the past 12 months, UBS AG, its affiliates or subsidiaries has received compensation for investment banking services from this company/entity or one of its affiliates.
5. UBS AG, its affiliates or subsidiaries expect to receive or intend to seek compensation for investment banking services from this company/entity within the next three months.
7. Within the past 12 months, UBS Securities LLC and/or its affiliates have received compensation for products and services other than investment banking services from this company/entity.
22. UBS AG, its affiliates or subsidiaries held other significant financial interests in this company/entity as of last month`s end (or the prior month`s end if this report is dated less than 10 working days after the most recent month`s end).

Unless otherwise indicated, please refer to the Valuation and Risk sections within the body of this report. For a complete set of disclosure statements associated with the companies discussed in this report, including information on valuation and risk, please contact UBS Securities LLC, 1285 Avenue of Americas, New York, NY 10019, USA, Attention: Investment Research.

Global Disclaimer

This document has been prepared by UBS Limited, an affiliate of UBS AG. UBS AG, its subsidiaries, branches and affiliates are referred to herein as UBS.

Global Research is provided to our clients through UBS Neo and, in certain instances, UBS.com (each a "System"). It may also be made available through third party vendors and distributed by UBS and/or third parties via e-mail or alternative electronic means. The level and types of services provided by Global Research to a client may vary depending upon various factors such as a client's individual preferences as to the frequency and manner of receiving communications, a client's risk profile and investment focus and perspective (e.g., market wide, sector specific, long-term, short-term, etc.), the size and scope of the overall client relationship with UBS and legal and regulatory constraints.

All Global Research is available on UBS Neo. Please contact your UBS sales representative if you wish to discuss your access to UBS Neo.

When you receive Global Research through a System, your access and/or use of such Global Research is subject to this Global Research Disclaimer and to the terms of use governing the applicable System.

When you receive Global Research via a third party vendor, e-mail or other electronic means, your use shall be subject to this Global Research Disclaimer and to UBS's Terms of Use/Disclaimer (http://www.ubs.com/global/en/legalinfo2/disclaimer.html). By accessing and/or using Global Research in this manner, you are indicating that you have read and agree to be bound by our Terms of Use/Disclaimer. In addition, you consent to UBS processing your personal data and using cookies in accordance with our Privacy Statement (http://www.ubs.com/global/en/legalinfo2/privacy.html) and cookie notice (http://www.ubs.com/global/en/homepage/cookies/cookie-management.html).

If you receive Global Research, whether through a System or by any other means, you agree that you shall not copy, revise, amend, create a derivative work, transfer to any third party, or in any way commercially exploit any UBS research provided via Global Research or otherwise, and that you shall not extract data from any research or estimates provided to you via Global Research or otherwise, without the prior written consent of UBS.

This document is for distribution only as may be permitted by law. It is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or would subject UBS to any registration or licensing requirement within such jurisdiction. It is published solely for information purposes; it is not an advertisement nor is it a solicitation or an offer to buy or sell any financial instruments or to participate in any particular trading strategy. No representation or warranty, either expressed or implied, is provided in relation to the accuracy, completeness or reliability of the information contained in this document ("the Information"), except with respect to Information concerning UBS. The Information is not intended to be a complete statement or summary of the securities, markets or developments referred to in the document. UBS does not undertake to update or keep current the Information. Any opinions expressed in this document may change without notice and may differ or be contrary to opinions expressed by other business areas or groups of UBS. Any statements contained in this report attributed to a third party represent UBS's interpretation of the data, information and/or opinions provided by that third party either publicly or through a subscription service, and such use and interpretation have not been reviewed by the third party.

Nothing in this document constitutes a representation that any investment strategy or recommendation is suitable or appropriate to an investor’s individual circumstances or otherwise constitutes a personal recommendation. Investments involve risks, and investors should exercise prudence and their own judgement in making their investment decisions. The financial instruments described in the document may not be eligible for sale in all jurisdictions or to certain categories of investors. Options, derivative products and futures are not suitable for all investors, and trading in these instruments is considered risky. Mortgage and asset-backed securities may involve a high degree of risk and may be highly volatile in response to fluctuations in interest rates or other market conditions. Foreign currency rates of exchange may adversely affect the value, price or income of any security or related instrument referred to in the document. For investment advice, trade execution or other enquiries, clients should contact their local sales representative.

The value of any investment or income may go down as well as up, and investors may not get back the full (or any) amount invested. Past performance is not necessarily a guide to future performance. Neither UBS nor any of its directors, employees or agents accepts any liability for any loss (including investment loss) or damage arising out of the use of all or any of the Information.

