Overview on Country Risk

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FINANCIAL TURMOIL ON EMERGING MARKETS HAS GENERALLY BEEN CONTAINED WELL UP TO NOW

Emerging countries are generally enjoying sustained growth in 2006 without any obvious or increasing macroeconomic imbalances. The overall reduction in country risk since 2001/02 continues and is most evident in the sovereign and non-transfer components. In May, new uncertainty over the future of the US economic cycle and Federal Reserve monetary policy created turmoil on the leading financial markets as well as on emerging markets. In this document, we analyse this situation and its consequences. In summary, although renewed market volatility increases country risk within its market risk component, the other country risk components (sovereign, non transfer, credit) are not likely to be affected, possibly moderately. But Turkey should be watched.

Nevertheless, this episode of global market corrections, which has may be not ended, remind us that country risk is still up to date.

I – FAVOURABLE INTERNATIONAL ENVIRONMENT DESPITE WIDER BALANCE OF PAYMENTS DEFICITS. THE US ECONOMIC CYCLE SEEMS TO BE PEAKING, MAKING INVESTORS INCREASINGLY NERVOUS

• **In mid-2006, the international environment continues to benefit emerging countries as a whole**. **In April, the IMF revised its growth forecasts sharply upwards for 2007 while the World Bank and OECD followed suit in May; these compare with the projections made in October/November of last year.** All three institutions now expect world growth to remain solid and be more balanced between the major zones: United States, EMU and Japan. None foresee excessive inflationary tension even though oil prices remain high. Growth should remain robust in China and India.

In the United States, GDP should start to slow in the summer and drop slightly below trend (3.4% a year according to the OECD). The rise in interest rates is gradually diluting household wealth effects and mortgage borrowing power, in line with a slow growth in housing prices[1]. However, high corporate earnings, tension on production capacity in the manufacturing sector, and decreasing non-financial enterprises debt ratio over recent years all paint a bright picture for investment.

In the eurozone, activity has firmed up over the first six months of the year thanks to improved confidence among consumers and, in particular, business leaders. The recovery should continue over the second half of the year on the back of private investment – given the high level of earnings – and, progressively, consumer spending.

Japan is enjoying growth in all components of demand. As with the Asian expansion of the last few years, the recovery has primarily resulted from exports and corporate investment. Household spending – residential investment in particular – is accelerating due to improvements in nominal wages and employment. This trend should continue over the next quarters.

In the other leading OECD economies, growth should accelerate (United Kingdom) or remain strong (Australia, Canada).

REAL GDP

(Annual change as %)	**2003**	**2004**	**2005**	**2006**	**2007**
United States	2.7	4.2	3.5	3.4	3.3
Eurozone	0.8	2.1	1.3	2.0	1.9
Japan	1.8	2.3	2.7	2.8	2.1
China (*)	10.0	10.1	9.9	9.5	9.0
World	3.9	5.3	4.8	4.9	4.7

Source: IMF (April 2006).
(*) The BNP Paribas economic research department's growth forecasts for 2007 are slightly lower where the United States and eurozone are concerned (lower wealth effect in the United States, German VAT hike in the eurozone).

[1] The latest housing market statistics appear to indicate that the cycle is about to turn (20% y/y decline in mortgage applications in April, and monthly drop of 7.4% in the construction of new homes), and this is one of the main risks to US growth in the second half of the year.

• Despite the rise in commodity prices, **world inflation is largely under control**. Holding rates back are the effects on globalisation on import prices[2] and, especially in the eurozone and Japan, unused production capacity and the abundance of supply on the labour market. In the eurozone, weak domestic demand continues to exert a disinflationary influence. However, **in the United States, tension on production capacity and even the labour market is slowly increasing core inflation above the Fed's "acceptability" zone**[3]. Furthermore, additional income resulting from exports of manufactured goods (Asia) and energy commodities (Middle East, Russia) is generally being saved rather than spent[4], limiting the rise in bond yields (recycling of central bank currency reserves) and thus potentially contributing to the increase in the price of assets but not of goods.

In recent months, monetary policy tightening at the Federal Reserve and Bank of England, and the prospect of this in other leading economies, have pushed up nominal bond yields. However, **financial conditions remain accommodative** with real bond yields still close to all-time lows[5].

