# Overview on Country Risk March, 2006

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## CONTINUITY SCENARIO FOR EMERGING COUNTRIES IN 2006: STILL STRONG GROWTH WITHOUT EXCESSIVE IMBALANCES

The international environment can be expected to remain favourable for the emerging countries in 2006 for the fourth consecutive year, with regard to global demand, commodity prices and financing sources. Growth has been at least twice as fast in the emerging countries as in developed countries since the global industrial recession in 2001 and continues without either worrisome macroeconomic imbalances or blatant bubbles in asset prices or credit despite the inflow of foreign capital. In contrast with the 1990s, the major developing countries are unlikely to fall victim - at least in the short term - to a sudden cyclical slowdown or a financial crisis of internal origin[1], barring a socio-political upheaval. This said, their commercial and financial integration has gathered pace in recent years, which makes them more vulnerable to the global cycle than in the past.

The traditional components of the country risk - the sovereign risk and the non-transfer risk - are gradually declining on average. The liquidity and solvency ratios have improved significantly, raising visibility in the short and medium term, even if visibility in certain zones is lowered by rising social, political or geopolitical uncertainties. The credit risk of banks and corporates also continues to diminish, particularly in countries which are gaining ground in international trade. Nevertheless, liberalisation and financial internationalisation are increasing the weight of foreign-currency-denominated corporate debt, whereas companies are not always prepared for the possibility of exchange rate shocks (particularly in Central Europe, India, Russia and Turkey).

While on the whole favourable, this new landscape nevertheless raises questions about the trend of global risks in view of the following observations: many developing countries are simultaneously experiencing improvement of macroeconomic or financial indicators, socio-political tensions are mounting, particularly in zones on the rims of globalisation, and trade integration is likely to strengthen the correlation between the economic cycle of developing countries and the developed countries.

[1] Exceptions: Hungary and to a lesser extent Turkey, which are beginning to show overheating risks.

## I – STILL VIGOROUS GROWTH OF EMERGING COUNTRIES IN 2006 WITHOUT WORSENING IMBALANCES

• **Absorption of the oil shock and financing of the US external deficit continue without hurting global growth.** In the spring and summer of 2005, the steadily worsening current-account deficit of the United States and the oil shock raised doubts about the possibility of buoyant, non-inflationary global growth in 2006. We now observe that the indirect consequences of the oil shock have not significantly dented global demand of the major consumer countries nor tweaked underlying inflation in the United States, the European Union or Japan[2]. Similarly, the US external deficit continues to be financed without difficulty: the growing interest rate spread has stimulated investments in dollars, helped by the fact that many developing zones are reporting high and/or growing current-account surpluses (Latin America, Asia, Middle East, Russia) and that the wish to stabilise exchange rates in order to preserve external competitiveness prompts countries in these zones to increase their official reserves (certain countries in Latin America and Asia) and even their private reserves (Middle East). **In other words, global growth continues to surf the United States' rising current deficit**. The purchase of US Treasury bonds by non-residents limits the increase in long-term interest rates, which stimulates debt and so boosts demand and asset prices. The resulting wealth effect supports activity, in turn widening the external deficit[3]. While this trend is worrisome in the long term, the deficit should continue to be financed without difficulty in the short term barring the occurrence of a major negative event (such as a serious geopolitical crisis, a natural disaster, etc.), because:

- the current-account surplus of countries where savings are recycled is likely to remain stable on the back of persistently high commodity prices;
- there is no reason to expect a significant change in geographical asset allocation since the money market rates remain higher in the United States than in the euro zone and Japan.

**Although underpinned by growing external imbalances, the dynamics of the global economy remains paradoxically robust, at least in the short term.** The financing of the US external deficit could become topical again once key rates have peaked in the United States and economic growth is expected to start slowing down.

• **In this 'brave new world" scenario[4], the growth estimates and forecasts for 2006 have been slightly revised upwards for most major zones compared with last autumn.** After reaching a historic peak of 4.9 % in 2004, global growth dropped back to its potential in 2005 (+4.4%). It is not expected to weaken in 2006. **The biggest uncertainty in the short term is the possibility of pressure on oil prices.**

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[2] Import prices of the major developed countries (United States, European Union and Japan) are becoming structurally less sensitive to commodities prices and exchange rate fluctuations, while consumer prices are becoming less sensitive to import prices. These long term trends are due to the falling weight of industry in GDP as well as to deregulation and globalisation, which are sharpening competition.

[3] See "2006, a year of transition" by Philippe d'Arvisenet, Conjoncture, BNP Paribas, February 2006.

[4] See the previous "Overview on Country Risk" - a brave new world scenario for emerging countries: is the consensus well-founded?" by G. Longueville, November 2005.

