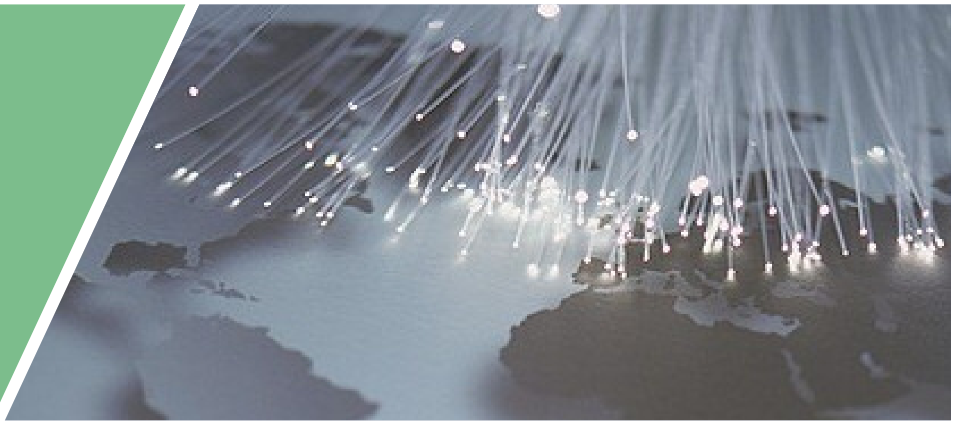
THE COFACE ECONOMIC PUBLICATION

panorama

Spring 2013

coface

Country Risk



CONTENTS

FOCUS

In this Panorama, Coface highlights the radical transformation of risks in emerging countries. While traditional country risk (sovereign risk, external vulnerability) has appreciably declined, three new risks are appearing and need to be monitored:

- **The risk of political instability**

  This risk has grown as emerging country societies now have new demands and increasingly the means of expressing them. So with the help of a renewed framework for assessing political risk, Coface can demonstrate that there is still a high risk of instability in countries in the North African/Middle Eastern region. Venezuela, Russia, China, Nigeria and Kazakhstan are facing significant pressures for change too.

- **The risk of creeping protectionism**

  This protectionism (financial but also trade) is the result of exogenous shocks which have affected emerging countries since 2008. It could, in future, involve possible payment deadlines for importers but also more barriers to entry for foreign businesses wanting to take advantage of the emerging economies' vigorous domestic demand. Argentina, Russia and, to a lesser degree, India, are the countries to watch.

- **Banking credit risk**

  Bank credit has been very dynamic in the emerging countries, to the point of forming real bubbles in the business and household credit markets. Coface points out the countries where there is a danger of such credit booms. Some Asian emerging countries, buoyed by a very favourable growth dynamic, have credit markets that need watching. Chile, Turkey, Russia and Venezuela are also recording excessive credit growth.

Transformation of emerging country risk

Julien Marcilly, Yves Zlotowski
Finalised on 6 March 2013

Lehman Brother's collapse and its consequences on advanced economies have radically changed the country risk assessment. Risks associated with most advanced countries have distinctly increased, particularly because of the explosion of their public debt and their weak economic growth. Conversely, emerging countries have appeared less risky: their public debt has continued to decline despite the crisis, their foreign currency liquidity has remained very comfortable and growth has been robust. Long-term trends confirm this: the median potential growth rate of emerging economies more than doubled from the 1970-1989 period to the 1990-2007 one, rising from 1.5 to 3.5%. At the same time, the standard deviation of GDP growth fell from 4.25 to 3.25%. In other words, emerging country growth rates are now stronger than they were, with less marked fluctuations.

But their strong fundamentals have not prevented economic activity in the emerging countries from taking a temporary hit due to the recession of the main advanced economies in 2008-2009. This has had secondary effects on their growth via different channels (trade, investment, banks). Confronted with this temporary shock, the reactions of the economies and businesses of the emerging countries have been as diverse as they have been many, but can nonetheless be summarised in a single word: resistance, although this resistance has taken several forms. Politically, the rise in unemployment and increased inequality resulting from the crisis is one of the triggers of the protest movements in the Middle East and North Africa. Economically, this resistance was at first characterised by the rise of protectionism in various forms (for example trade protectionism, capital controls) and also resulted in far-reaching economic stimulus measures, mainly through monetary policies. These measures then led to an excessive credit growth in several emerging countries.

These recent changes underline the fact that the nature of the risks in the emerging countries has profoundly altered: traditional country risk (sovereign risk, external vulnerability) seems to have diminished, but new risks have appeared. In this Panorama we focus particularly on three of these new risks, which result in part from the 2008-2009 global crisis and which are affecting emerging countries today: political and social risk, protectionism risk and credit bubble risk.

MORE POLARISED SOCIETIES [1]

New grounds for political tension in emerging countries

The wave of Arab revolutions has had a seismic effect on traditional country risk. As a general rule, political upheavals are poorly anticipated both by private observers and by academic researchers. The regimes of Hosni Mubarak in Egypt (President from 1981 to 2011) or of Zine El Abedine Ben Ali in Tunisia (Tunisian Head of State from 1987 to 2011), were considered stable. Only the periods of succession were seen as potentially problematic. Unrest could arise from « endogenous » changes in the political regime itself, but not from « exogenous » societal pressures.

The globalisation of protests has also caused surprise. Through a subtle process of imitation and representation, the Tunisian revolution was followed by similar uprisings: Egypt, Libya and Yemen have had their authoritarian regimes overthrown. Moreover, demonstrations have been held in Bahrain, Morocco and Jordan. But this wave goes beyond the Arab countries alone: in late December 2012, because of legislative elections, unprecedented protest movements developed in Russia. In 2011 and again in 2012, India was shaken by protests against corruption and then against violence inflicted on women. In 2012, South Africa was the scene of an unusually violent social movement in the mines. These various episodes of tension seem dissimilar. However, these protests – whether or not they result in revolutions – express a form of social exasperation with institutions under notice to account for their actions. Since the Tunisian revolution, the societies of emerging countries have given voice to their latent concerns. What is it in this area that has been ignored or underestimated by the framework for assessing country risk?

Political and institutional demands

The traditional social and economic indicators (unemployment, inequalities, inflation, GDP per capita) remain key variables. However, they do not entirely account for the reasons for the « exasperation ». It is interesting to note that the Egyptian revolution took place after years of record growth for Egypt [2] and that Tunisia seemed to be a model of reform. The IMF acknowledges in a recent publication [3] that the strategy of separating

(1) This section was written with the contribution of Guillaume Baqué.
(2) Between 2006 and 2008, the GDP annual average growth rate in Egypt was 7%. Between 1998 and 2008 Tunisian GDP per capita in dollars rose from 2336 to 4345 (source: IMF).

political and economic reforms has not worked. Without a system of « checks and balances » by society, reforms and growth have increased inequalities and sustained frustration. Marwan Muasher quotes the example of privatisations, which in a deficient system of governance, is tantamount to the grabbing of public assets by an elite close to the government. All in all, reforms aimed at economic liberalisation promoted by international institutions may have had devastating consequences, when they have not been accompanied by political reforms.

