PANORAMA

January 2016

Country Risk Barometer
Key challenges of 2016

COFACE ECONOMIC PUBLICATIONS

By Coface Group Economists

After US households in 2007-2008 and Eurozone states in 2011-2012, emerging countries are now getting their turn at the epicentre of the storm, in part because of excessive debt. How did that happen? Growth cut in half in the emerging world between 2010 and 2015, highly expansionary monetary policies after the Lehman Brothers crisis, and the drop in commodity prices since mid-2014 are all part of the answer.

In this environment of increased risks for companies, Coface is downgrading a number of ratings of emerging countries or revising their outlook to negative, in Latin America (Brazil for the 2nd time in less than a year), Africa (South Africa, Algeria, Zambia, Tanzania, Gabon, Namibia, Madagascar), the Middle East (Bahrain), and Asia (Kazakhstan).

A small consolation prize: many economies are more resilient today (increased flexibility of exchange rate regimes, abundant exchange reserves, better capitalisation of banks, low public debt compared to that of advanced economies, etc.) than during the 1990s, which was marked by numerous emerging crises. Furthermore, regions are not affected by this double shock on growth and corporate debt in the same way: for example, there is still little effect on Central Europe at this stage, which has also led Coface to reclassify Hungary's country rating (from B to A4) and revise Latvia's outlook to positive.

On the bright side, the eurozone is continuing to recover gradually, as reflected in the revision of the outlook of Italy's rating to positive. However, cheap oil, the weak euro, and the slow decline in unemployment should not detract from the many sources of possible risk this year, with political risk foremost among them (Spain, Greece, Portugal, etc.). Apart from those whose activity depends very much on the energy sector (Canada downgraded to A2) and/or Chinese growth (negative outlooks for the ratings of Japan, Taiwan, and Hong Kong), the advanced economies overall should continue to benefit from moderate growth in 2016. Unfortunately, this good news will not be enough to restart global growth this year!

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No take-off of growth despite global oil prices at the lowest

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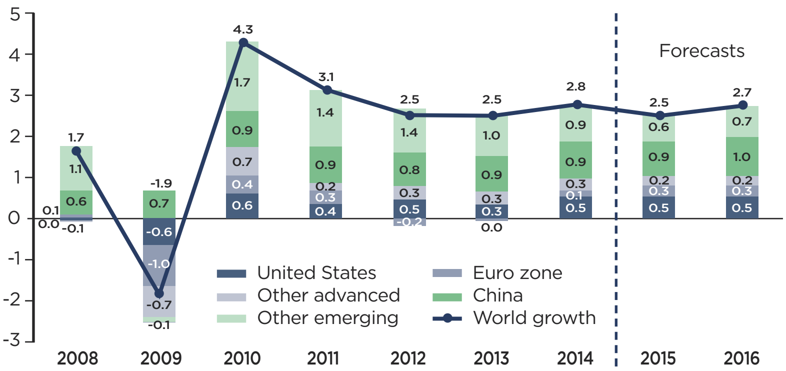
United States and United Kingdom: the growth peak is behind us...

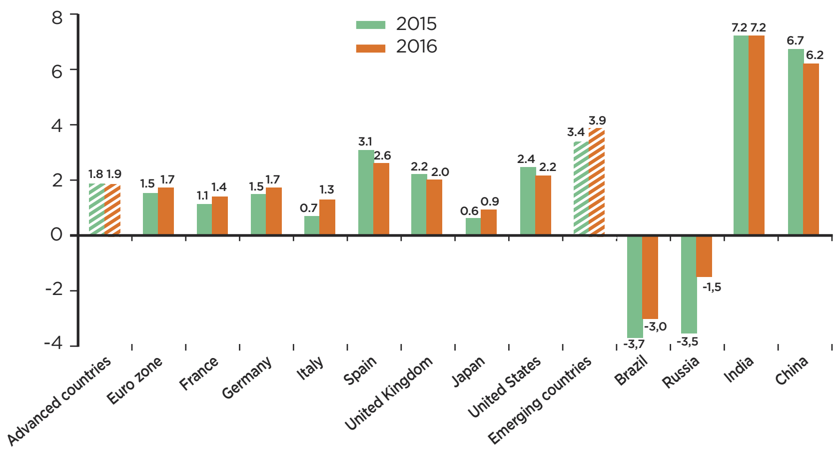
Among advanced economies, the United States and the United Kingdom outperformed the Eurozone in 2015 *(except Spain, see graphs n°1 and 2)*, despite a significant appreciation of their exchange rates and the anticipation of the increase in the US key interest rate, which finally took place on 16 December 2015 and put an end to seven years of zero-rate policy. The dynamism of domestic demand is indeed encouraging there, although a slight slowdown is expected in 2016. In addition, there are political uncertainties for these two countries in 2016, a year marked by new elections in the United States and especially the risk of *Brexit* in the United Kingdom likely to weigh on business confidence. Conversely, performance in Japan is still disappointing, and *Abenomics* does not seem to be producing sufficient results: the risk of deflation lingers, and fiscal consolidation is far from guaranteed. Moreover, the country remains vulnerable to the Chinese slowdown (18% of its exports go to China).