**REAL GDP**

| (Annual change as %) | **2003** | **2004** | **2005** | **2006** |
|---|---|---|---|---|
| **United States** | 2.7 | 4.2 | 3.5 | 3.7 |
| **Euro zone** | 0.8 | 1.8 | 1.4 | 2.2 |
| **Japan** | 1.8 | 2.3 | 2.8 | 3.2 |
| **China(*)** | 10.0 | 10.1 | 9.9 | 9.0 |
| **World** | 3.9 | 4.9 | 4.4 | 4.5*(e)* |

*Source: BNP Paribas (February 2006), except global growth: Rexecode (February 2006).*
*(*) China is added to the "major zones" because of its significant contribution to growing export sales of other emerging countries and to support for commodity prices.*

We therefore do not expect the latest **world trade** forecasts (IMF, World Bank), dating from October and November 2005, to be revised downward. The wavering trend of **certain commodity prices** in the spring and summer of 2005 has since made way for a consolidation movement (coffee, wheat, meat, etc.)[5]. **Oil prices** are also likely to remain high with possible spikes in the case of incidents in certain production zones (such as Nigeria and Saudi Arabia in February 2006)[6].

The surplus capacity is a low 1.5 to 2 million barrels a day, compared with 6 million three years ago, and can be expected to remain low at least in the short term, particularly as regards light crude. The output of non-OPEC countries is close to maximum capacity and slowly declining due to the diminishing yield of certain fields in production and lack of investments. Except for Saudi Arabia, the OPEC members do not have significant excess capacity. Refining capacities are also strained.

**In conclusion, commodity prices are likely to remain high in 2006 and world trade in real terms can be expected to grow rapidly,** which would primarily benefit the developing countries.

| (Annual change as %) | **2003** | **2004** | **2005** | **2006** |
|---|---|---|---|---|
| **World trade in real terms (goods and services)** | 5.9 | 10.3 | 6.2 | 7.0 |
| • o.w. exports of the "industrialised economies" | 3.1 | 8.3 | 5.0 | 6.3 |
| • o.w. developing countries exports | 10.8 | 14.5 | 10.4 | 10.5 |
| **Commodity prices excluding energy (in USD)** | 6.9 | 18.5 | 8.6 | -2.0 |

*Source: IMF, October 2005. The World Bank forecasts of November 2005 and the UN forecasts of January 2006 are close to the IMF's.*

[5] Prices of industrial commodities continue to rise. The dollar-denominated averages of indices for food and other agricultural commodities changed little in 2004 and 2005, even though there were marked differences between products.

[6] A recent World Bank study reports that a decrease in oil production of two million barrels/day could boost crude prices to USD 90/barrel for one year.

• **This buoyant environment has prompted us to upgrade our growth forecasts for the developing countries compared with the autumn 2005 forecasts.** This zone is likely to maintain the same growth rate in 2006 as in 2005, except the Middle East, where GDP is expected to grow faster on the back of rising oil income.

**REAL GDP**

| (Annual change as %) | **2002** | **2003** | **2004** | **2005** | **2006** |
|---|---|---|---|---|---|
| Main Developing countries | 3.7 | 5.3 | 6.8 | 5.9 | 5.9 |
| Pacific Asia | 6.6 | 7.4 | 7.5 | 7.3 | 7.3 |
| Emerging Europe | 4.3 | 5.5 | 6.8 | 5.1 | 5.0 |
| Latin America | -0.9 | 1.3 | 5.9 | 3.9 | 3.9 |
| Africa - Middle East | 3.4 | 4.1 | 4.5 | 4.8 | 5.4 |

*Source: IIF (February 2006); the IIF aggregates 29 emerging countries*

**Since 2004, growth has been driven by buoyant internal demand after the export spurt in 2002 and 2003.** In 2005, imports of capital goods rose sharply in Latin America, Asia and Eastern Europe, suggesting that the **developing countries are still in the upward leg of the investment cycle**[7] without the appearance of excess capacities save in a few sectors[8]. The global electronic cycle, which is relatively decorrelated from the cycle of traditional capital goods, bottomed out in the fall of 2005. **Consumption** is dynamic in most zones, generally underpinned by increased availability of private bank credit (Asean 4, new EU members, South Africa, Brazil, India, Morocco, Tunisia, etc.). This said, **the substitution of export by internal demand probably does not keep growth sufficiently autonomous.** The period from 2000 to 2006 was characterised by the historic integration of the Developing countries in the world market. The openness rate[9] of the Developing countries, nearly stable at around 20% from 1992 to 1997, has since soared to 31.5% in 2005. A marked slowdown in global demand would therefore also decrease their internal demand[10]. Consequently, **while growth of the developing countries since 2004 and 2005 is driven by demand, consumption, investment and exports, exports are probably required to drive the first two factors, even more so than in the 1990s.**

• **Growth of the developing countries, which since 2003 has been at least twice as fast as growth in the major developed countries, continues without significant aggravation of macroeconomic imbalances.**