We also note that the slogans of the demonstrators often refer to governance. The corruption issue is often cited (4). The young Tunisian vegetable seller, Mohammed Bouazizi, who set fire to himself at Sidi Bouzid in December 2010, had had his scales and his merchandise confiscated because he was in a prohibited place (the taxi rank outside the governor's office). Mr Bouazizi's act had a massive impact, firstly because of its tragic and desperate nature, but also because it embodied a significant situational deadlock frequently experienced by citizens. In this particular case, the barriers to entry handicapped the small-scale entrepreneurship synonymous with survival. Society had become incapable of allowing essential initiatives (economic or political) to develop and the obstacles were such that they could only be overcome by a disruptive act.

The people of emerging countries are asking for political and institutional reforms allowing them greater political and economic participation. They are demanding democracy as defined by Armatya Sen, that is to say a demand for participation, for deliberation and for new aspirations to be taken into account. It is therefore more far-reaching than the demand for formal elections and it is for this reason that this demand also occurs in countries which have democratic institutions, like India. The obstacles to participation in political or economic life are not the result merely of the absence of freedom of speech. They are also sometimes the result of less formal invisible rules (for example, failure to safeguard property rights, corruption and invasive administrative harassment, barriers to the socio-economic and political development of women, of the young) which have become intolerable.

Profound cultural changes often ignored

If the demand for democracy (in the broad sense) has become increasingly important in emerging countries, it is also because societies have more means of instigating it. The depth of civil society in authoritarian political systems has been underestimated. Economic prosperity plays a driving role by freeing citizens from the concerns of mere survival. This evolution of needs is characterised by the famous pyramid developed by the psychologist Abraham Maslow, representing a hierarchy of individuals' needs based on the idea that these needs evolve as they are satisfied. When survival needs are met, other needs must also be satisfied (security, belonging, esteem, achievement, in the order defined by Maslow). The rise in the education of the young is also an essential driver of frustrations. The researcher, Florence Gaub, in her summary of the lessons to be drawn from the Arab spring (5) gives considerable weight to the frustration linked to the arrival of young graduates on job markets unable to absorb them: « Although described as strong, Tunisian state institutions were finally incapable of filling the gap which the educational reforms had created between expectations and reality ». Finally, the role of women in Arab societies has evolved profoundly and many of them were present in the demonstrations, both in Egypt and in Tunisia. The demographer, Philippe Fargues, a specialist in the Arab world notes that in the MENA region, « whereas in the past a high fertility rate was linked to early marriages and the low participation of women in the economy...the fertility rate fell from 7 children per woman in 1960 to 2.9 in 2008 » (6). Democratic demands therefore also concern gender, since profound demographic changes have changed the role of women in Arab societies.

Finally social networks are a new way of expressing frustration. Internet access in many emerging countries has literally exploded. Social networks play two roles. They are a means of rapid mobilisation, easy to use and poorly controlled by the authorities. But, further upstream, they are similar to a democratic experiment allowing many young people to express themselves freely in an admittedly virtual but non-hierarchical world. Gradually the discrepancy between the obstacles in real society and the freedom experienced on the screen has become difficult to accept. It should be remembered that the Russian activist and dissident Alexey Navalnyi made his reputation, among other things, thanks to his « Rosspil » site, which suggested to Russian citizens that from the end of 2010 they list, by means of completely official public documents, misappropriation of funds by the administrations in the area of public procurements.

Towards a redefinition of the indicators of political risk

From this rapid analysis, the indicators of political risk seem to us to be of two kinds: pressures for change can be measured by variables which represent the degree of intensity of economic, social and political frustrations in a given country. Inequalities, the scale of unemployment, political freedoms, and corruption constitute the multidimensional drivers of these frustrations. However, the existence of these tensions, even if very intense, does not mean that social disruption will occur. The capacity of societies to transform these pressures into effective change requires the development of instruments which themselves allow the expression, channelling and mobilisation of these discontents. The development of such instruments, of an essentially cultural nature, has played a key role in Arab countries. It is about the level of education, increased access to the Internet, urbanisation, the fertility rate and the rate of women's participation in the labour market. In our analysis, these cultural changes are a measure of a society's capacity to transform frustration into political action.

(3) See especially Muasher M. (2013), Freedom and Bread Go Together, in the special number devoted to Middle Eastern countries « The Middle-East: Focus on the Future », Finance & Development, March 2013.

(4) The subject of corruption was at the centre of the Russian demonstrations of December 2011 and January 2012. The fight against corruption was behind the movement led by the militant Anna Hazare, which led to massive torchlight vigils in Delhi in 2011.

(5) F. Gaub (2012) « Lessons Learnt: Understanding instability: Lessons from the « Arab Spring », AHRC Policy Series n°9, Arts and Humanities Research Council, Report for the « History of British Intelligence and Security Research Project » December 2012.

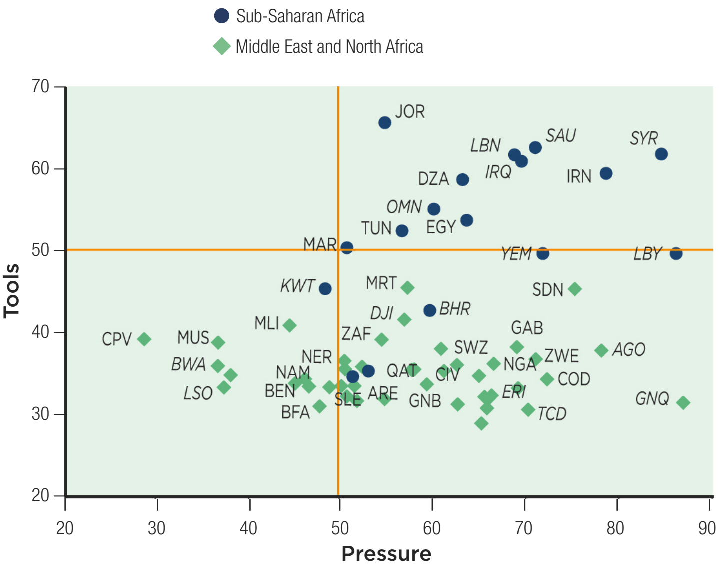
(6) Ph. Fargues (2008), Emerging Demographic patterns across theMediterranean and their Implications for Migration through 2030, Migration Policy Institute, Transatlantic Council on Migration, November.

The political risk must therefore combine two types of module, as summarised in the following table. Each of these modules – pressures for change and instruments of change – is composed respectively of a combination of 6 and 7 elements, the total weighting of which comes to 100%. In the « pressures » module, the level of unemployment, corruption and freedom of expression (« expression and responsibility ») have the most important relative weighting, i.e. more than 20%.