• **For the fourth consecutive year, emerging countries continue to benefit from favourable world trade environment, concerning volumes and prices**. Sustained by import growth in developing countries and increases in market share, annual growth in the volume of emerging countries' exports will be above 10% in 2006 and 2007, as has been the case since 2003. **Emerging countries' GDP growth should remain strong.**

(Annual change as %)	**2003**	**2004**	**2005**	**2006**	**2007**
World trade in real terms (goods and services)	5.9	10.3	7.3	8.0	7.5
• o/w **imports** by "advanced economies"	4.1	8.9	5.8	6.2	5.6
• o/w **exports** by "advanced economies"	3.1	8.5	5.3	6.6	6.1
• o/w **exports** by "developing economies"	10.8	14.5	11.5	10.9	10.3
Non-energy commodity prices (USD)	6.9	18.5	10.3	10.2	-5

Source: IMF, April 2006.

[2] Please refer to two recent studies: "World Economic Outlook", IMF, April 2006; and "Economic Outlook" OECD, May 2006. The OECD believes that, over the last five years, the integration of "low-cost industrial economies" into world trade has reduced inflation by three points a year in the eurozone and one point in the United States.
[3] In April, the core PCE stood at +2.1% y/y, compared with a tolerance range of +1% to +2%. Core inflation will probably continue to accelerate over the coming months as it is out of synch with the economic cycle.
[4] According to the OECD, oil revenues have been spent more slowly than during the crisis periods of the 1970s and 1980s, with several oil-producing countries preferring to deposit a significant percentage of additional income in stabilisation funds.
[5] Deflated by the consumer price index, these range from +1% in Japan to +2% in the United States; deflated by core inflation, they vary from 1.3% in Japan to 2.8% in the United States. Eurozone real interest rates are between the two.

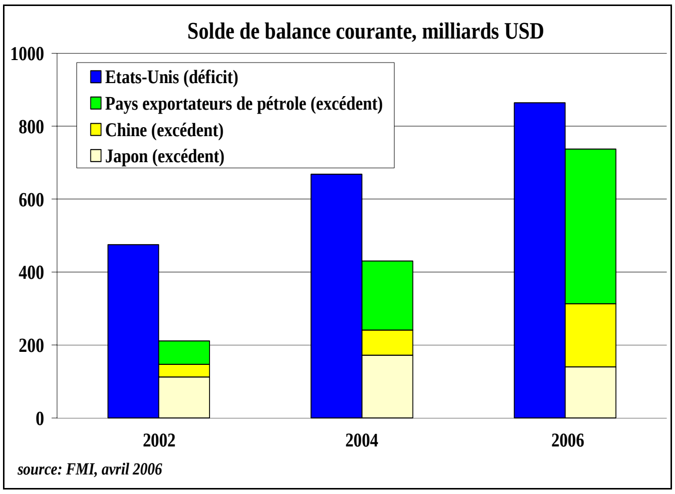
REAL GDP

(Annual change as %)	2002	2003	2004	2005	2006	2007
New industrialised Asian economies	5.1	3.0	5.8	4.6	5.2	4.5
Other emerging countries	**4.6**	**6.1**	**7.6**	**7.2**	**6.**9	**6.6**
o/w:						
- Africa	3.5	4.1	5.5	5.2	5.7	5.5
- Central and Eastern Europe	4.4	4.5	6.5	5.3	5.2	4.8
- CIS	5.1	7.6	8.5	6.5	6.0	5.8
- Developing Asia	6.4	7.8	8.8	8.6	8.2	8.0
- Near-Middle East	4.2	5.4	5.4	5.9	5.7	5.4
- Latin America	-0.1	1.7	5.6	4.3	4.3	3.5

Source: IMF, April 2006.

• Simultaneous to this sustained world growth, **current payment imbalances have increased**. The US current account deficit widened from USD 520bn in 2003 to USD 805bn in 2005. For 2007 it has been estimated at between USD 899bn (IMF) and USD 1,050bn (OECD), with the latter figure representing 7.6% of GDP, an unprecedented level in absolute and relative terms.