Graph n°1
Contributions to global growth



Sources: IMF, Coface estimates

Graph n°2
Coface growth forecasts (%)



Source: Coface

... and the gap with the Eurozone is reducing

Growth is expected to continue to strengthen in the Eurozone in 2016 (+1.7%, after +1.5%), still fuelled by consumption and investment. The job market's gradual improvement (unemployment rate of 10.7% in October 2015 versus 12.1% at its peak in April 2013), a continued weak euro against the dollar, as well as a lower energy bill will have something to do with this upturn.

In France, growth should be more dynamic, as evidenced by the decline in the number of insolvencies or the sharp increase in the number of start-ups.

In Germany, activity should also be slightly more energetic, despite its relative exposure to the slowdown in emerging markets. Wage growth and low unemployment favour both household consumption and real estate investment. In addition, the increase in the number of refugees should enable an increase in public spending, whereas the impact of the Volkswagen scandal on GDP should be limited.

In Italy, growth should rebound also, favoured by buoyant household consumption, and progress is expected in terms of structural reforms: adoption of Senate reform, accelerated payment of public arrears, and labour market reform. However, credit conditions will remain difficult, as banks continue to be negatively affected by their large amount of non- performing loans.

In Spain, the economy is expected to slow down somewhat this year, but starts from a significantly higher level of growth than its neighbours. Nevertheless, the risk of prolonged uncertainties as to the composition and stability of the future Spanish government weighing on business confidence cannot be ruled out.

An additional positive factor: the situation of companies has improved overall in the Eurozone recently. Business insolvencies have declined in the major European countries, moderately in France, Germany, and Italy (between 3.5% and 5% over the first nine months of 2015 compared with the same period in 2014), but strongly in Spain (-26%). Conversely, Portugal saw a sharp increase in insolvencies in 2015 (+12% compared with 2014).

Emerging countries: no upturn in sight

The concept of the BRICS (Brazil, Russia, India, China, and South Africa) as a synonym for a group of high-growth countries now appears outdated.

Among them, only India continues to stand out, enjoying sustained and stable growth thanks to low commodity prices and the reforms of the Modi government.

In China the slowdown is expected to continue (+6.2%, after +6.7% in 2015), with the structural imbalances of its economy continuing to weigh on businesses: high debt *(see Focus 1 page 5)*, overcapacities existing in many industrial sectors, high corporate debt, loss of competitiveness due to the past appreciation of the yuan, etc. Although the Chinese authorities continued to support the economy through expansionary monetary (lower interest rates and reserve requirements ratios) and fiscal policies (with a fiscal impulse of 0.9 point of potential GDP in 2015, one of the biggest increases since 2008), its interventions remains difficult in a context of gradual financial liberalisation, which also includes increased flexibility of the yuan. Therefore, further financial upheavals should not be ruled out, as evidenced by the closure of the Chinese stock exchange on 4 and 7 January, particularly following the publication of a poor business confidence indicator and the entry into force on 4 January of the measure providing for the closure of the stock exchange when the Chinese reference index CSI 300 decreases by more than 7% (before its abandonment three days later). As in 2015, the ability of the authorities to manage macroeconomic imbalances as well as the volatility of financial markets will be a key factor.

In Turkey, growth will remain moderate, but companies will continue to suffer from high debt and their exposure to fluctuations in the lira *(see Focus 1 page 5)*, especially since the domestic and regional political environment is still difficult, even if December's legislative elections provided more visibility. Lastly, note the negative impact of the Russian embargo on economic activity of around -0.7 point of GDP.

In South Africa, growth is expected to remain sluggish, far from its pre-crisis levels, in a context of power cuts, higher key interest rate, increased twin deficits, depreciation of the rand, and political instability.

The outlook will remain highly deteriorated in Brazil and Russia, countries still marked by recession: the first will still be in a difficult economic and political situation *(see Focus 2 page 6)*, whereas the second will remain considerably affected by the low level of barrel prices. The rouble, whose evolution is highly correlated with oil prices, also reached a new low against the dollar in January 2016, with depreciation of around 50% in a year and a half.