Any prices stated in this document are for information purposes only and do not represent valuations for individual securities or other financial instruments. There is no representation that any transaction can or could have been effected at those prices, and any prices do not necessarily reflect UBS's internal books and records or theoretical model-based valuations and may be based on certain assumptions. Different assumptions by UBS or any other source may yield substantially different results.

This document and the Information are produced by UBS as part of its research function and are provided to you solely for general background information. UBS has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient. In no circumstances may this document or any of the Information be used for any of the following purposes:

(i) valuation or accounting purposes;

(ii) to determine the amounts due or payable, the price or the value of any financial instrument or financial contract; or

(iii) to measure the performance of any financial instrument.

By receiving this document and the Information you will be deemed to represent and warrant to UBS that you will not use this document or any of the Information for any of the above purposes or otherwise rely upon this document or any of the Information.

UBS has policies and procedures, which include, without limitation, independence policies and permanent information barriers, that are intended, and upon which UBS relies, to manage potential conflicts of interest and control the flow of information within divisions of UBS and among its subsidiaries, branches and affiliates. For further information on the ways in which UBS manages conflicts and maintains independence of its research products, historical performance information and certain additional disclosures concerning UBS research recommendations, please visit www.ubs.com/disclosures.

Research will initiate, update and cease coverage solely at the discretion of UBS Investment Bank Research Management, which will also have sole discretion on the timing and frequency of any published research product. The analysis contained in this document is based on numerous assumptions. All material information in relation to published research reports, such as valuation methodology, risk statements, underlying assumptions (including sensitivity analysis of those assumptions), ratings history etc. as required by the Market Abuse Regulation, can be found on NEO. Different assumptions could result in materially different results.

The analyst(s) responsible for the preparation of this document may interact with trading desk personnel, sales personnel and other parties for the purpose of gathering, applying and interpreting market information. UBS relies on information barriers to control the flow of information contained in one or more areas within UBS into other areas, units, groups or affiliates of UBS. The compensation of the analyst who prepared this document is determined exclusively by research management and senior management (not including investment banking). Analyst compensation is not based on investment banking revenues; however, compensation may relate to the revenues of UBS Investment Bank as a whole, of which investment banking, sales and trading are a part, and UBS's subsidiaries, branches and affiliates as a whole.

For financial instruments admitted to trading on an EU regulated market: UBS AG, its affiliates or subsidiaries (excluding UBS Securities LLC) acts as a market maker or liquidity provider (in accordance with the interpretation of these terms in the UK) in the financial instruments of the issuer save that where the activity of liquidity provider is carried out in accordance with the definition given to it by the laws and regulations of any other EU jurisdictions, such information is separately disclosed in this document. For financial instruments admitted to trading on a non-EU regulated market: UBS may act as a market maker save that where this activity is carried out in the US in accordance with the definition given to it by the relevant laws and regulations, such activity will be specifically disclosed in this document. UBS may have issued a warrant the value of which is based on one or more of the financial instruments referred to in the document. UBS and its affiliates and employees may have long or short positions, trade as principal and buy and sell in instruments or derivatives identified herein; such transactions or positions may be inconsistent with the opinions expressed in this document.

United Kingdom and the rest of Europe: Except as otherwise specified herein, this material is distributed by UBS Limited to persons who are eligible counterparties or professional clients. UBS Limited is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. **France:** Prepared by UBS Limited and distributed by UBS Limited and UBS Securities France S.A. UBS Securities France S.A. is regulated by the ACPR (Autorité de Contrôle Prudentiel et de Résolution) and the Autorité des Marchés Financiers (AMF). Where an analyst of UBS Securities France S.A. has contributed to this document, the document is also deemed to have been prepared by UBS Securities France S.A. **Germany:** Prepared by UBS Limited and distributed by UBS Limited and UBS Deutschland AG. UBS Deutschland AG is regulated by the Bundesanstalt fur Finanzdienstleistungsaufsicht (BaFin). **Spain:** Prepared by UBS Limited and distributed by UBS Limited and UBS Securities España SV, SA. UBS Securities España SV, SA is regulated by the Comisión Nacional del Mercado de Valores (CNMV). **Turkey:**