As US interest rates are still higher than those of the eurozone or Japan, **it is still proving easy to finance this deficit as the regions in which surplus income is rising are those which tend to direct their savings into risk-free, liquid financial assets**. Between 2002 and 2004, Asian central banks were the main contributors to the financing of the US foreign deficit, through their investments. At the time, oil-exporting countries had already earmarked most of the new oil windfall to reducing public and foreign debt, and have now done this. In 2005/06, the US current account deficit widened to a similar extent as it did in 2003/04, contra to the further increase in Chinese and oil-producing countries' surpluses. As well as Asian central banks and the Reserve Bank of China in particular, oil-producing countries – especially from the Gulf – are now buying US securities[6].



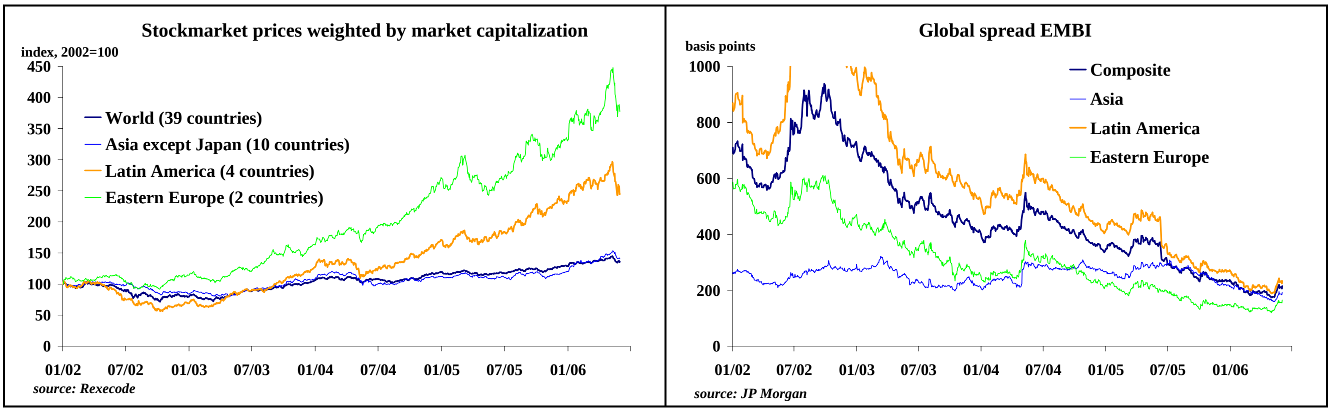
[6] Sometimes directly, often via offshore investments.

II – IN MAY, THE SPREAD OF FINANCIAL TURMOIL FROM THE LEADING INTERNATIONAL MARKETS TO EMERGING COUNTRIES WAS QUITE SELECTIVE, AND DID NOT UNDERMINE THE GENERAL IMPROVEMENT IN COUNTRY RISK

- **Against the backdrop of a prosperous global economy, a growing belief among investors that the US foreign deficit is becoming unsustainable, a probable peaking of the US economic cycle and a further modest rise in inflation, volatility has increased on the financial markets**. In May, the announcement of higher-than-expected inflation in the United States, uncertainty about monetary policy (ECB, Fed), rising long rates and the prospect of the US economy slowing at the end of the year prompted a wave of profit taking. The risk markets (equities, commodities) suffered upheavals that spread to emerging countries (equities, bonds, money market and exchange rates). Although only a few currencies lost significant ground against the dollar (Turkish lira -15%, South African rand -12%, Brazilian real -11%, Indonesian rupiah -7%), numerous stock markets plummeted: Turkey (-25%), India (-18%), Egypt, Colombia (-16%), Argentina, Indonesia (-13%), Brazil, South Korea, Hungary, Mexico, Poland, Philippines, Czech Republic, Russia, Thailand (around -10%)[7]. Euro bond spreads increased a little.