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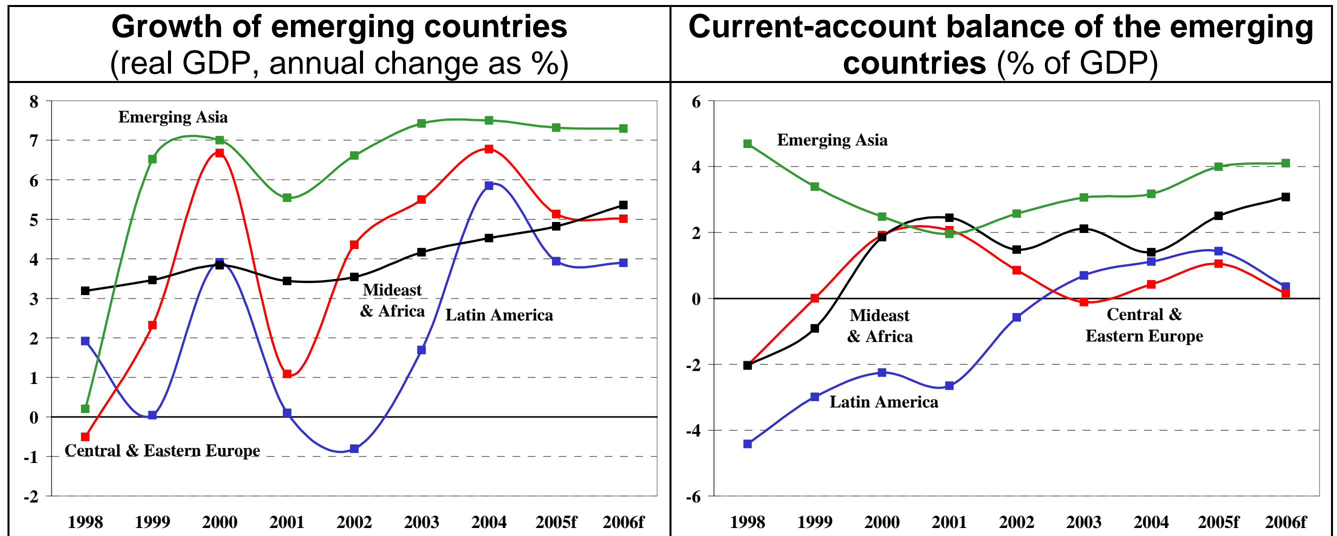
[7] See "Position in the cycle of capital goods, a definite upward leg of the cycle", Denis Ferrand, Rexecode 15.2.06.
[8] Probable exceptions at global level: automotive, cement and steel industry, also in China.
[9] Measured by half the sum of exports plus imports of goods on GDP (source: BNP Paribas, based on IMF data on the scope of "Other Emerging Markets and Developing Countries").
[10] When examining the factors underlying the recovery of internal demand of each country in 2004 and 2005 and the shift from external to internal demand, we see that this conclusion applies to the vast majority of emerging countries, which generally have little budgetary leeway. Nevertheless, the major oil exporters, especially the members of the Gulf Cooperating Council, have adequate financial reserves to pursue large-scale investment plans.




*Source: IIF*

The advent of tighter monetary policies in 2005 **limited the possible inflationary pressures caused by the oil shock.** Argentina, Iran and Venezuela, which pursue heterodox monetary policies, and to a lesser extent Indonesia and Russia, are the only countries expected to experience persisting pressure on consumer prices (around 10% p.a. in 2006). In all other major Developing countries, the increase in consumer prices hovers in a social acceptability bracket of 2% to 7% p.a. **The budgetary balances did not worsen in 2005 and no significant slide is expected in 2006**. Except for Turkey, however, countries with high deficits in 2003 and 2004 have failed to take advantage of growth to reduce the gap (Egypt, Hungary, India, Iran, Lebanon, Poland). Thanks to high commodity prices and market share gains, **the major developing zones show a current-account surplus** (see the Chart below). This said, a few countries are recording growing or relatively high deficits (South Africa, Bulgaria, Hungary, India, Romania, Slovakia, Thailand and Turkey). This deterioration is largely due to the rising energy bill of these countries, all of which are rapidly becoming an integral part of world trade[11].

**There is therefore no reason why macroeconomic imbalances should keep developing countries from growing at a significantly higher pace than the developed countries in 2006 and even after**. This diagnosis is borne out by the following analysis of changes in the country risk and the development of financial markets in the developing countries.

[11] The aggravation of the South African trade deficit is primarily due to the impact of a strong Rand on competitiveness.