Oil prices should continue to be low in 2016

Beginning of 2016, oil prices reached a new twelve-year low ($30). The volatility of prices recently increased significantly, with the "Oil VIX" exceeding 50 in early 2016 (1) *(see graph n°3)*. Predicting changes in barrel prices thus remains a perilous exercise.

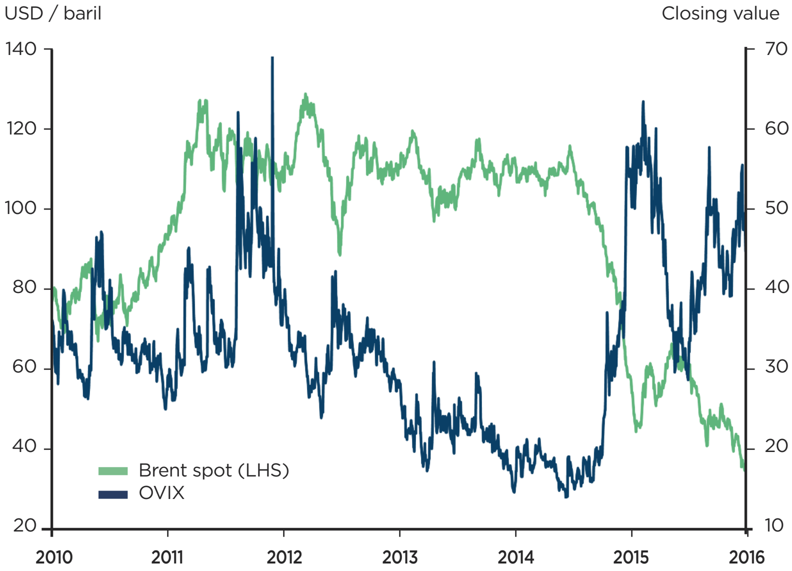
It should remain low in 2015. Indeed the fundamentals indicate that supply is still abundant, but the supply from non-OPEC countries is expected to reduce according to the International Information Agency -IEA- (particularly the US shale oil supply (2)), although OPEC did not provide any numerical quota at the last meeting (previously set to 30 mbd), highlighting the uncertainty around the number of additional barrels Iran will bring to market this year. Nevertheless, global oil demand should slightly increase (+1.2 mbd to 94.6 mbd in 2016), but the oil market overall would continue to have a surplus (particularly with inventories well above their historical average). In addition, the Energy Information Administration -EIA- considers that Iran's return to the oil market following the lifting of sanctions could lead to a price reduction of approximately $5 to $15 in 2016. According to the agency, the country holds 30 million barrels of crude oil in stock and could increase its production to at least 700,000 barrels per day by the end of 2016, the same order of magnitude as claimed by the World Bank. Moreover, although market liquidity is ample and causing high volatility, the influence of financial factors is blurring visibility on the future evolution of oil prices.

2016: a year of tension

Global activity is ultimately not expected to bounce back significantly in 2016 (+2.7%, after +2.5%). Significant risks, although already known, remain, such a slowdown in Chinese activity more pronounced than anticipated and changes in commodity prices. On the political and geopolitical level, uncertainties remain high, whether within developed countries (United States, United Kingdom, Spain) or emerging countries (recent increase in instability in the Middle East because of tensions between Iran and Saudi Arabia in particular). In addition, the risk of terrorism has also increased around the world (France, Tunisia, Egypt, Lebanon, etc.) and could lead to stronger nationalist movements. Finally, the question of migration should remain a key issue after the record level of 2015 (according to the World Bank, the number of migrants exceeded 250 million (3)).

Graph n°3

Oil: price of Brent and Oil VIX



Sources: CBOE and Datastream, last available data: 7 january 2016

(1) The "Oil Vix" is an index measuring "implied" volatility on financial markets. It records anticipated movements in barrel prices in 30 days. Reaching 56.2 on 7 January, the participants anticipate that oil prices may fluctuate by 56.2% more or less in the next 30 days.

(2) The American energy sector will continue to suffer from the decline in the price of a barrel. Shale oil producers have refocused on oil wells offering the best returns in order to limit their costs. Thus, in 2015, more than 60% of rotary rig counts were closed.