Pressures for change	GDP per capita * Inflation * Unemployment * GINI ** Expression and responsibility ** Control of corruption **
Instruments for change	Higher education rate ** Adult literacy rate ** Internet access ** Proportion of young people ** Fertility rate ** Urbanisation rate ** Female participation rate **

* Source: IMF
** Source: World Bank

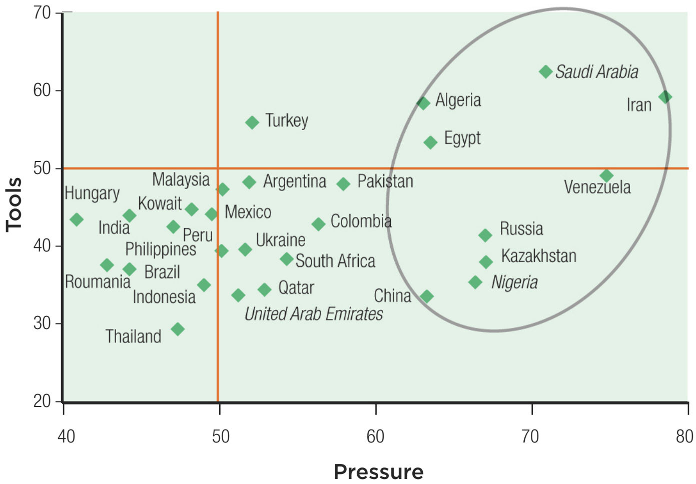
In the « instrument » module, the proportion of young people and the participation of women have a relatively higher weighting of over 30%.



Countries in italic: Only 90% of aggregates comprising the synthetic indicator available
Source: Coface

The graphs combine the two modules: the pressures for change (X-axis) and the instruments of change (Y-axis). Numerous Sub-Saharan African countries are in the lower right hand part of the table. Strong pressures for change are associated with a relatively weak presence of the « instruments ». We can interpret this result as follows: the frustrations are immense but the capacity of societies to provoke political disruption is relatively limited. On the other hand, many of the countries of the North Africa/Middle East region (Syria, Iran, Lebanon, Jordan, Algeria, Egypt, Tunisia, Saudi-Arabia) are situated in the top right hand part of the graph, which shows a combination of strong pressures for change and significant instruments, resulting in large-scale political changes or recurrent demonstrations, as in Jordan. One of the major challenges is that the political transitions need to be capable of dealing with the frustrations which gave rise to them, which is the source of the recurrent instability in post-revolutionary Tunisia and Egypt.

30 emerging countries (2011 GDP)



Countries in italic: Only 90% of aggregates comprising the synthetic indicator available
Source: Coface

If we place 30 emerging countries selected by their importance, the North Africa/Middle East region is again clearly distinguished from the other regions occupying the top right hand part of the graph. We note that Nigeria, Venezuela, Russia, Kazakhstan and China have pressures for change at a level above or equal to the Tunisian and Egyptian situations. This configuration calls for two comments:

- In systems characterised by uncertain political transitions as in Venezuela (a topical case in the context of the death of Hugo Chavez announced at the beginning of March 2013), the polarisation can be virulently expressed when elections are held.
- The capacity of state institutions to respond to a high frustration level varies and are not taken into account in this diagram. Systems, whether or not democratic, are sometimes able to reform themselves without disruption. However, political regimes which are undergoing enormous pressures for change and strong popular mobilisation can choose the path of radical repression, as in the cases of Iran and Syria. The existing regimes then take the risk that disruptions will be even more violent and destabilising than the Tunisian and Egyptian revolutions. Repression has in fact led to bloody civil war in the Syrian case. The « respite » from the disturbances in Iran probably will not last.

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The « Arab Spring » two years on: North Africa and the Middle East in constant turmoil

Pierre Paganelli

After two years of political, social and economic turmoil, the transition in the states of the Arab world which underwent upheaval – Tunisia and Egypt in particular – remains problematic. In Syria the « unfinished » revolution took a dramatic turn, transforming itself into a civil war. Since 2011, other Arab countries, such as Jordan, Morocco and Algeria, have faced less intensive political and social opposition.

Conservative Islamists faced with the difficulty of exercising power in Tunisia and Egypt

In these two countries, democratic elections brought previously illegal conservative Islamist parties to power, chiefly because of their better organisation and their integration into society through their mutual aid networks. Growing polarisation between the Islamists, who put their religious identity first, and the secular nationalists, however, threatens the stability of these countries. These two opposing groups think they have democratic legitimacy and that they represent the spirit of the revolution. The governments in place, inexperienced to boot, therefore do not enjoy a political consensus and face complex structural problems and high popular expectations.

In Tunisia, the gulf is growing between the Islamists and the secular parties or forces, following the assassination of Chokri Belaid, a secular opposition figure, at the beginning of February 2013. This political climate will delay the drafting of the future constitution and the holding of legislative and presidential elections, probably postponed from June to the end of 2013. Moreover, social tensions are growing because of the still high unemployment rate, particularly among the young, and the great social and geographical inequalities. The conservative Islamists profess a liberal economic programme but are experiencing difficulty in implementing an economic policy. The effect of this climate is to undermine the political transition process as well as the fragile economic and financial equilibrium.

In Egypt the wide-ranging powers that the conservative Islamist president, Mohamed Morsi, of the Muslim Brotherhood, has arrogated to himself have provoked big demonstrations since the end of 2012, with a polarisation between Islamists and non-Islamists. The protests are also motivated by the controversial approval by referendum at the end of 2012 of a new constitution drawn up by an assembly dominated by the Islamists and disputed by the opposition. Uncertainty will remain at least until new elections, originally scheduled for the end of April 2013 but suspended at this stage. Such elections, due, among other things, to their boycott by the opposition, could cement the control of power by the Islamists in a more authoritarian way. Moreover, the direction of economic policy is uncertain, which, in particular, is illustrated by the difficulty the authorities have in reaching an agreement with the IMF, whereas the economic and financial situation is getting worse.

Civil war conditions in Syria

President Bashar al-Assad's regime's military repression of the opposition has led to civil war. In this context, Syria's international isolation has increased, the country being subject to sanctions by the United States, the European Union, Turkey and the Arab League. However, the Syrian regime is likely to continue counting on Russian and Chinese and diplomatic support, as well as economic and military aid from Iran.

In spite of increased control of several areas in the country by the Free Syrian army and by jihadist groups, these disparate forces have insufficient military capacity to overthrow the regime quickly. Politically, the National Coalition of Opposition and Revolutionary Forces formed at the end of 2012 has not been able to take adequate measures to lessen the disagreements within that opposition.

Consequently, the most likely situation is the continuation of the civil war in 2013, with a de facto partition of the country. In the final analysis, the regime – of which the hard core is limited to the Alawite minority (about 12% of the population) – could succumb to the rise in the power of the armed rebellion, to a social revolt linked to the worsening of the economic crisis in which the country is plunged, to external pressures or a combination of all these factors.

In monarchies poorly endowed with natural energy resources, cosmetic changes in Jordan and soft change in Morocco.