## II – Change in country risk: steady improvement of the sovereign and non-transfer risks. The flow of private capital to the Developing countries is not a threat, at least not in the short term, but social and geopolitical risks continue to spread

**• Sovereign risk continues to decline, notably its foreign-currency component**

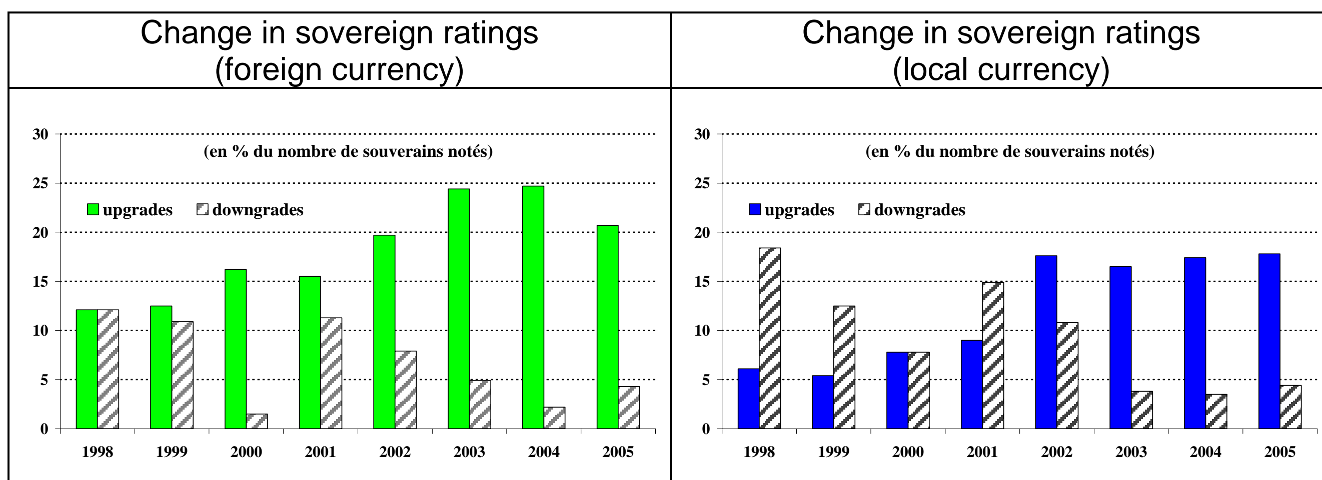
Helped by a stable average public deficit and sharp GDP growth, the public debt/GDP ratio continued to improve in 2005[12]. Most countries took advantage of the strong international financial environment to optimise debt management with three objectives in mind: **lowering interest expense, reducing exposure of debt to unforeseen financial market developments and, in certain cases, regaining autonomy from IMF oversight.**

The first objective is achieved by negotiating new maturities before their term in order to benefit from lower interest rates for both foreign and local currencies.

The second is inter alia achieved by the financing programme for 2006 (already well underway in February), extending maturities, repurchase of Brady securities[13] (Brazil and Venezuela in February 2006), substitution of domestic-currency debt for foreign-currency debt, de-indexation of debt in local currency, international issues in local currency (Brazil, Colombia, Uruguay) [14].

The third objective is reached by early repayment of soft loans, sometimes offset by international bond issues (Argentina, Brazil, Indonesia, Mexico, Philippines, Poland).

As a result, far more sovereign ratings of emerging countries were upgraded than downgraded in 2005 (in both foreign and local currency). At the end of 2005, there were also far more positive than negative outlooks, with a wider gap than at the end of 2004: **the trend towards improvement of sovereign ratings started at the beginning of the decade can therefore be expected to continue this year** (see the example below of Fitch's change in sovereign ratings).




*Source: Fitch, February 2006*

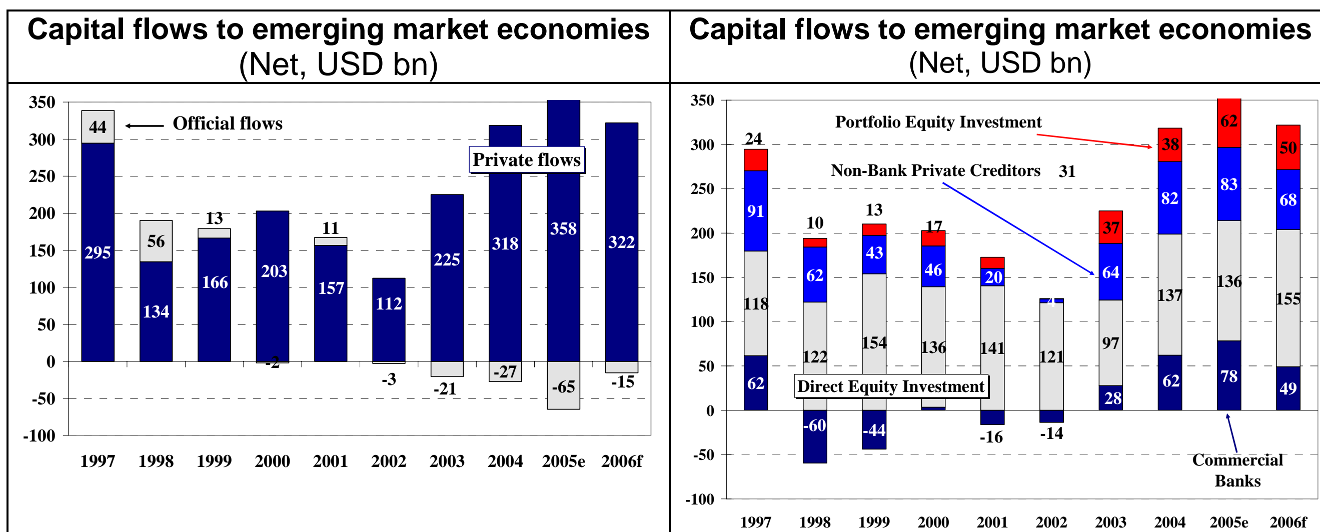
[12] Brazil is a noteworthy exception under the impact of high real interest rates.
[13] Nominal Brady outstandings reportedly dropped from USD 156 billion in 1997 to about USD 50 billion in 2005 (source: Financial Times).
[14] This is a recent and growing trend, even if the amounts remain insignificant compared with the borrowing requirements of the developing countries.