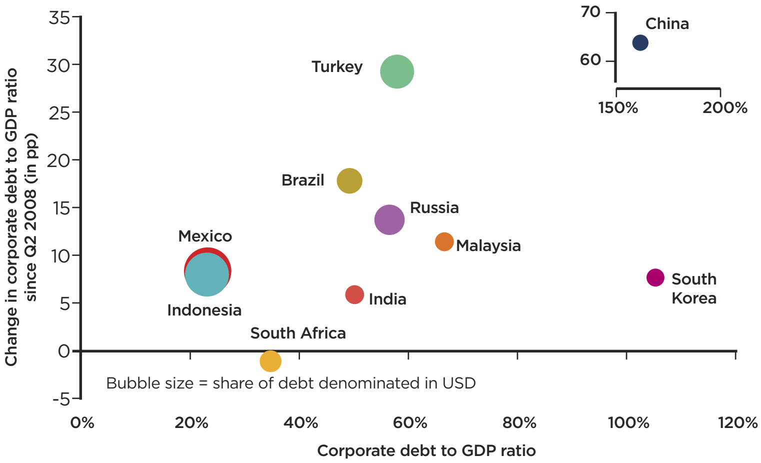
(3) Migrations and remittances factbook 2016, World Bank, December 2015.

FOCUS 1 :

Businesses in emerging countries: the new subprimes of the global economy?

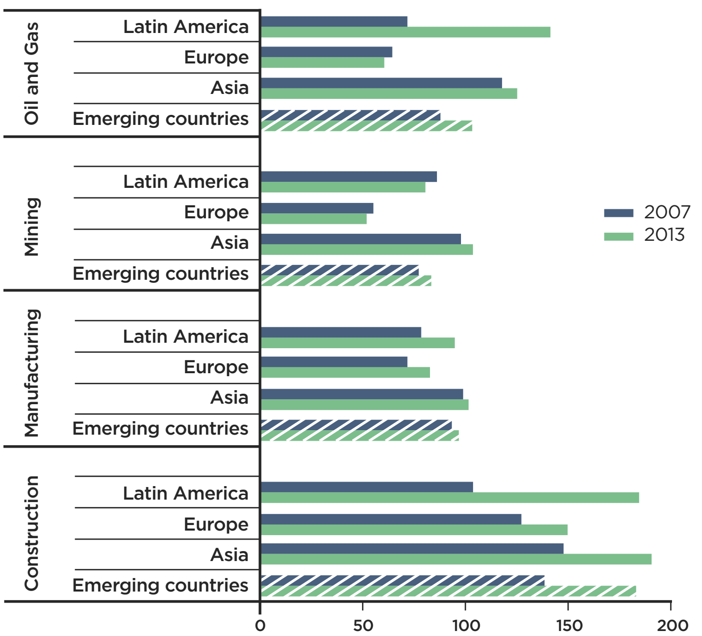
In addition to sluggish GDP growth negatively affecting their profitability, businesses in emerging countries are currently facing a second problem: their growing debt. It multiplied by a factor of 4.5 between 2004 and 2014 in absolute value.

Graph n°4
Corporate debt as % of GDP
(Exemple: South Korea : 8 % - Mexico : 66 %)



Sources: BIS, Coface

Graph n°5
Corporate debt (ratio between total debt and total capital)



Source: FMI

Relative to GDP, it increased by 26 percentage points during the same period. This upward trend involves most of the major emerging countries, although the extent of the increase differs from one country to another. Chinese companies lead the pack in terms of debt: their debt now represents more than 160% of GDP, 60 points more than in 2008 *(see graph n°4)*. Next come Turkey (approximately +30 points), Brazil, Russia, and Malaysia. Similarly, rising debt is affecting companies in all major business sectors. It is most pronounced in construction sector, followed by that of energy *(see graph n°5)*.

How do we explain this trend? First of all, the expansionary monetary policies decided upon after the bankruptcy of Lehman Brothers relaxed bank lending conditions in emerging countries. The deepening of local financial markets and, in particular, the development of bond markets during the 2000s also contributed to the indebtedness of companies in emerging countries. Although bank loans still account for the largest share of this debt, the weight of bonds is increasing rapidly (from 9% in 2004 to 17% in 2014).

Increased indebtedness is not necessarily bad news, given that it makes it possible to finance further investment and therefore stronger growth. However, recent times have shown that debt and growth do not necessarily go hand in hand, since growth decreased from 7.2% in 2010 to 3.4% in 2015 for emerging countries overall. Beyond a certain threshold, high debt means greater interest expenses and therefore less ability to invest. The IMF echoes this thinking, stressing that crises preceded by excess private debt are deeper, and recovery is slower than for other types of crisis [3].

