



Monthly Comments – Emerging Markets

April 2017

Key Messages

Country Focus: A rising economic and financial risk in Algeria

Algeria's average Economic & Financial Risk Rating has deteriorated sharply over the past quarters, though remaining at a favorable level. This translates both a very strong short- to medium-term financial resilience and the increasing pressures coming from the inability to accelerate economic growth, the latter intimately associated to potential social and political tensions at a moment of unavoidable political transition.

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RiskWatch: Structural negative reversal for overall performance on the Debt Balance pointing to the end of "easy funding" for EM

The update of our RiskMonitor's debt indicators highlights a simultaneous worsening of the two indicators used to assess the quality of a country's international funding: our debt service and financing stability suggest a structural change in the long-term financing of Emerging Markets' development, with lower foreign direct investment and higher cost of external debt. This new paradigm suggests a more negative trajectory for foreign debt sustainability in the medium-term for EM, and is associated with a larger dispersion of performances, including within the largest EM: China in particular sees a visible deterioration in financial stability and Turkey remains significantly constrained by external debt obligations.

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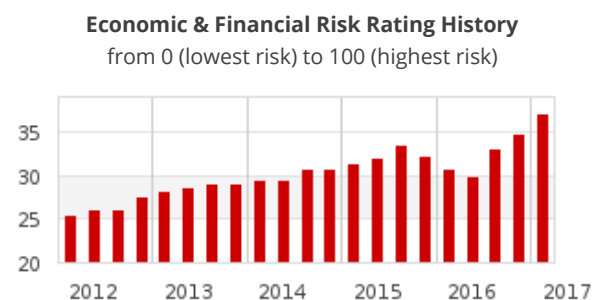
As always, readers are most welcome to come back to us for further details or clarifications.

Completed on April 14, 2017.

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With an Economic & Financial Risk at 36.8 (B), the overall economic risk in Algeria remains low, though it has been rising since 2012 with a sharper deterioration over the past few quarters.



Source: TAC ECONOMICS

The diagnostic on Algeria's current economic situation is based on four key points:

- (1) Algeria is a "rent-economy" highly dependent on hydrocarbon revenues and redistribution policies with a declining efficiency of such policies over time,
- (2) the large increase in energy price during 2003-2014 swelled the external rent, which was largely accumulated to create substantial economic and financial buffers,
- (3) these buffers have been used to mitigate the macroeconomic and social impact of sharp decline in energy prices since mid-2014 and remain large enough to accompany a moderate fiscal adjustment,
- (4) this would not be enough to alleviate constraints on economic growth, which will remain mediocre, clearly pointing to rapidly increasing social and political risks.

Revenues from hydrocarbons were accumulated during 2003-14, giving strong financial buffers

Production and exports of oil and gas are the pillars of Algeria's development since independence. The hydrocarbon sector represents 32% of the country's total production, account for 95% of total exports and contribute to 60% of budget revenues. The massive contribution to fiscal revenues mechanically leads to a very strong role for public authorities in terms of financial allocation.

During periods of higher energy prices, this contributes to "Dutch Disease" symptoms pushing exchange rates at levels that are uncompetitive for manufactured or agricultural production.

The sharp increase in oil prices during the 2000s and early 2010s have *de facto* not been used to foster higher economic growth, but resulted in very large external and fiscal surpluses, with two direct implications: (1) a very high level of foreign currency reserves when energy prices collapsed in 2014H2, and (2) the absence of public debt.

Using its very high fx reserves and the fiscal surplus accumulated in an off-budget Fund enabled Algeria to keep its economic growth at a level slightly higher in 2015-2016 than during the previous three years. Though helped by the currency depreciation against the USD (from DZD 80 in mid-2014 to 110 in April 2017), this was achieved with a major decline in reserves (USD 114bn in Dec. 2016, 42% below the mid-2014 peak), a depletion of the budgetary reserve fund and a modest rise in public debt.

Our computations show however that the level of reserves and ability to raise more debt, associated with the implementation of progressive fiscal adjustment (fiscal deficit moving from 15% of GDP to 5-7% at the end of the decade) keep Algeria in decent strength position.

Structural headwinds and political risks

Even though the economic adjustment to lower energy prices has been moderate, the negative impact includes a transmission from currency depreciation and administrative price adjustment to higher inflation (+7.6% year-on-year in February 2017) and higher pressures on employment opportunities.

With a young / fast-growing population and a poor / declining economic efficiency of overall investment, the structural inability to accelerate economic growth in a highly sensitive political moment is by far the largest component of Algeria's country risk, notwithstanding a low Economic & Financial Risk rating justified by a very robust financial resilience.

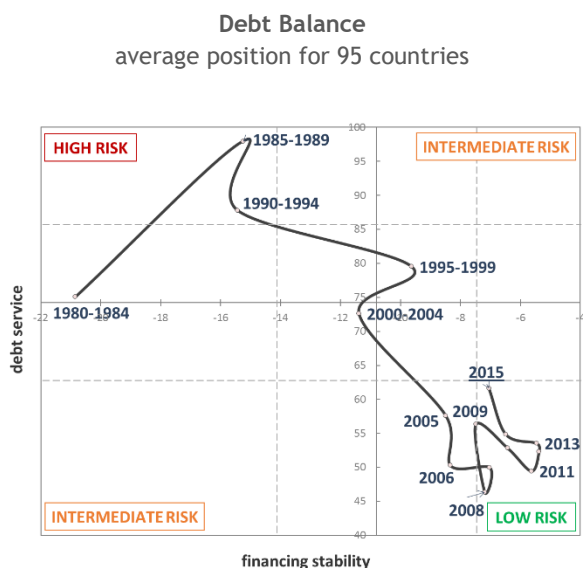
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A slight deterioration of external debt pressure

The Debt Balance evaluates the characteristics of a country’s medium-term foreign currency funding, by confronting a traditional external *debt service* (vertical axis) with an assessment of the degree of *financing stability* (i.e. whether foreign direct investment provides a substantial share of foreign funding, versus banking or portfolio capital).