This improvement of the foreign-currency-public-debt/GDP ratio is nevertheless accompanied by **a weakening structure**: market debt is becoming more important than bank debt and soft loans[15]. Moreover, sovereign debt ratings improve more slowly in local currency than in foreign currency, since the relative risk of domestic-currency debt increases by replacement of foreign-currency-denominated debt by debt in local currency.

**Last year saw progress in the area of sovereign risk, both in the way in which the debt of the poorest countries is treated and in the international financial architecture,** which encourages a market-driven approach. In September 2005, the IMF and the World Bank approved the preliminary G8 agreement to cancel the entire multilateral debt of 18 poor countries which have completed the HIPC (Heavily Indebted Poor Countries) initiative. More and more bond issues are tied to collective action clauses (CAC). At the behest of the IMF and major private international financial associations (IIF, ICMA), many large developing countries have adopted charters of principles with regard to the transparency of macroeconomic and financial information, the stability of capital flows and debt restructuring measures (especially Brazil, Korea, Mexico and Turkey). In 2005, for example, the Dominican Republic restructured public debt owed to private creditors on a market-friendly basis. However, two restructuring initiatives, both in a special context, sidestepped the cooperation principles (Argentina in early 2005 and Iraq at the end of 2005).

- **Emerging countries' currency reserves will continue to build up**

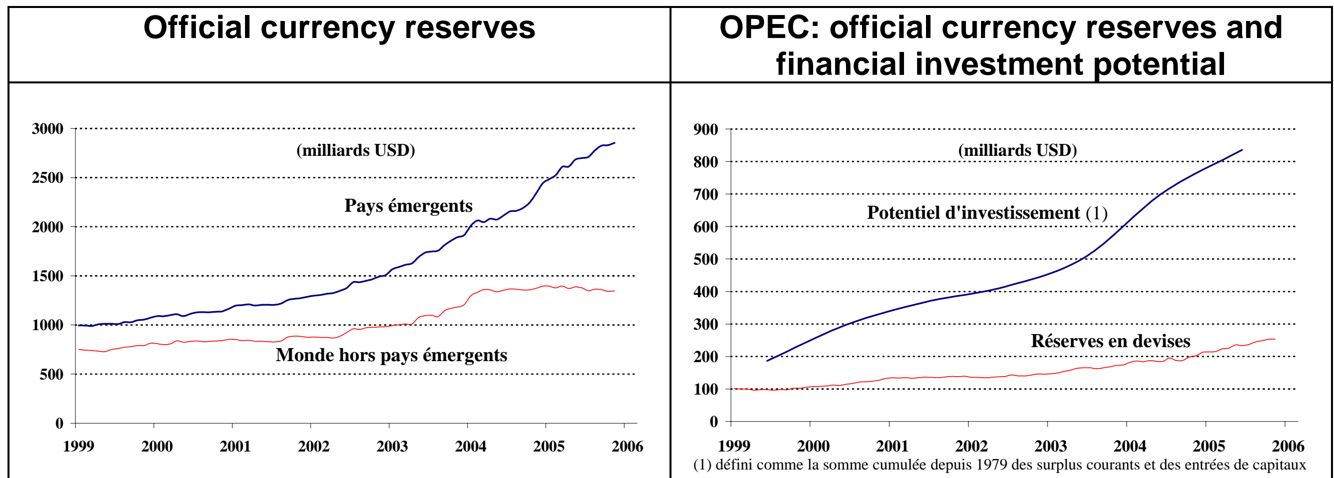
In January, the IIF published higher estimates/forecasts for net private capital flows to the emerging countries in 2005 and 2006. The structural trends observed in 2004 and 2005 can therefore be expected to continue this year. The IIF expects 2006 to bring further growth for FDIs, in line with the trend underway since 2004, as well as high (if slightly lower) portfolio investments, commercial bank loans and international bond issues (with a growing proportion of corporate issues). Net flows should continue to focus on the two main zones whose growth is driven by integration in the globalisation process: Eastern Europe and Asia.




Source: IIF

15 The bond debt accounted at the end of 2004 for about 60% of the total external debt of the public sector, compared with 40% at end-1999 (source: World Bank).