In Jordan there have been successive demonstrations since 2011 and the government remains faced with the divergent demands of the loyalists and the tribes on one side, and of the opposition on the other, in particular of the Islamic Action Front, an offshoot of the Muslim Brotherhood, which is demanding a constitutional monarchy. Added to this are the problems related to Jordanian / Palestinian relations within the kingdom (Palestinians making up over 60% of the total population). Moreover, renewed protests are likely, due to the reduction in subsidies resulting from the agreement concluded with the IMF in August 2012. So, despite the beginning of reforms, King Abdullah II – who still has broad support amongst the population and the support of the armed forces – wants to keep the essentials of power. In this context, Jordan is over-exposed to regional political instability, particularly in Egypt and in Syria, with the risk that the fall of the Syrian regime will strengthen the Islamist opposition and weaken the Hashemite monarchy a little more.

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Pierre Paganelli

(continued)

In Morocco, in response to growing political and social dissatisfaction and in the light of the uprisings in the Arab world, constitutional reform initiated by King Mohamed VI in mid-2011, is aimed at rebalancing the monarchy by strengthening the powers of the prime minister and Parliament. It does not, however, essentially change the prerogatives of the Moroccan monarch, who remains popular. A small part of the population, however, complains of corruption and clientelism, protest movements implicating in this respect certain members of the King's close entourage. The legislative elections at the end of 2011 resulted in a relative majority of the (Islamist) Justice and Development Party, the nomination of its leader as prime minister and the formation in early 2012 of a government coalition with three secular parties. In this framework, the implementation of the new constitution seems to be on track, but the search for greater social justice will be more problematic, involving a risk of rising tensions.

The apparent Algerian « exception »

Popular protests are recurrent in Algeria, without presenting a real threat to the regime. After the trauma of the hidden civil war of the nineteen-nineties, the population aspires more to peace than to a revolutionary experience, despite popular discontent. Moreover, thanks to a hydrocarbon windfall, the government has the means to ease political and social opposition by, for example, taking various measures from early 2011, such as public sector wage rises or increased subsidies. In this context the May 2012 legislative elections, marked by a high level of abstention, did not lead to the dominance of the Islamist parties, as the ruling nationalist coalition kept its majority. The next important date will be the April 2014 presidential election in which President A. Bouteflika is not expected to seek a fourth term. After the ousting, in early 2013, of the leaders of the two main government coalition parties, the outcome of his succession is unpredictable at this stage. Moreover, despite a relatively improved security situation, the activism of radical Islamist groups has intensified on the country's southern borders, as was shown by the attack on the In Amenas gas complex in January 2013.

Before any improvement, the situation is likely to deteriorate, especially in the countries at the forefront of change, namely Tunisia and Egypt. After decades of authoritarian regimes, the transition processes will be long and it will take time for stable political systems to emerge in countries that have experienced uprisings.

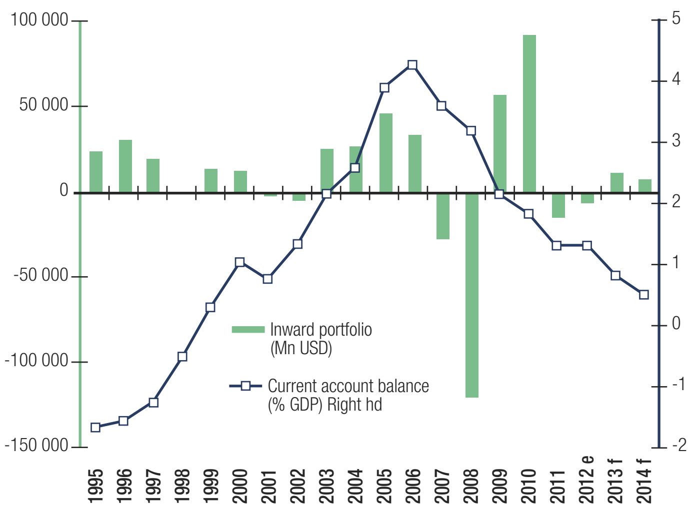
ECONOMIES MORE PROTECTED

Growing use of capital controls

Since the fall of Lehman Brothers, the emerging countries have put in place an unprecedented series of capital controls to mitigate the shocks suffered by emerging countries' balances of payments in 2008. The data available from the IFI (International Finance Institute) indicate that net portfolio flows (7) reached a record outflow level of 120.6 billion dollars in 2008. Two years later, in 2010 the net flows were positive and reached a record net inflow level of 90.8 billion dollars. This volatility of speculative flows is destabilising: massive inflows lead to strong currency appreciation, which affects the manufacturing sector's competitiveness. Sudden outflows are dangerous for businesses or banks exposed to exchange rate risk. The capital controls introduced therefore result from this volatility. Moreover, the determinants of this volatility are exogenous to the emerging countries. Unlike the crises of the nineteen-nineties, the dynamic of the capital flows is actually the result of the subprime crisis and the Fed's unconventional policy (quantitative easing) and the Eurozone sovereign crisis. The advanced countries are the epicentre of these driving forces. Accordingly, capital controls, in a way legitimised, are considered as a means of protection against shocks for which the emerging countries are not responsible.

Capital flows and current account balance in emerging countries

Source: IIF



(7) The portfolio flows correspond to purchases by non-residents of bonds or shares (as a small proportion of an entity's total capital). They are volatile by definition.

Indeed, the doctrine of international financial institutions has very noticeably evolved along with the return of capital controls. In November 2012, the IMF [8] (after several fruitless attempts, as they were heavily criticised by India and Brazil, which considered their positions insufficiently favourable to capital controls) published a balanced « institutional view », which acknowledged the potential benefits of controls. These are no longer considered as an ineffective and provisional expedient. Their relevance is of course discussed according to the case, but it is seen as being linked to the maturity of the financial sectors, which can, if they are still weak, benefit from the protection they provide. Moreover, the IMF stresses the fact that reform must also come from the countries exporting speculative capital. The doctrine as a whole calls into question the systematically positive character of financial openness.

The measures taken in the wake of the 2008 crisis encompass three different types of capital control to meet different needs. The first (like the Brazilian tax) is the use of instruments for the regulation of markets which act directly on the capital flows themselves via taxation or restrictive measures. Taxation mainly targets the exchange rate and, in the light of this objective, its effectiveness is a matter for debate (cf. box). The second type of control consists in limiting convertibility. This is about restricting residents' access to foreign exchange (or conversely of non-residents to the domestic currency), as illustrated by the measures introduced in Argentina. Finally, a third group of measures falls within the field of the prudential regulation of banks. These measures tend to limit bank exposure to exchange rate risk (as in the case of measures taken in South Korea). In the Korean case [9], the aim is to protect a banking system very exposed to the volatility of the won.