These corrections to asset prices and exchange rates on emerging markets showed the following characteristics:

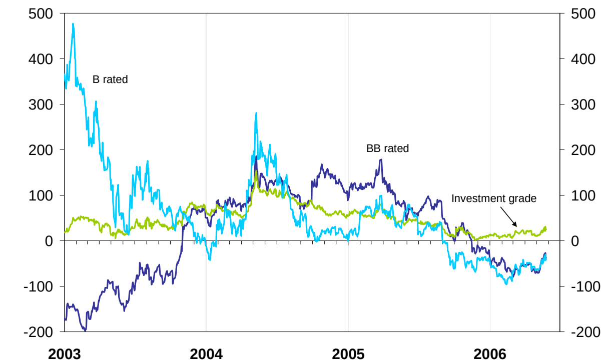
1/ They followed an exceptional rise in share prices and narrowing of bond spreads since 2003[8]. If it does not continue, the correction of May will have been small in proportion to the gains made in previous years.



2/ As during previous periods when financial turmoil spread from leading international marketplaces to emerging countries (September 2001, Autumn 2002 after doubts about the reliability of US corporate accounts, Spring 2003 at the start of the Iraq war), **the equity and bond market declines was fairly widespread** due to risk aversion in times of volatility, **but the foreign exchange market was more selective**. There was better recognition of specific risks (the spread differential between investment grade and speculative grade bonds increased slightly in May), while the spread advantage that emerging issuers had held over US corporate issuers of the same rating, decreased.

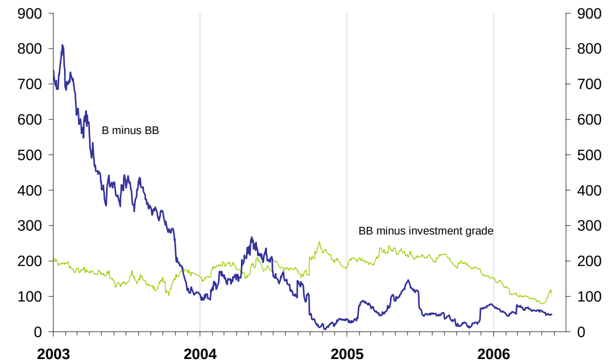
[7] The sharp correction to Gulf stock markets occurred in February and are independent.
[8] For the EMBG, there was an increase of around 30 points in May, compared with a decrease of 229 points between April 2004 and April 2006.

8. Spread differential between emerging market sovereign bonds and comparably rated US corporates (in basis points)



Source: JP Morgan Chase, Merrill Lynch

6. Spread differential between emerging market sovereign issuers (in basis points)



Source: JP Morgan Chase, Merrill Lynch

3/ The most affected markets have been in countries with the most obvious macroeconomic imbalances, and these may also be experiencing political issues. Turkey in particular but also Hungary, South Africa and, to a lesser extent, Indonesia, have been overheating in the past couple of years: appreciation of real exchange rates, partly due to speculative capital inflows[9] and a sharp increase in domestic demand, sustained by bank credit and leading to a deterioration of the current account balance. In Turkey, the will to reform seems to be fading. In Hungary the budget deficit is persistently high. **Brazil**, whose currency also depreciated in May, is a special case as the real exchange rate had previously strengthened with an improvement in the current account balance. **The slump in the value of the real is a further example of the risks attached to carry trades**[10]

INDICATORS OF EXTERNAL FINANCIAL VULNERABILITY
(before the financial mini-crisis starting in May)

		Particularly vulnerable countries		
		South Africa	**Hungary**	**Turkey**
Deteriorated current account		Yes	Yes	Yes
Overvalued currency		Yes	A little	Yes
Vulnerability of currency reserves(1)		High	High	High
Foreign debt as a % of GDP		Moderate	Rather high	Rather high
Carry trades	High domestic rates	Yes	Yes	Yes
	Used by investors(2)	Yes	Yes	Yes
Freedom of capital movement		Yes (for NR)	Yes	Yes
Stock market bubble		Forming	Forming	Forming
Recent growth in private-sector borrowing		Strong	Strong	Quite strong
Political issues		No	Yes	Yes

(1) Ratio of volatile capital to currency reserves; (2) Acquisition of government securities and shares by non-residents

[9] FDI (Hungary), public and/or private sector currency-denominated borrowing (Indonesia, Hungary, Turkey), portfolio investments (all four countries).