It is not designed to look at solvency issues for specific borrowers (i.e. not examining sovereign risk as such), but aims at observing whether a country can find a balanced way of funding its development with foreign currency resources.



Source: TAC ECONOMICS

The annual update of the Debt Balance confirms a structural change that started in 2011-12, with a dual deterioration (rising *debt service* accompanied by a deterioration in *financing stability* after three decades characterized by a massive structural improvement.

In 2015, the negative move of the indicator was due to lower revenues from international trade, which weighed on EM’ external sustainability despite a stabilization in the dollar-value of total EM external (USD 8.6tn in Dec. 15, -507bn over a year).

This was accompanied by a further deterioration of the *financing stability* i.e. the structural ability to attract sufficient foreign direct investment (FDI) to compensate for the more unstable capital flows (banking and portfolio). Indeed, after the large increase in annual flows of FDI between 2010 and 2013 (up to USD 810bn), the long-term trend has reverted with 8% decline in 2015 (to USD 699bn).

On average across the 95 countries included in RiskMonitor, EMs still remain in the *Low Risk* quadrant on the Debt Balance, implying a relative absence of foreign currency over-indebtedness or high degree of long-term payment risks.

However, the dual degradation leads to a more delicate position closer to secondary thresholds. Additionally, using more recent quarterly data on short-term debt obligations, our index of *maximum potential service* in the Liquidity Balance confirms the deterioration in aggregate indebtedness, with a worsening since end-2013 that accelerated since the beginning of 2015. In parallel, more recent FDI figures (2016Q3) for the 10 key EM¹ show the decline accelerating (-15% y/y in 2016 against -8% in 2015 and -5% in 2014).

A new and less favorable debt paradigm for EM

The long-term observation of EM’s path on the Debt Balance is revealing of the late reversal after a long period of structural improvements. From a situation

¹ Brazil, Mexico, India, Indonesia, China, South Korea, Poland, Russia, Turkey and South Africa

the 1970s/80s when EM were marked by a growing indebtedness and a wave of debt crises and defaults. After 1987, the combination of more open policies for FDI and the parallel break-up in supply chains and overall globalization, lower external deficits and structurally declining US interest rates created powerful forces of overall improvement up to the end of the 2000s.

After the global financial crisis and its short-term rebound, a new paradigm emerges with stabilization in world trade, relocation investment strategies and rising protectionism. In parallel, the ultra-low interest environment in mature economies has induced a tremendous incentive for foreign currency borrowing in EM, even more so by corporates and banks than from sovereign borrowers.

Looking ahead, we believe that this new and less-favorable paradigm should last. The overall trade momentum in EM has even turned negative in 2016 and is likely to persist over the medium term, with a negative impact on related foreign currency receipts and capital inflows.

Meanwhile, higher interest rates globally in relation with the end of global accommodative monetary policies will increase *debt service* obligations and should push the overall EM path closer to our critical risk threshold, though not on a short-term horizon.

A wide dispersion with few high-risk spots

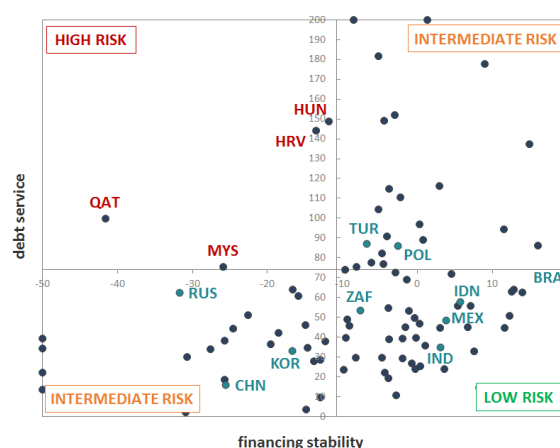
The next scatter plot shows the position of the 95 RiskMonitor countries on the Debt Balance, for 2015). Readings can be summarized in four key points:

- The dispersion across countries is large and increasing over time. This true for the whole universe of EM as well as for the 10 key EM: only 3 out of these 10 are still clearly in the *low risk* area (Mexico, India and Indonesia). Highly revealing is the rapid move of China out of this low risk area because of stabilization in FDI, larger influence of portfolio capital and thus a rapidly deteriorating *financing stability*. Paradoxically, Brazil is now the best positioned among the 10 key EM in terms of *financing stability*, a tribute to the very large and stable level of FDI with much lower “portfolio inflows” during 2015 when political uncertainty was very high. Though appetite for Brazilian portfolio and banking assets has substantially increased

during 2016, the current position ensures that *financing stability* should not be an issue in Brazil over the short-term.

- 24 countries out of the 95, including Turkey, Poland and 7 other as new entrants, have an excessive *debt service*, but with a favorable indicator of *financing stability* suggesting that debt issues are not yet “biting”, though it creates more vulnerability, notably to changing political / policy landscapes (e.g. Turkey or Poland!).
- 4 countries are in the *high risk* area, with Croatia and Hungary still significantly constrained by large external debt; Malaysia as well as Qatar show weaknesses in terms of long-term funding, though our indicator is more paradoxically more severe for countries that have structural current account surpluses.

Debt Balance 2015



Source: TAC ECONOMICS