More specifically, corporate debt denominated in dollars is now garnering everyone's attention. Its nature and weight vary considerably from one country to another. It may involve credit from international banks or bonds issued on international markets by large businesses through their subsidiary abroad. Yet, it also involves credit denominated in dollars obtained by SMEs from their local bank. While the massive debt of Chinese companies is essentially in local currency, this is not the case for Turkey. This exposes local businesses to currency risk such as that in 2015, when the Turkish lira depreciated by around 20% against the dollar in 2015 compared to 2014. However, note that this exchange

(4) Bornhorst F. and Ruiz Arranz M. (2011): "Growth and the Importance of Sequencing Debt Reduction across Sectors", Jobs and Growth: Supporting the European Recovery, Chapter 2, International Monetary Fund.

risk can be limited through hedging instruments (derivatives). Businesses whose revenues are mainly denominated in dollars (energy and mining sector, for example) benefit from a "natural hedge".

In an environment seeing a gradual rise in US rates conducive to capital outflows from emerging countries, and low commodity prices favouring the deterioration of the trade balance of many of them, their central banks will be faced with a difficult choice in 2016, if emerging currencies continue to depreciate. They will have to increase their rates to limit these downward pressures, at the risk of increasing the vulnerability of companies already heavily in debt, or let the currency depreciate, at the risk of penalising companies with debt in foreign currencies.

FOCUS 2 :

Renewal of the political landscape in Latin America – what changes await the region?

The year 2015, and in particular the month of December, was characterised by historical political changes in Latin America.

In Argentina, Mauricio Macri's victory in the presidential elections has put an end to 12 years of "Kirchnerism". In Venezuela, the opposition party's victory in the legislative elections is a strong sign of the weakening of "Chavism". Beyond these symbols, though, the concrete changes to be expected, particularly from an economic point of view, are quite different.

In Argentina, President Macri has proven to be very proactive since his inauguration on 10 December by putting an end to currency control (the exchange rate was devalued by about 30% against the dollar). He also promised to remove export taxes on several agricultural products for this country deemed to be among the most protectionist in the world. Nevertheless, in the short term, these adjustments should be painful for the economy in an environment of low foreign exchange reserves, given that the devaluation of the peso is likely to lead to additional upward pressures on prices through imported products. In the medium term, though, the normalisation of economic policies should restore efficiency and increase the country's growth potential.

In Venezuela, the victory of the opposition party (the Democratic Unity Roundtable – MUD) shows the limitations of the "Chavist" model and the popular discontent with the population strongly affected by the consequences of falling oil prices (95% of exports), notably through hyperinflation. The deputies, who took up their duties on 5 January, are expected to try to put an end to President Maduro's current mandate. However, the MUD coalition is fragmented and does not have a clearly defined economic agenda, blurring the future directions of the government, in a context in which the risk of default remains very high for 2016.

As for Brazil, it seems to be sinking into recession and political crisis. The government's lack of credibility, particularly from a budgetary point of view (which led S&P and Fitch to downgrade the country's rating to speculative in September and December 2015 respectively) is harming the country considerably. The Minister of Finance, Joaquim Levy, appointed at the beginning of the year and whose reputation of orthodoxy reassured investors, left the government in December. President Dilma Rousseff, re-elected a little more than a year ago, is seeing record levels of unpopularity. She is now the target of impeachment proceedings in connection with the Petrobras corruption scandal and also accused of falsifying the government's accounts.

Cuba provides a glimmer of hope. 2015 was marked by the thaw in relations with the United States (severance of diplomatic relations since 1961) with the opening of their respective embassies. The embargo is still in effect, but its lifting would lead to a return of foreign capital and increased tourism, which suggests a market with potential. Main drawback to be emphasised: Venezuela remains Cuba's main trading partner, with around 40% of transactions, both for export and import. It is therefore sensitive to changes in Venezuela's situation.

COUNTRY RISK ASSESSEMENTS CHANGES

CORPORATE DEFAULT PROBABILITY

A1: VERY LOW
A2: LOW
A3: ACCEPTABLE
A4: QUITE ACCEPTABLE
B: SIGNIFICANT
C: HIGH
D: VERY HIGH

↗ Country under positive watch list
↘ Country under negative watch list

Assessment either upgraded, or removed from negative watch list or placed under positive watch list

Country	Country risk previous	Country risk new
Hungary	B↗	A4
Italy	B	B↗
Latvia	B	B↗
Ivory Coast	C	C↗

Assessment either downgraded, or removed from positive watch list or placed under negative watch list

Country	Country risk previous	Country risk new
Hong Kong	A1	A1↘
Japan	A1	A1↘
Taiwan	A1	A1↘
Canada	A1↘	A2
Finland	A2	A2↘
Namibia	A3	A3↘
South Africa	A4↘	B
Algeria	A4↘	B
Bahrain	A4↘	B
Kazakhstan	B	B↘
Brazil	B	C
Gabon	B↘	C
Tanzania	B↘	C
Zambia	C	C↘
Madagascar	C↘	D

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