[10] Non-resident institutional investors have been trapped by purchases of medium-term, local-currency-denominated government securities, for which the secondary market is fairly illiquid. Finding themselves exposed to the exchange rate risk, their sudden demand for currency hedging contributed to the decline of the real.

4/ Stock market corrections appear to have been sharper in countries where the weight of non-resident investors in stock market capitalisation is relatively high due to portfolio investment inflows over the past few years, and in some cases they have pushed P/E ratios above long-term averages.

Net portfolio equity investments in emerging countries (USD bn)

	2002	**2003**	**2004**	**2005**
Total	5.8	25.2	37.3	61.4
South Africa	-0.4	0.7	6.7	7.1
Brazil	2.0	3.0	2.1	6.5
China	2.2	7.7	10.9	19.0
South Korea*	-1.1	12.4	8.6	-1.3
India	1.0	8.2	8.8	12.2
Turkey	0.0	0.9	1.4	5.7

Source: World Bank, May 2006; (*) not including the World Bank's definition of emerging countries, source IFI.

5/ The financial mini-crises of late should be viewed separately from those of Iceland and New Zealand in March, as the crux of the problem in these two countries was domestic. Nevertheless, there is a reminder that countries with high living standards are no more immune to market crises than emerging countries in some circumstances: domestic credit bubble, worsening foreign accounts, carry trades (see Appendix).

In summary, dips in prices have been relatively small, and rather selective regarding their magnitude. Cases in which the correction was sharpest may well have been due to previous overvaluations. However, the global synchronisation of the declines illustrates how the financial markets of emerging countries are dependent on those of developed countries.

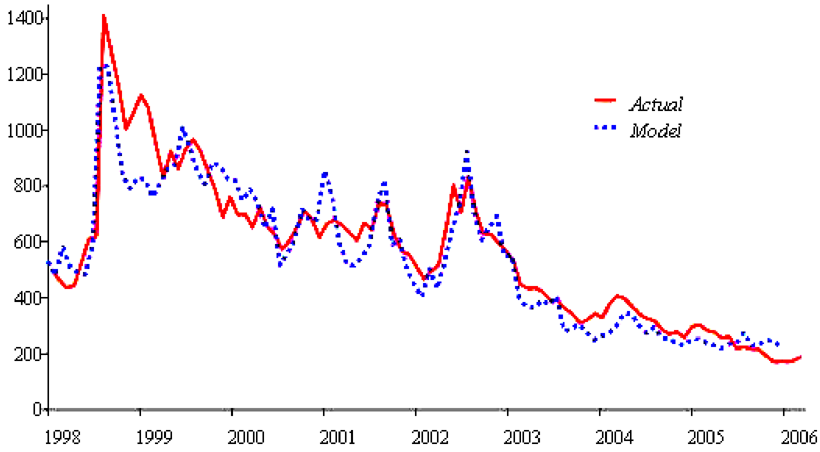
- **Are these financial mini-crises a warning of more serious crises to come, implying deep recessions? Probably not, for the following reasons**:

1/ Recent corrections have been on markets that, overall, were not significantly overvalued. In the spring of 2006, **P/E ratios** on emerging stock markets were fluctuating around their long-term averages, with a few recent exceptions: Colombia, Egypt, Indonesia, India, Turkey and, to a lesser extent, Brazil, Morocco and Venezuela. For these countries, P/E ratios had been above their long-term averages for three to nine months, albeit without any serious excesses. Although very low, **sovereign bond spreads** appear to reflect the fundamentals of the countries in question and the abundance of international liquidity, without there being any obvious sign of a bubble: such is the conclusion of an econometric study by the IMF[11] (chart below). With a few rare exceptions, **exchange rates** are not overvalued.

[11] Global Financial Stability Report; IMF, April 2006. For February 2006, the estimated spread for the indicator in question, the aggregate EMBIG, is 230-240 points, versus an actual level of 195-200 points, i.e. a modest differential of 30-45 points. The 30bp increase in the spread over May merely seems to have corrected this slight discrepancy.

Aggregated EMBIG spreads - Actual and Model

(In basis points)



Sources: Bloomberg L.P.; JPMorgan Chase & Co.; The PRS Group, Inc.; and IMF staff estimates.