Distributed by UBS Limited. No information in this document is provided for the purpose of offering, marketing and sale by any means of any capital market instruments and services in the Republic of Turkey. Therefore, this document may not be considered as an offer made or to be made to residents of the Republic of Turkey. UBS AG is not licensed by the Turkish Capital Market Board under the provisions of the Capital Market Law (Law No. 6362). Accordingly, neither this document nor any other offering material related to the instruments/services may be utilized in connection with providing any capital market services to persons within the Republic of Turkey without the prior approval of the Capital Market Board. However, according to article 15 (d) (ii) of the Decree No. 32, there is no restriction on the purchase or sale of the securities abroad by residents of the Republic of Turkey. **Poland:** Distributed by UBS Limited (spolka z ograniczona odpowiedzialnoscia) Oddzial w Polsce regulated by the Polish Financial Supervision Authority. Where an analyst of UBS Limited (spolka z ograniczona odpowiedzialnoscia) Oddzial w Polsce has contributed to this document, the document is also deemed to have been prepared by UBS Limited (spolka z ograniczona odpowiedzialnoscia) Oddzial w Polsce. **Russia:** Prepared and distributed by UBS Bank (OOO). **Switzerland:** Distributed by UBS AG to persons who are institutional investors only. UBS AG is regulated by the Swiss Financial Market Supervisory Authority (FINMA). **Italy:** Prepared by UBS Limited and distributed by UBS Limited and UBS Limited, Italy Branch. Where an analyst of UBS Limited, Italy Branch has contributed to this document, the document is also deemed to have been prepared by UBS Limited, Italy Branch. **South Africa:** Distributed by UBS South Africa (Pty) Limited (Registration No. 1995/011140/07), an authorised user of the JSE and an authorised Financial Services Provider (FSP 7328). **Israel:** This material is distributed by UBS Limited. UBS Limited is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. UBS Securities Israel Ltd is a licensed Investment Marketer that is supervised by the Israel Securities Authority (ISA). UBS Limited and its affiliates incorporated outside Israel are not licensed under the Israeli Advisory Law. UBS Limited is not covered by insurance as required from a licensee under the Israeli Advisory Law. UBS may engage among others in issuance of Financial Assets or in distribution of Financial Assets of other issuers for fees or other benefits. UBS Limited and its affiliates may prefer various Financial Assets to which they have or may have Affiliation (as such term is defined under the Israeli Advisory Law). Nothing in this Material should be considered as investment advice under the Israeli Advisory Law. This Material is being issued only to and/or is directed only at persons who are Eligible Clients within the meaning of the Israeli Advisory Law, and this material must not be relied on or acted upon by any other persons. **Saudi Arabia:** This document has been issued by UBS AG (and/or any of its subsidiaries, branches or affiliates), a public company limited by shares, incorporated in Switzerland with its registered offices at Aeschenvorstadt 1, CH-4051 Basel and Bahnhofstrasse 45, CH-8001 Zurich. This publication has been approved by UBS Saudi Arabia (a subsidiary of UBS AG), a Saudi closed joint stock company incorporated in the Kingdom of Saudi Arabia under commercial register number 1010257812 having its registered office at Tatweer Towers, P.O. Box 75724, Riyadh 11588, Kingdom of Saudi Arabia. UBS Saudi Arabia is authorized and regulated by the Capital Market Authority to conduct securities business under license number 08113-37. **Dubai:** The information distributed by UBS AG Dubai Branch is intended for Professional Clients only and is not for further distribution within the United Arab Emirates. **United States:** Distributed to US persons by either UBS Securities LLC or by UBS Financial Services Inc., subsidiaries of UBS AG; or by a group, subsidiary or affiliate of UBS AG that is not registered as a US broker-dealer (a **'non-US affiliate'**) to major US institutional investors only. UBS Securities LLC or UBS Financial Services Inc. accepts responsibility for the content of a document prepared by another non-US affiliate when distributed to US persons by UBS Securities LLC or UBS Financial Services Inc. All transactions by a US person in the securities mentioned in this document must be effected through UBS Securities LLC or UBS Financial Services Inc., and not through a non-US affiliate. UBS Securities LLC is not acting as a municipal advisor to any municipal entity or obligated person within the meaning of Section 15B of the Securities Exchange Act (the "Municipal Advisor Rule"), and the opinions or views contained herein are not intended to be, and do not constitute, advice within the meaning of the Municipal Advisor Rule. **Canada:** Distributed by UBS Securities Canada Inc., a registered investment dealer in Canada and a Member-Canadian Investor Protection Fund, or by another affiliate of UBS AG that is registered to conduct business in Canada or is otherwise exempt from registration. **Mexico:** This report has been distributed and prepared by UBS Casa de Bolsa, S.A. de C.V., UBS Grupo Financiero, an entity that is part of UBS Grupo Financiero, S.A. de C.V. and is an affiliate of UBS AG. This document is intended for distribution to institutional or sophisticated investors only. Research reports only reflect the views of the analysts responsible for the reports. Analysts do not receive any compensation from persons or entities different from UBS Casa de Bolsa, S.A. de C.V., UBS Grupo Financiero, or different from entities belonging to the same financial group or business group of