Since 2004, high net inflows of private capital and a current-account surplus have enabled developing countries to **build up official currency reserves** whose amount is boosted in proportion to intervention by central banks to dampen appreciation of domestic currencies versus strong currencies. The developing countries in Asia account for almost three-quarters of this increase (about USD 300 billion on a total of USD 400 billion; these figures are expected to be the same in 2006). **Their stock is currently twice that of the developed countries.** The oil producing countries in the Middle East hardly use their financial surplus to build up official reserves but recycle them partly through other public or private channels (see the graphs below)[16].




*Source: FMI* *Sources: FMI, BRI*

This build-up in reserves allowed many countries to make historically high repayments, and often early repayments, to official creditors in 2005 (USD 65 billion, mainly Argentina, Brazil, Peru, Poland and Russia). These amounts are expected to diminish significantly in 2006.

**• The volume of net private capital flows to the emerging countries, which since 2004 has continually outstripped the previous highs in 1996 and 1997, has raised concerns about the risk of an external liquidity crisis and collapse of the bubble in the case of a sudden outflow of capital.**

**This risk needs to be qualified, at least for the short term, for the following reasons:**

⇨ At present, **the foreign currency reserves of the major emerging countries have risen above the delicate threshold of 3 months of imported goods and services** (with the exception of Hungary). The reserves of many countries cover more than 6 months. These reserves primarily reflect inflows of stable capital (current-account surplus, FDI) rather than volatile capital (portfolio investments, deposits in local currency, short-term credits). The exceptions are South Africa, Mexico, Philippines, Hungary, Turkey and to a lesser extent Indonesia and Poland, all countries where hot money[17] is almost equivalent to official reserves without being their multiple as at the end of the 1990s. However, all these countries can count on financial aid from the IIF in the case of a liquidity crisis or else they benefit from monetary

[16] See the Bank for International Settlements Quarterly Review, December 2005, section on "Petrodollars and the international banking system" page 16 and following .

[17]The sum of portfolio investments held by non-residents, non-resident deposits and short term credits.

cooperation agreements between central banks (Asia, EU). In the case of better foreign exchange policies, these developments **significantly reduce the non-transfer risk.**

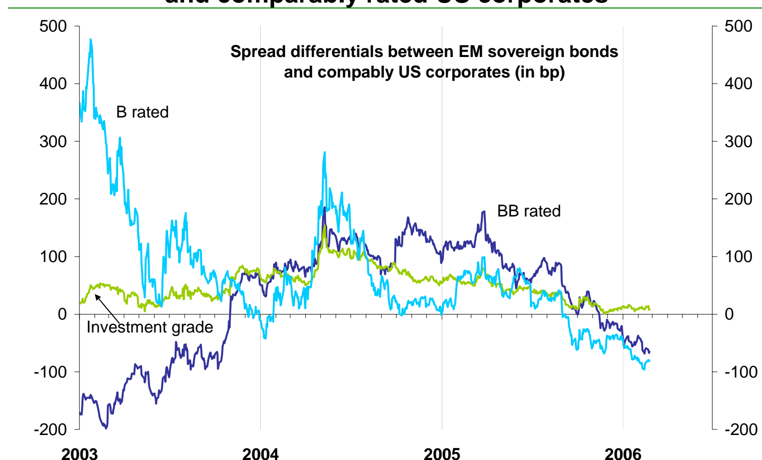
⇨ **Today, economic and commercial considerations, as reflected in FDIs and commercial credits, account for a larger part of net private flows than in 1996 and 1997.** Portfolio investments are once again high, reflecting the wish to diversify pension and investment fund assets, which was only marginally the case in 1996 and 1997. These types of investments focus moreover on countries with high growth rates, such as South Korea and India. Moreover, while the volume of these flows is similar to 1996 and 1997, commercial flows have gone up by almost 300%.

⇨ **Thanks to abundant international liquidity and the improving fundamentals of developing countries, the Fed's key rate hikes and growing US corporate spreads do not affect emerging market spreads, even though they are very low.**

**First observed in 2005, this decorrelation can be expected to persist at least in the short term for the following reasons:**

- the dollarisation of the world economy continues under the impact of the American external deficit[18] despite the Fed's tightening its monetary policy. The dollar-denominated liquidity aggregate of the central banks[19] continued to increase by 15% year on year in December 2005 (down from a high of 24% in the beginning of 2004) despite 14 consecutive Fed fund hikes since the summer of 2004, i.e. significantly faster than the nominal GDP of the countries in question. **International liquidity is therefore likely to remain abundant;**
- **the emerging markets, as a separate asset class, will consolidate their position on the back of improving fundamentals, growth of their financial markets and the introduction of derivatives to hedge the currency risk**[20]. This attraction and the upside perspectives of the default rates of US corporates explain why the spreads of emerging sovereign issuers have performed better than US corporate issuers with the same rating since the spring of 2005. Indeed, their spreads have been lower than their US counterparts since the autumn of 2005.