2/ We have discussed this subject in previous editions of the overview: **the improvement in the fundamentals of emerging countries – especially those involved in globalisation – has been significant since the beginning of the decade**.

3/ Even ignoring the levels reached since 2003/04, **the structure of net capital flows into emerging countries has become more stable.** In its latest publication dated May 2006, the World Bank covered the details: increase in the relative percentage of FDI flows from 47% between 1992 and 1997 to 57% over the 2002-05 period; decrease in the weight of portfolio investments to a low level (from 11 % to 9 %). Within foreign debt, the proportion of which has fallen from 42% of GDP to 33%, the short-term component shrank from 19% of total debt in 1996 to 16% in 2004. Furthermore, debt owed by private borrowers has in part substituted public borrowing[12], **largely due to the financing of foreign trade, for which flows have tripled since 1998[13],** and quadrupled since 1994. There is therefore nothing unusual with the multiplication by 1.8 of net private capital flows into emerging countries in the 2004-06 period compared with 1995-97.

4/ Central banks have learned to absorb the potential inflationary impact and stem the appreciation of their currencies when there is a new wave of capital inflows by sterilising most of their accumulated currency reserves[14] or adopting alternative policies, e.g. offering local institutional investors the possibility of diversifying internationally.

5/ Traditional factors behind the widening of emerging countries' current account deficits, the modest rise in interest payments and sharper increase in dividend payouts have, in recent years, been partly offset by the rapid growth in remittances (doubled to USD 167bn between 2000 and 2005 according to the World Bank) and income from external assets. **Emerging countries became net exporters of capital in 2000 and flows have been significant since 2003-04.**

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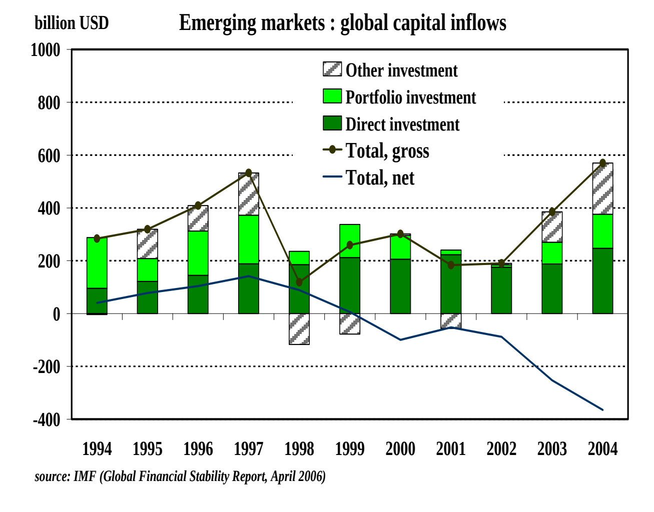
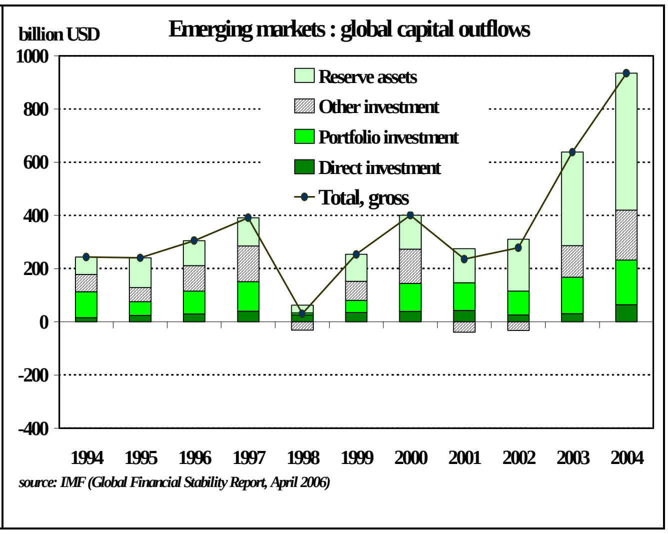
[12] According to the World Bank, while the public or government-underwritten debt of emerging countries stabilised at around USD 1,480bn between 1998 and 2005, private borrowers' debt increased from USD 851bn to USD1,317bn.