The wave of capital controls must be seen as a resort to pragmatism. The authorities of emerging countries no longer hesitate to use unorthodox measures and will no longer be content with discretionary interventions on the foreign exchange market. Firmer regulation of financial openness is becoming a tool for combating excessive currency appreciation or for protecting the financial system. In practice this also means greater difficulty in gaining access to foreign currencies. Many countries have made it more difficult to obtain import licences or have restricted importers' access to foreign exchange (China, Argentina, Brazil). This growing use of restrictive measures – which can, admittedly, be justified from a macroeconomic point of view – is likely to result in longer payment delays for exporters. More generally, capital controls signal the end of an ideology which systematically favours market liberalisation solutions. Since the crisis financial opening up is no longer considered as a panacea, either by emerging countries or by international financial institutions. And the general questioning of the systematic opening up of capital markets increasingly applies also to the market for goods and services.

(8) International Monetary Fund (2012), The Liberalization and Management of Capital Flows: An Institutional View, November 14.

(9) In November 2012, the external liabilities of the South Korean banking system represented 187% of external assets (source: IMF).

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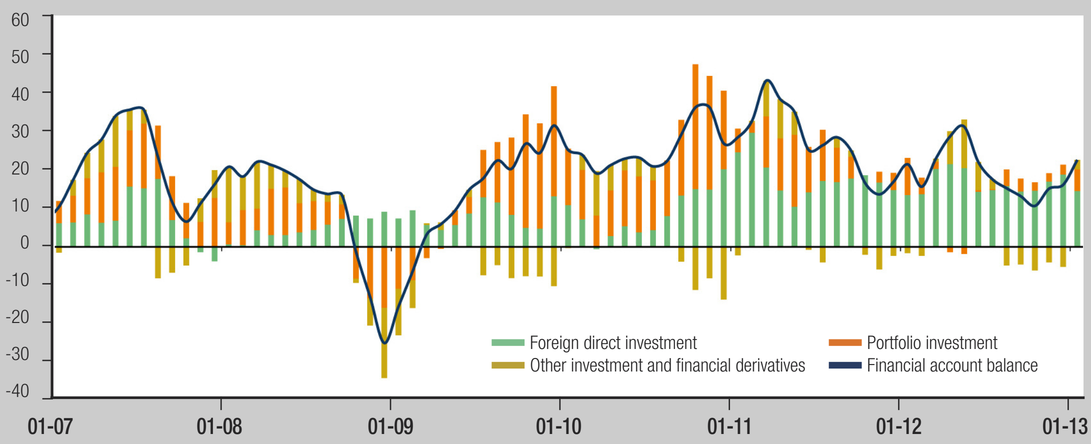
Effects of capital controls: The example of Brazil

Axelle Fofana

The Brazilian real appreciated strongly between the end of 2008 and July 2011, going from BRL2.6 for a USD to 1.53. This appreciation resulted mainly from an upward trend of capital inflows into Brazil since the spring of 2009, in a context of abundant global liquidity and investors' search for yields. Net capital flows therefore climbed from 3 billion dollars to nearly 23 billion dollars [10] between March 2009 and January 2013 (see graph below). Though the country attracts many foreign direct investments, the proportion of the most volatile portfolio investments also increased over the period.

Brazil: Net capital flows (USD billion)



Source: Datastream

(10) Net capital flows expressed as a 3-month sum.

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Axelle Fofana

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In order to limit the appreciation of the real, deemed damaging to the competitiveness of the manufacturing sector, the Brazilian authorities introduced several capital control measures from 2008:

- A financial transactions tax (IOF) of 1.5% on foreign investments on the local bond market was passed in March 2008. Abolished in 2008, when the real was subject to downward pressures, the tax was then reinstated in October 2009 (2%) and increased in October 2010 (6%). Meanwhile, a 2% tax was levied between October 2009 and December 2011 on foreign investments in equities, in order to affect all portfolio inflows. These measures were abolished at the end of 2011 in the context of a strong depreciation of the real, with the return of global risk aversion.
- Loans contracted abroad were also subjected to the tax on financial transactions. At first 2%, the tax on borrowing with a maturity of one year went up to 6% in March 2011. This tax was extended to securities with up to 2 years maturity in April 2011, then to up to 5 years maturity in March 2012. The government then reasserted its intention of curbing an over-appreciation of the Brazilian currency in a context of a global decline in risk aversion.

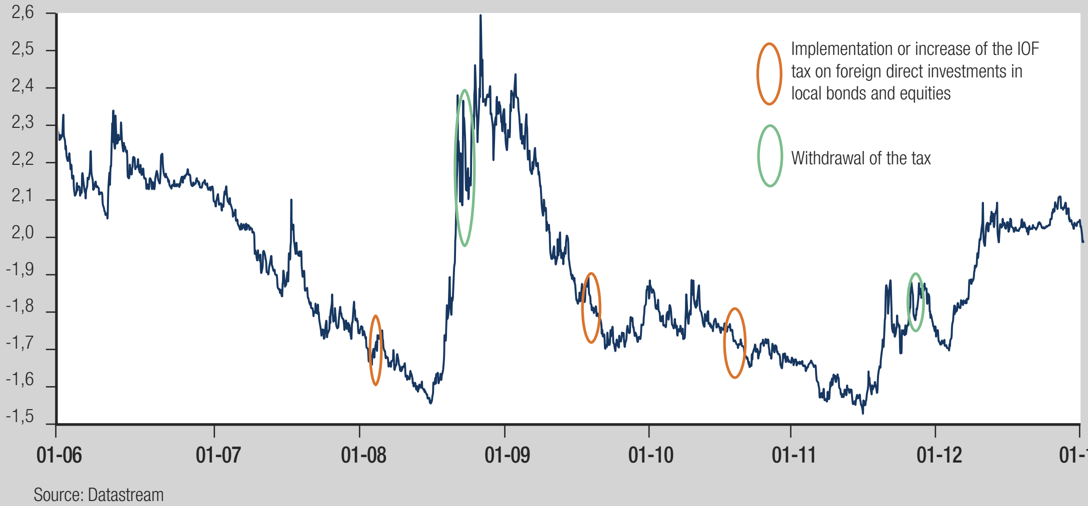
However, although these control measures had little effect on exchange rates, they nevertheless improved the quality of the inflows:

- The introduction of controls on portfolio flows in March 2008, October 2009 and October 2010 could not stave off the medium term appreciation of the Brazilian currency (see graph below). According to Jinjarak, Noy and Zheng (2012)[11], this low impact is explained by the fact that the introduction of capital controls was not considered as different from the policy usually conducted by the government and that it had been largely anticipated by investors.

However, new taxes were set up in March 2012 and the real fell by 10% against the dollar in the course of the year. The introduction of these taxes could partly explain this development. This assertion, however, needs qualifying because the central bank also intervened on the foreign exchange market and conducted a more accommodative monetary policy. Moreover Brazil benefitted from increased risk aversion from late 2011 and saw its exchange rate depreciate (BRL2 for USD1 in late 2012 against 1.75 a year earlier).