**Spread differential between emerging market sovereign bonds and comparably rated US corporates**



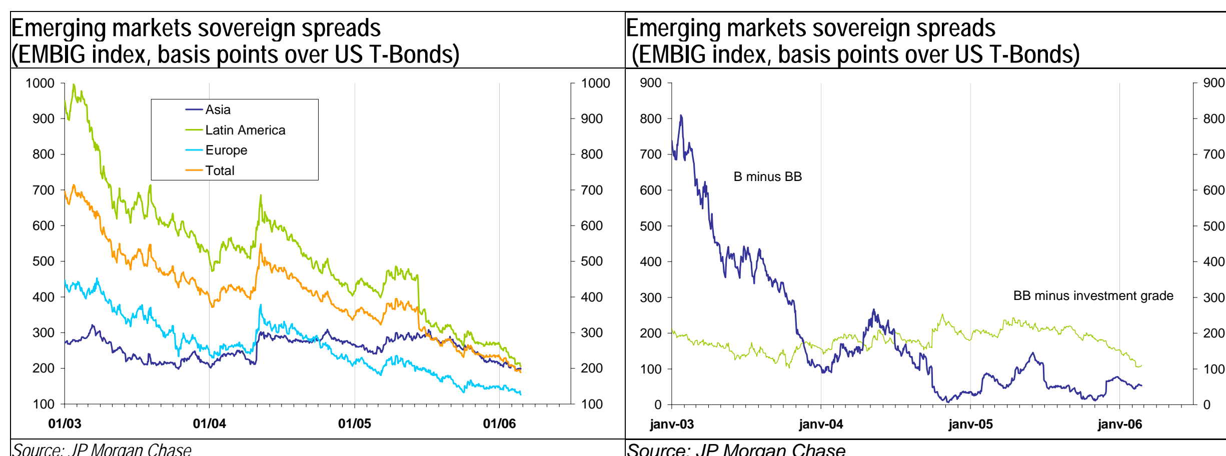

*Source: JP Morgan Chase, Merrill Lynch*

[18] Notably through the international multiplier effect of credit.
[19] Sum of US monetary base (M0) and global dollar reserves of central banks; aggregate calculated by Goldman Sachs.
[20] These markets enjoyed strong growth in 2004 and 2005, particularly in China, South Korea, Hong Kong, Malaysia, Singapore, Thailand, Brazil, Chile and Colombia.

⇨ **The historically low level and dispersion of current spreads can be considered realistic in the light of the brave-new-world scenario, expected to remain valid at least in the short term. However, they do not factor in a deterioration in this scenario.**[21]

Granted, several econometric studies have shown that the market has overvalued emerging market assets in view of their fundamentals and the credit risk[22].

However, it is more difficult to quantify the dynamics driving the relative attraction of the developing countries (stronger growth, more efficient local financial markets) and the structural excess of global liquidity, two factors which combine to whet the appetite for risk.




⇨ **The abundance of emerging-market liquidity since 2003 and 2004 through foreign currency inflows still does not appear to be a source of financial asset-price, currency or credit bubbles**[23] **but to accompany their growth**.

The recent modest appreciation in **exchange rates** against the dollar (Latin America, Asia except India and Thailand, even China) partly offsets undervaluation of the real trade-weighted exchange rate. The stock market rallies of the last three years, driven by large non-resident portfolio investments, track the increase in the earnings of listed companies, keeping P/E ratios below the historic long-term average. Moreover, several stock exchanges have undergone a timely downside correction in recent months (in the Middle East and in the Asean group).

By contrast, **the boom in bank loans to the private sector** for the last several years can be expected to weaken the balance sheet of banks and businesses alike and to fuel inflation. On the supply side, the increase is helped along by growth of the monetary base (M0) and abundant bank liquidity with far larger deposit than credit volumes. **Since 2002, credits have risen sharply as a percentage of GDP in half of all major emerging countries**. However, except for South Africa and Malaysia and even Morocco and Croatia, all countries with a soaring ratio started from low levels (with credit/GDP ratios anywhere between 15% and 30%). This suggests that the increase is probably due to a catching-up effect. Domestic liquidity is nowhere under pressure except in certain East European countries (Bulgaria, Croatia, Hungary) and in Turkey, and there seems to be no deterioration in the non-performing loan/credit ratio (with the exception of Hungary and perhaps Indonesia and China).

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[21] Topic discussed in the previous "Overview on Country Risk" of November 2005
[22] IMF model based on data to end-2004, Bank of England report published in December 2005. This report shows moreover that the risk of contagion between developing countries has decreased (lower correlation between market indicators), helped by diversification of creditor portfolios.
[23] But there are likely bubbles in the residential property sectors of the major cities (Shanghai, Dubai, etc.).