[13] Exports and imports of emerging countries' goods and services should rise from USD 2,407bn in 1998 to USD 7,208bn in 2006 (source: IMF).

[14] A World Bank analysis, based on a sample of 72 emerging countries with access to the international capital markets, revealed no significant acceleration in the money supply due to net capital inflows. In fact, annual growth in the median broad monetary aggregate of emerging countries remained stable at around 13% between 2001 and 2005 (source: IMF).





• **All in all, the risk of asset bubbles overcorrection on emerging markets is much less than it was during the 1997-2001 period.** The emergence of bubbles in developing countries could, in theory, have been a concern since 2002-03, due to the upturn in growth that had already occurred in leading industrialised countries after the 2001 industrial recession, the new inflow of foreign capital and return of current account surpluses. However, **the emergence has been limited and spread over time** for the reasons mentioned above – the most notable of these being the improvement in the fundamentals.

This was not the case after the US recession of 1991. From the beginning of the lengthy period of growth that followed, capital flowed into emerging markets. With the countries in question not prepared for this, the inflow contributed to real estate, stock market, bond and foreign exchange bubbles. When the electronics cycle swung in 1996, investors withdrew their risk assets from emerging Asian countries, leading to massive over-adjustments in other emerging zones during the years that followed.

In 2006, after four years of strong world growth, the start of a cyclical downswing in the United States and prior/simultaneous monetary tightening has (temporary) reduced risk appetite among investors in developed and emerging countries. Since 2002, though, emerging nations have proved quite good at managing the inflow of liquidity, meaning that international turmoil arising from cyclical jolts has led to "normal" price drops[15], releasing a little air from the bubbles without bursting them.

• **In the medium term, however, this financial situation is unstable**

1/ the accumulation and sterilisation of currency reserves is not a viable long-term solution to capital inflows. Issuance of government securities to absorb liquidity must compete with the corporate issuance, pushing up domestic interest rates and thus carry trade appeal. Furthermore, banking sector could be seriously affected by fluctuations in the price of securities that banks predominantly hold. Also, sterilisation and reserves holding could come at a high cost to central banks. Even if markets consider macroeconomic policies as sustainable, central banks would have to face a rising dilemma in their monetary and

[15] In terms of standard deviation from historical data.

exchange rate policy. As a result, capital cannot continue to flow in at this rate without financial bubbles emerging.

2/ capital flows into emerging countries have traditionally lasted several years, or even a decade. Economic history shows a close pro-cyclical relationship between emerging countries' capital inflows and non-energy commodity prices. In recent years, the accelerated financial internationalisation of some emerging countries (rising net capital inflows and outflows) and the gradual opening of the capital account have extended the issue of international portfolio relocation during crises from non-resident institutional investors to residents. Considerable uncertainty surrounds the behaviour of the latter.

It is worth remembering that regular access to the international bond market concerns only a fraction of emerging countries (52 according to the World Bank, more or less the same since 2002, and eight in particular: Chile, China, Hungary, Malaysia, Mexico, Poland and Russia). The other countries only have access to bank credit including medium-to-long-term loans, or short-term bank financing and official loans.

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In summary, recent financial turmoil on emerging markets will not undermine the continued improvement in country risk since 2002/03. Admittedly, it will probably lead to a period of increased market risk, reflecting in greater volatility, but it will not prompt downward revisions to growth forecasts (except marginally) or negative outlooks on debt ratings. For all that, Turkey is worth watching. Despite the tightening of monetary policies, international liquidity is still abundant, meaning that emerging countries will probably retain their considerable attraction, even for portfolio investments and carry trades. Repeats of recent financial turmoil are therefore possible, given the rise in US interest rates and market volatility but probably without any real threat to the strength of emerging countries' growth. But as we have already mentioned in previous editions, these nations have become vulnerable to a cyclical downswing in the global economy.