such. For Spanish translations of applicable disclosures, please see www.ubs.com/disclosures. **Brazil:** Except as otherwise specified herein, this material is prepared by UBS Brasil CCTVM S.A. to persons who are eligible investors residing in Brazil, which are considered to be: (i) financial institutions, (ii) insurance firms and investment capital companies, (iii) supplementary pension entities, (iv) entities that hold financial investments higher than R$300,000.00 and that confirm the status of qualified investors in written, (v) investment funds, (vi) securities portfolio managers and securities consultants duly authorized by Comissão de Valores Mobiliários (CVM), regarding their own investments, and (vii) social security systems created by the Federal Government, States, and Municipalities. **Hong Kong:** Distributed by UBS Securities Asia Limited and/or UBS AG, Hong Kong Branch. **Singapore:** Distributed by UBS Securities Pte. Ltd. [MCI (P) 007/09/2016 and Co. Reg. No.: 198500648C] or UBS AG, Singapore Branch. Please contact UBS Securities Pte. Ltd., an exempt financial adviser under the Singapore Financial Advisers Act (Cap. 110); or UBS AG, Singapore Branch, an exempt financial adviser under the Singapore Financial Advisers Act (Cap. 110) and a wholesale bank licensed under the Singapore Banking Act (Cap. 19) regulated by the Monetary Authority of Singapore, in respect of any matters arising from, or in connection with, the analysis or document. The recipients of this document represent and warrant that they are accredited and institutional investors as defined in the Securities and Futures Act (Cap. 289). **Japan:** Distributed by UBS Securities Japan Co., Ltd. to professional investors (except as otherwise permitted). Where this document has been prepared by UBS Securities Japan Co., Ltd., UBS Securities Japan Co., Ltd. is the author, publisher and distributor of the document. Distributed by UBS AG, Tokyo Branch to Professional Investors (except as otherwise permitted) in relation to foreign exchange and other banking businesses when relevant. **Australia:** Clients of UBS AG: Distributed by UBS AG (Holder of Australian Financial Services License No. 231087). Clients of UBS Securities Australia Ltd: Distributed by UBS Securities Australia Ltd (Holder of Australian Financial Services License No. 231098). This Document contains general information and/or general advice only and does not constitute personal financial product advice. As such, the Information in this document has been prepared without taking into account any investor's objectives, financial situation or needs, and investors should, before acting on the Information, consider the appropriateness of the Information, having regard to their objectives, financial situation and needs. If the Information contained in this document relates to the acquisition, or potential acquisition of a particular financial product by a 'Retail' client as defined by section 761G of the Corporations Act 2001 where a Product Disclosure Statement would be required, the retail client should obtain and consider the Product Disclosure Statement relating to the product before making any decision about whether to acquire the product. The UBS Securities Australia Limited Financial Services Guide is available at: www.ubs.com/ecs-research-fsg. **New Zealand:** Distributed by UBS New Zealand Ltd. UBS New Zealand Ltd is not a registered bank in New Zealand. The information and recommendations in this publication are provided for general information purposes only. To the extent that any such information or recommendations constitute financial advice, they do not take into account any person's particular financial situation or goals. We recommend that recipients seek advice specific to their circumstances from their financial advisor. **Korea:** Distributed in Korea by UBS Securities Pte. Ltd., Seoul Branch. This document may have been edited or contributed to from time to time by affiliates of UBS Securities Pte. Ltd., Seoul Branch. **Malaysia:** This material is authorized to be distributed in Malaysia by UBS Securities Malaysia Sdn. Bhd (Capital Markets Services License No.: CMSL/A0063/2007). This material is intended for professional/institutional clients only and not for distribution to any retail clients. **India:** Distributed by UBS Securities India Private Ltd. (Corporate Identity Number U67120MH1996PTC097299) 2/F, 2 North Avenue, Maker Maxity, Bandra Kurla Complex, Bandra (East), Mumbai (India) 400051. Phone: +912261556000. It provides brokerage services bearing SEBI Registration Numbers: NSE (Capital Market Segment): INB230951431, NSE (F&O Segment) INF230951431, NSE (Currency Derivatives Segment) INE230951431, BSE (Capital Market Segment) INB010951437; merchant banking services bearing SEBI Registration Number: INM000010809 and Research Analyst services bearing SEBI Registration Number: INH000001204. UBS AG, its affiliates or subsidiaries may have debt holdings or positions in the subject Indian company/companies. Within the past 12 months, UBS AG, its affiliates or subsidiaries may have received compensation for non-investment banking securities-related services and/or non-securities services from the subject Indian company/companies. The subject company/companies may have been a client/clients of UBS AG, its affiliates or subsidiaries during the 12 months preceding the date of distribution of the research report with respect to investment banking and/or non-investment banking securities-related services and/or non-securities services. With regard to information on associates, please refer to the Annual Report at: http://www.ubs.com/global/en/about_ubs/investor_relations/annualreporting.html

The disclosures contained in research documents produced by UBS Limited shall be governed by and construed in accordance with English law.

UBS