- Spillover effects on FDIs: The recent literature has concluded that taxes on foreign investments in local equity and bond markets have effectively led to a reduction in the growth of portfolio investments in Brazil. They have had a spillover effect on foreign direct investments, which reached a historic peak of nearly 68 billion dollars in 2011[12]. These spillover effects have limited the impact of control measures on the exchange rate, but this change in the nature of capital inflows has also proved beneficial: the introduction of these controls discouraged speculative capital inflows in favour of foreign direct investments, a less volatile financing source, enabling Brazil to compensate for the weakness of its domestic investment.
- Spillover effects on neighbouring countries: According to the Bank of France[13], capital controls are the source of spillover effects on neighbouring countries' local financial markets. The rise in the tax on bond portfolio flows by Brazil would therefore explain the totality of the rise in flows on Mexican bonds in October 2010: while the tax on foreign investments in the Brazilian bond market rose from 2% to 6% in October 2010, inflows on Mexican bonds rose from 3.7 billion dollars in September to 5.1 billion dollars in October. The flows on Brazilian bonds fell from 4.2 to 2.2 billion dollars at the same time. Similar developments have been observed in Chile, Colombia and Peru.

Evolution of the Brazilian real vs US dollar exchange rate



Source: Datastream

(11) Jinjarak, Noy and Zheng (2012), « Capital controls in Brazil: Stemming a tide with a signal? », Working Paper, School of Economics and Finance, Victoria, University of Wellington.

(12) Net FDI flows over a year.

(13) Lambert F., Ramos-Tallada J. and Rebillard C. (2011): « Capital controls and spillover effects: Evidence from Latin-American countries », working paper of the Bank of France N° 357, December.

Trade protectionism is a risk for companies

The protectionism level remains high

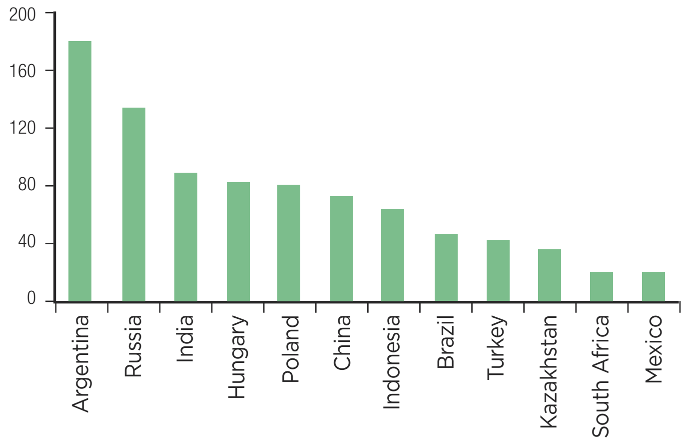
Trade protectionism is also a risk affecting companies in emerging countries as well as businesses which export to these countries. According to the WTO, the introduction of protectionist measures increased markedly in the aftermath the 2008-2009 global crisis. The experience of the great depression of the nineteen-thirties shows that measures restricting trade tend to become permanent, though initially they are intended to be temporary (see Eichengreen and Irwin [14]). The recent period confirms this: though the number of new measures grew less strongly in 2012 [15], the number of existing restrictive measures continues to increase and now affects 4.4% of the imports of the G20 countries. According to the independent estimates of the Global Trade Alert (GTA)[16], the effect of the measures taken since November 2008 is even more significant and will affect at least 10% of the G20 country imports. This increase is explained by the fact that only 21% of the measures introduced in the G20 countries since 2008 have been abolished.

Argentina and Russia are by far the most protectionist countries

The term protectionism covers very diverse measures. It covers all the measures aimed at favouring domestic producers or disadvantaging foreign businesses. The types of measures can therefore be very varied: tariff measures (taxes) or non-tariff ones (quotas, standards), direct (taxes) or indirect (subsidies). The main measures taken in emerging countries during the last two years reflect this diversity. They concern preferential access to public markets for domestic businesses (Brazil, India, South Africa), import quotas (Argentina, Brazil, Russia) and taxes on imports (China, Argentina). These measures have not only been taken at the national level: Mercosur, for example, authorised its member countries to increase the common external tariff for 200 products in 2012. This diversity in the types of measures taken makes it difficult to itemise them. For example, China varies the level of VAT refunds made to businesses in certain sectors in order to influence their profitability and to favour their exports. Therefore it changed the level of these refunds thirteen times between 2007 and 2010, so that 71% of Chinese exports were affected by these changes in 2010, against only 4% in 2007. So it is difficult to take into account every change in the level of VAT applied to Chinese exporting companies.

This is why there are no exhaustive lists of the protectionist measures adopted in the world. Outside the WTO, the GTA is an exception: it lists all protectionist measures taken since November 2008, which restrict international trade as well as those which favour it. By subtracting the second from the first, we can deduce a « net number » of existing protectionist measures by country (see chart below). These data show that Argentina and Russia are by far the most protectionist countries (respectively 180 and 136 measures). India completes the podium (91). At the other end of the scale, Mexico and South Africa are countries with few such measures (only 21 each). Turkey is also relatively open to trade while China's degree of protectionism seems moderate (72). By way of comparison, the developed countries have on average more protectionist measures (between 90 and 115). Finally, Brazil is a case apart: It does not seem very protectionist with regard to this overall indicator, but it is worth noting that a number of important measures favouring trade offset partly the numerous restrictive measures introduced particularly in 2012. For example in the car sector the Brazilian government decided to increase by 30% a tax on vehicles with a local content below 65%, to deal with the increase in the number of imported ones. It also went back on the free trade agreement with Mexico in the motor industry and imposed quotas. A minimum local content of 65% was imposed for oil-related services and equipment, at the risk of raising the equipment cost necessary for the exploitation of new deep sea oil fields. The Brazilian government finally adopted tax exemptions for the industries most affected by competition from imports such as textiles.

Net Number of Protectionist Measures by Country



Source: GTA

These measures pose a risk to opportunities for businesses

The reasons for protectionism are known: it is about a country protecting employment in the short term by protecting a sector of activity weakened by a slowdown in world demand and/or a deterioration of its competitiveness. This is particularly the case for many emerging countries, which experienced a growth slowdown in 2009 related to the Lehman Brothers crisis, as well as a significant appreciation of their currency since 2009. Apart from these external factors, the current rise in protectionism has its origin in the changes in emerging countries' growth strategies: after undergoing a contraction in world trade in 2009, some emerging countries decided to favour sectors related to their domestic demand. From this perspective, protectionist decisions are aimed at protecting these developing sectors. Finally, certain emerging countries are further restricting their commodities exports, so as to contain prices on the local market and therefore stimulate household consumption and reduce business's production costs. Export restrictions on rare earth elements and coal in China, of cotton in India or of wheat in the Ukraine are instances of this strategy.

(14) Eichengreen B. et Irwin D. (2009): « The Slide to Protectionism in the Great Depression: Who Succumbed and Why? », National Bureau of Economic Research, working paper N° 15142, July.

(15) The restrictive measures introduced in the G20 countries between May and October 2012 affected 0.4% of the regions's imports compared with 1.1% during the previous 6 months.

(16) Global Trade Alert is a supplier of independent data on world trade which is led by the CEPR (centre for research on economic policy).