Even without warning signs, the relatively widespread increase in consumer loans needs to be watched since most consumers in the developing countries are still in the "learning phase". **In conclusion, however, there are no clear signs of excessive credit facilities for the private sector in the emerging countries, save for a few exceptions.**

**Credit to the private sector**

| Countries with rapid credit growth | | | Countries with slow or declining credit growth | | |
|---|---|---|---|---|---|
| **(% of GDP)** | **Level in 2002** | **Change to 02-05 (GDP percentage points)** | **(% of GDP)** | **Level in 2002** | **Change to 02-05 (GDP percentage points)** |
| Bulgaria * | 20 | 22 | Brazil | 28 | 4 |
| Malaysia *□ | 99 | 18 | Venezuela | 10 | 3 |
| Hungary | 35 | 16 | Romania | 8 | 3 |
| South Africa | 70 | 14 | Colombia | 20 | 1 |
| Turkey * | 14 | 10 | Poland | 28 | 0 |
| Croatia * | 51 | 10 | Mexico | 17 | 0 |
| Indonesia | 19 | 9 | Tunisia | 61 | 0 |
| Russia □ | 18 | 9 | South Korea | 92 | -1 |
| Pakistan | 24 | 9 | Chile | 63 | -1 |
| Morocco | 54 | 9 | Peru | 23 | -3 |
| Saudi Arabia | 29 | 8 | Argentina | 15 | -4 |
| India | 33 | 7 | China □ | 119 | -5 |
| Czech Republic | 30 | 5 | Philippines | 34 | -6 |
| Iran | 22 | 5 | Thailand | 81 | -7 |
| | | | Egypt | 50 | -11 |

*Caption:* * *indicates pressure on interbank liquidity*
□ *indicates an actual or probable deterioration of the non-performing credit/total credit ratio*

*Source: BNP Paribas*

- **Despite growth, socio-political risks have gradually worsened in recent months**

In the **Middle East**, the tension between Iran and the international community remains high what with the importance of nuclear power for the regional geopolitical balance. In Iraq, mounting tensions between the Shiite and Sunnite communities are permanently scuttling the constitution of a viable nation and may start having regional repercussions. The problems in the **Near East** have been made even more complex by the Hamas victory in Palestine, the recent political uncertainties in Israel and the worsening relations between the religious communities in Lebanon (mainly the gap between Shiite and other groups). In **Egypt**, the growing influence of the Muslim Brothers on the population is likely to last beyond their one-off success in the general elections of December 2005, which has prompted the authorities to postpone the scheduled municipal elections for two years. Against the backdrop of these developments, we are witnessing the emergence of a largely Shiite anti-American politicised Islam movement, whose lawful political representation is gaining ground. In **Southeast Asia,** political issues are weakening the power of the leaders (the attempted, but failed, overthrow in the Philippines in February [24], the political deadlock – that may last - in Thailand between the President and the opposition, expected to boycott the next elections). **In Latin America**, the

[24] However, the state of emergency was lifted on 2 March.

elections scheduled in 2006 should confirm the regional shift to the left[25]. Bolivia and Peru risk following the example of Argentina and Venezuela, whose presidents are strengthening their hold on the executive, legislative and judicial branches in order to pursue a heterodox and populist economic policy without constraints. **In Sub-Saharan Africa**, most of the politically loaded ethnic conflicts remain as intense as ever.

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**Analysis of growth versus macroeconomic imbalances, sovereign risks and non-transfer risks, shows that the developing countries in general are currently in a much better position than they have been for many years. Indeed, their economies may be stronger than at any other time since the early 70s.**

This conclusion results from the lessons learned from the crises in the 1990s (which led to a shift in macroeconomic and microeconomic policies, especially in Brazil, Turkey and Southeast Asia), the global liberalisation and deregulation movement combined with the ICT revolution, China's inclusion in the group of traditional markets for the developing countries, an abundance of international liquidity and, finally, the unusual length of this buoyant environment: 2006 can be considered the fourth consecutive year of strong global trade, high commodity prices and low borrowing costs.

This said, **there is a growing divide between countries participating actively in the globalisation process** (most major countries in Central Europe and Asia, and a few countries in Latin America) and **countries stuck to the rim** (Sub-Saharan Africa, some countries in Latin America notably). A third group of countries can be found at the **crossroads** (North Africa, Egypt, Indonesia, Philippines, to a certain extent Russia and Gulf countries which benefit from oil revenues). With the decline of the EU's international influence and the recognition of US leadership by the emerging powers, economic growth in Developing countries is accompanied by rising social, political and geopolitical tensions, concentrated almost exclusively in zones not actively involved in the globalisation process. These zones tend to be receptive to radical Islam. Analysis of their country risk may be thrown off by improvement of macroeconomic or financial indicators despite weak integration in global trade and questionable long-term sustainability of their socio-political model.

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End of redaction March 7th 2006.

[25] Venezuela and Argentina have already adopted heterodox economic policies and created a very difficult climate for private investors, while future policy is uncertain after the elections in Bolivia and Peru. By contrast, in Brazil, Mexico, Uruguay and Chile, the election of left-wing governments is unlikely to alter the course of macroeconomic orthodoxy.

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