- APPENDIX -
THE FOREIGN EXCHANGE MINI-CRISES IN ICELAND AND NEW ZEALAND:

• **In each of these two countries, the foreign exchange crisis has been based on the following chain of events:**

1. **From 2002-03, an overheating spiral gradually developed**. Fairly strong economic growth was buoyed by domestic demand, fuelled by a strong rise in bank lending to households and businesses, in particular through international bank loans. The currency appreciated and the current deficit widened. Real estate and stock market bubbles formed. The unemployment rate fell to low levels, putting pressure on wages.

2. From 2005, **the two central banks tightened their monetary policy with significant rises in key rates, creating favourable conditions for carry trade**. The differential between domestic and international interest rates became attractive[16] for new categories of investor. Local players (major corporates in the case of Iceland; commercial banks in the case of New Zealand) issued short-term loans in local currencies in the Japanese market in order to invest in the medium-to-long term. In particular, international investors, especially hedge funds, borrowed at low rates to benefit from high returns.

In 2005, this carry trade flow inflated the traditional flow of currency borrowing by corporates and local commercial banks, accentuating the appreciation of the currency and hence indirectly the widening of the current account deficit. **Consequently, any parasitic event was liable to shake investor confidence**. In the case of Iceland, the triggers were Fitch's announcement on 28 February[17] of a downgrade of Icelandic public debt and some alarmist brokers' notes (comparing the Iceland situation to that of Thailand in 1997 or Turkey in 2000), which led to contagion to countries with similar trends, New Zealand[18] and, to a lesser extent, Australia.

• **Overall**, in the case of these two economies, and more particularly Iceland, **it is likely that most of real and financial asset prices adjustment is yet to come**. Up until now, international investors have only moderated their carry trade. Given the satisfactory level of foreign exchange reserves and monetary co-operation agreements, external liquidity does not appear to be under threat, but further episodes of sudden exchange rate depreciation are possible as bubbles burst. The rise in key rates and the incipient currency depreciation are reducing households' net wealth and weighing on business costs. In Iceland, even though the expected fall in FDI inflows should reduce the current deficit (lower imports of capital goods), the massive purchases of foreign assets by residents due to international borrowing constitutes an additional source of vulnerability.

[16] The policy rate differential and the long rate differential. In the latter case, the arbitrage can even be hedged against the exchange risk if the rate curve is steeper in the recipient country than in the US, EU or Japanese market.

[17] Sovereign long-term currency debt revised from AA stable to AA-.

[18] It appears that the currency depreciation was caused in both cases by the disengagement of Japanese investors and of Australian investment in the case of New Zealand.

- **The following lessons can be drawn from these two crises:**

- **Carry trade poses a real threat of a foreign exchange crisis in some cases.** The downward pressure on risk premiums almost throughout the world has driven investors to search for yield, with a tendency to underestimate the risk, particularly in countries with manifest imbalances in which restrictive monetary policies and/or buoyant stock markets are delivering high yields, part of which are hedged. The participants in carry trade – investment funds or hedge funds – are by their nature particularly reactive once their assessment of a market changes. In this regard, they differ from local borrowers in foreign currency, who, although they too take advantage of differentials between domestic and international rates, generally finance operations of an economic nature, from which it can be more difficult and less appropriate to disengage[19];
- **This threat concerns economies in which the appreciation of the exchange rate becomes incompatible with the trend in external accounts.** Asset price bubbles appear to constitute an aggravating factor, while free movement of capital is a permissive factor;
- **The credibility of the policy mix was a moderately important factor in the investors' decision to disengage**. Iceland and New Zealand have in common a strict budgetary policy and a credible monetary policy with regard to meeting the inflation target;

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[19] It is possible to distinguish between three cases associated with three levels of risk of market overreaction. Currency borrowing by commercial banks and resident corporates is generally based on an economic logic and scarcely lends itself to speculative behaviour (particularly in central Europe). International investors, who exploit rate differentials in yield strategies, are of course more reactive (carry trade). These can be further subdivided into non-resident national investors whose country of origin benefits from a loyalty premium (e.g. Turkish non-residents investing in Turkish government bonds) and others who could be classified as conducting "pure carry trade". The inflow of more or less volatile capital into Iceland and New Zealand is more associated with "pure carry trade" than in the case of the aforementioned emerging countries.

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