But, though the reasons for such measures seem obvious, their effects on the country's growth are ambiguous. On the one hand, they can be considered as a necessary step for temporarily protecting a developing country's fledgling industries. But on the other hand, they have negative effects on growth, if they end up protecting declining sectors. This in effect reduces the resources available for promoting the development of sectors of activity generating longer term growth.

More generally, protectionism is likely to have a negative effect on companies' sales exporting to countries which impose such measures. But at a global level, the effects seem limited for the time being: the WTO predicts a 4.5% growth in world trade in 2013, after 2.5% in 2012. This is in line with a moderate GDP growth, which confirms that trade cycles coincide with GDP growth ones. However, in the context of the international division of production processes, particularly in the manufacturing sector, a continued increase in the number of protective measures would have disastrous effects on world trade: protectionist measures on a particular type of product are likely to have consequences for the whole production chain at world level and would therefore harm the activity of all the businesses participating in this process.

EXCESSIVE CREDIT GROWTH

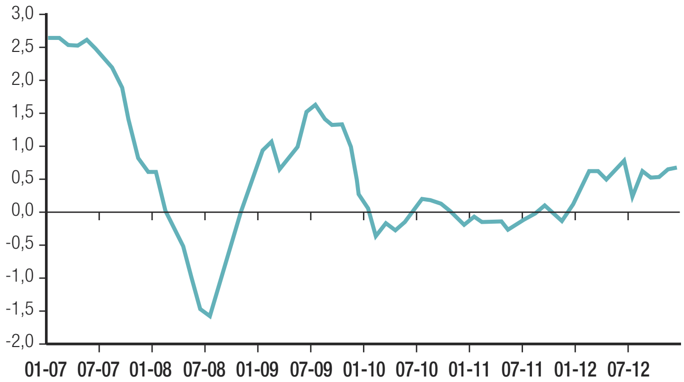
The private sector debt level is another risk affecting the emerging economies. Though attention is currently focussed on the high public debt in the bulk of advanced economies, let us not forget that the countries most affected by the effects of this global crisis often had as a point in common the fact that they had previously experienced a private sector credit boom (for example Iceland, the Ukraine, the Baltic countries, Spain, the United States).

Currently, some emerging countries are undergoing very sustained credit growth to companies and households. Even though the structures of emerging countries are different from those of the advanced economies, there is a risk that an excess of company and household debt could have comparable effects on growth in the medium term.

The collateral effects of expansionary monetary policies

There are several reasons for this tendency for the continuous growth of credit to the private sector in emerging countries. First of all, monetary policies have been expansionary in emerging countries since the 2008-2009 crisis. These policies have favoured sustained growth of bank credit to the private sector. Certain countries, which had cut their key rates very significantly at the end of 2008 and in 2009, did not raise them again when a strong economic recovery and inflation materialised in 2010 and 2011. Their key rates therefore are still at very low levels, as, for example, in some Asian countries: Thailand, the Philippines, Indonesia and South Korea. Next, other countries had higher interest rates until 2011 and therefore had room for monetary manoeuvre, but for the most part used them in 2012 (Brazil, India). This led on average to very accommodative monetary conditions in emerging countries: real interest rates remained close to zero (and even occasionally negative) at the time of the marked pick up in growth in 2010 and 2011. They are still at relatively low levels for emerging countries as a whole at the moment (see chart below).

Average Real Interest Rates Including 23 Emerging Countries*
(Key rate - inflation in %) Source: Datastream



* China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan island, Thailand, Brazil, Colombia, Peru, Mexico, Czech Republic, Hungary, Poland, Russia, Turkey, South Africa, Chile, Uruguay, Hong Kong, Israel, Kazakhstan.

Besides these expansionary monetary policies, deficiencies in terms of prudential rules for banks and policies aimed at favouring financial sector development have also played a role in the recent credit expansion. For example, there was no minimum income or minimum age in Indonesia for holding a bank card until 1 January 2013, while the number of cards per person was unlimited. Moreover, there was no minimum required contribution in order to obtain a mortgage loan until 2012.

The dangers associated with credit booms

Pointing the finger at the negative effects of credit to the private sector on the economy is in principle contradictory, insofar as this is an instrument for financing businesses and households and therefore investment and consumption. A credit growth acceleration must therefore favour more sustained economic growth. A recent IMF study [17] confirms this: an increase in the level of financial development is associated with less volatile economic growth (measured by the standard deviation of the GDP growth rate). However, this study also emphasises that, beyond a certain threshold, the correlation between financial development and GDP volatility becomes negative. The threshold is reached when the the total volume of credit to the private sector to GDP ratio exceeds 100%.

(17) International Monetary Fund: « World report on financial stability », chapter 4, October (2012)

But the growth of this ratio also needs to be taken into account in order to assess the credit boom risks [18]. This is because, if a country's credit growth increases very rapidly, this is likely to generate increased risks in the banking sector, even if the level of the total outstanding amount is relatively low. For example, credit grew by over 30% a year on average in Russia between 2006 and 2011. Admittedly, this strong growth in part illustrates a financial catch-up process, the total outstanding credit over GDP, reaching only 40% of GDP in late 2011. But it can also lead to a rise in non-performing loans, if this very sustained and rapid rise in credits granted is synonymous with a greater flexibility on the part of the banks in granting credit to households and businesses. In other words, in the case where credit growth to the private sector is durably greater than that of nominal GDP, the difference between the two corresponds to an excess of liquidity, which is not absorbed by the good market. It is therefore invested in asset markets (financial or property) and likely to favour the formation of bubbles in these segments. To take this into account, the IMF defines a credit bubble as a period during which the growth of this ratio significantly exceeds its long term average [19] or when it increases by more than 20 points in a year.

Let us, however, remember that not all credit booms give rise to financial crises - quite the contrary: the proportion of credit bubble episodes which have resulted in a crisis within 3 years is one third according to the IMF. The probability that the countries in question will experience at least one prolonged period of GDP growth below their potential for 6 consecutive years at the end of a credit boom is, according to the same source, 60%. During this period, the negative shock on growth is on average 2.2 points per annum. This confirms that periods of a bubble lead to the over-indebtedness of certain sectors of activity and hence to an adjustment of these when growth slows, even if a crisis is avoided. These adjustments are often explained by a tightening of bank credit conditions following a crisis or a period of marked economic slowdown: having suffered losses as a result of defaulting by businesses and households, they restrict credit to the private sector and therefore limit the latters' investment capacity.

Diagnosing credit bubbles

To identify credit boom risks, we looked both at the initial level of credit to the private sector over GDP and at its evolution. We judged that the countries likely to suffer the negative effects linked to a credit boom are those characterised by a ratio greater than 100% and/or a rise in this of at least 10 points in the course of the last year [20].

These criteria have the merit of making it possible to carry out an overall classification of the emerging countries according to the credit boom risk. But the limit of this analysis is that it does not take into account more qualitative criteria: apart from the level of outstanding credit and its growth, the composition of these loans has an impact on the risks associated with credit expansion. For example, the countries for which the proportion of credits to the private sector denominated in foreign currency is high are more vulnerable in the event of a credit bubble. Turkey is a significant example of this. Likewise, inadequate prudential rules (as in Russia) are also liable to aggravate the risks related to strong credit growth.

A combination of the level of outstanding credit and its dynamics

In the following chart, we are interested in both the amount of credit to the private sector (X-axis) and its evolution (Y-axis).

Firstly, a very large majority of emerging countries have a ratio below the level of 100% previously referred to, so that the credit growth to the private sector plays a positive role on GDP growth. But some are above or very close to this threshold. Estonia, for example, belongs to this group.

Then, by observing the evolution of the ratio of credit to the private sector over GDP for all the emerging countries, we conclude that several countries are today in a credit boom situation as we define it, or are very close to it. They are therefore facing a significant risk of a financial crisis or of durably weaker growth in the medium term. This concerns in particular Chile (+15 points between mid-2011 and mid-2012), Russia (+10 points) and Turkey, Venezuela and Cambodia (+9 points each). Several South American countries are also at risk according to this criterion (Guatemala, Honduras).

Finally, the countries most at risk are those which meet these two criteria: credit to the private sector relative to GDP is at a high level and is growing rapidly. They are therefore the most likely to undergo a crisis or at least a period of weaker growth. Numerous Asian countries come into this category or are very close to it: China, Malaysia, Korea, Thailand, Singapore and Vietnam. Lebanon and Guatemala also belong to it.

The capital account openness is an aggravating factor

Besides the level and growth of the credit to the private sector to GDP ratio, other indicators must be taken into account in order to assess the vulnerability of a country facing an excess of credit to businesses and households. In particular, countries with a very open capital account are more at risk of suffering a financial crisis in the event of a credit bubble, as capital flows are likely to limit the effects of any monetary tightening measure decided by the central bank. So, in the case where central banks of these countries tighten their monetary policy to limit the credit growth, these capital flows will limit their effects. The increase in foreign investments, especially on the local bond markets, eases the financing conditions for businesses and households. These capital flows therefore limit the channels for the transmission of monetary policy: long-term government bond rates fell in 2010 in Malaysia, South Korea and Brazil, even though the central banks of these countries raised their key interest rates.

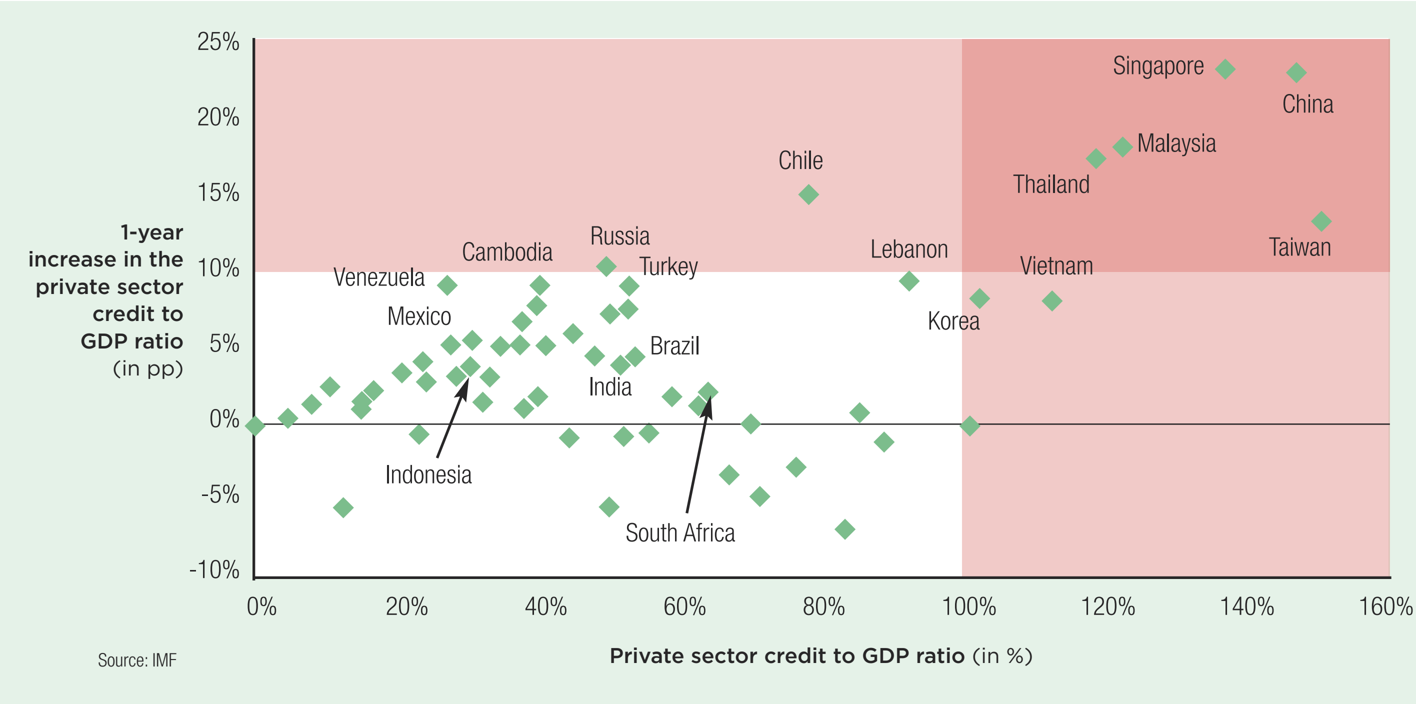
In this context, China's weak openness to foreign capital has been a factor minimising the risk resulting from the strong growth of credit to the private sector in recent years. By contrast, Malaysia, South Korea and Thailand appear to be more vulnerable countries with regard to this criterion. The Island of Taiwan is in an intermediate position.

(18) See for example BNP Paribas: « Country Risk Overview », Economic Research Department, February (2012)

(19) Difference between the growth achieved and average long term growth above a 1.5 standard deviation and growth of the ratio of credit to the private sector over GDP above 10 points.

(20) Year from mid-2011 to mid-2012.

Emerging countries: Private sector credit to GDP ratio (2012, source: IMF)



The countries most at risk are in Asia

In summary, the existence of credit bubbles does not mean that a crisis is imminent in countries which are experiencing it, but it does imply that a risk of a marked adjustment of growth (through a crisis or in a more gradual way) is probable there in the medium term. Several Asian countries seem to be particularly exposed to this risk, followed by Chile, Russia and Turkey.

The growth resilience as well as the improvement of the most important external sovereign and external fundamentals does not mean country risk has disappeared in emerging countries. This study highlights the rise of new risks, which must be closely watched in 2013 and 2014. In order to monitor these changed risks, Coface is focusing on new indicators. In particular, our political and social diagnosis underlines the persistent character of the risk of instability in the Middle East and North Africa. Our overall credit bubble indicator highlights the Asian countries. Finally, the protectionism risk also needs to be watched in the emerging world, especially in Argentina and Russia.