Monthly Comments – Emerging Markets

MacroFinance Research – March 2021

Key Messages

RiskWatch – Adjusted Country Risk Premium: Principles and Overview of most vulnerable Emerging Markets

In this issue of the Monthly Comments, the Overall Index of Sensitivity To Post-Covid Transition (presented in the last issue) is further unfolded and incorporated in our broad measure of country risk. Although the conversion of the Index into basis points is technically complex and relatively neutral at the aggregate level for 100 Emerging Markets (EMs), the Covid-19 Adjustment allows to better capture the short-term implications of the pandemic on overall country risk and on the likelihood of materialization of risks' factors. Hence, Adjusted Country Risk Premium for Europe remains on average in the low risk category, in the medium risk range for Asia; but high risk averages for Middle East and North Africa, Latin America, and Sub-Saharan Africa point to enhanced short-term vulnerabilities related to both economic and health conditions. Regional maps of the Adjusted Country Risk Premium will reveal individual country situation.

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

Completed on March 11, 2021.

RiskWatch – Adjusted Country Risk Premium: Principles and Overview of most vulnerable Emerging Markets

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Principles for adjusting Country Risk Premium

As at the beginning of every year, we summarize here the broadest quantitative assessment of country-risk for the 100 EMDEs included in our tool RiskMonitor. It took us slightly longer this year as we wanted to incorporate the uniqueness of the Covid-19 and its implications for country risk in the short-term. In the February issue of the Monthly Comments, we introduced and described an *Overall Index of Sensitivity to Post-Covid Transition* that specifically focuses on the country-level implications of the pandemic for the economic recovery, for credit and financial risks, and in terms of overall resilience.

In this note, we quantify the impact of this *Sensitivity to Post-Covid Transition* on the aggregate country-risk premium for each of the 100 countries. This premium is the broadest quantitative assessment of country risk and is expressed in basis-points based on the perspective of a long-term real investor (technically, a Risk-Related Extra-Cost of Capital, RRECC). In our methodology, the RRECC quantifies the implication of Economic & Financial Risk Ratings, Political & Governance Risk Ratings, Early Warning Signals of upcoming shocks, and structural / historical features of each country (commodity dependence, and history of external debt restructurings).

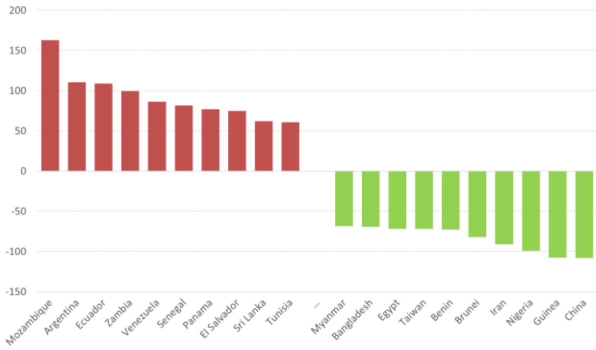
Each of these components of the RRECC is adjusted by the elements constituting our *Sensitivity to Post-Covid Transition*, with larger impact of Credit Risk Sensitivity on the History of Debt Restructurings component, or Economic & Financial Risk rating adjusted by the three broad factors…

The result is an Adjusted Country-Risk Premium (ACRP), which captures better the implications of the 2020 shock and the transition to the post-Covid period. The reading of the metrics should however keep in mind that (1) the ACRP remains a country-risk quantification for long-term real investors with therefore a time-horizon above five years; (2) conversely, the direct metric for the *Sensitivity to Post-Covid Transition* index captures more aptly the shorter-term country-risk factors able to affect the immediate country risk materialization.

For example, looking only at the top 10 and bottom 10 countries for the specific quantification of *Sensitivity to Post-Covid Transition* is a better way of highlighting countries that are already or will benefit from this transition phase (in green in the chart), and conversely the countries most likely to register strong short-term difficulties (in red: Mozambique, Argentina, Ecuador, Zambia, Venezuela, Senegal, Panama, El Salvador, Sri Lanka, and Tunisia) than the longer-horizon ACRP.

RRECC adjustment to Post-Covid Transition

(bp, 10 best and 10 worst countries across 100 EMDE)



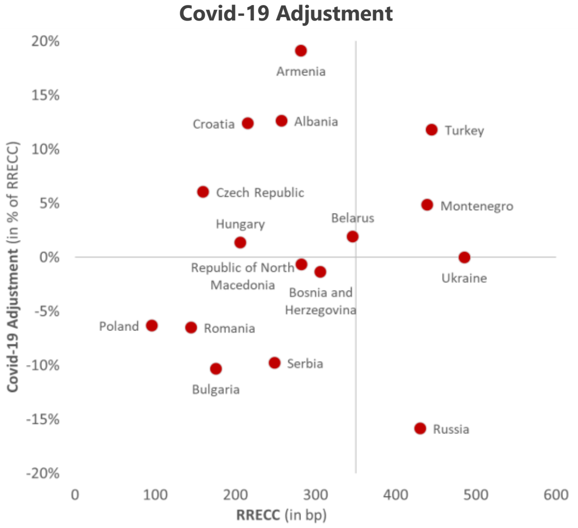
Source: TAC ECONOMICS

Interestingly, the aggregate effect of incorporating the adjustment brought by the countries' *Sensitivity to Post-Covid Transition* is almost neutral on the (unweighted) average of our original RRECC (-4.2bp), as a majority of countries (56) register now a favorable adjustment in their relative cost of capital, thanks to a combination of limited Credit and/or Growth Sensitivity and stronger-than-expected Resilience.

Mapping country risk in emerging markets

The following sections cover the different regions (Emerging Europe, Middle East and Africa, Latin America, and Asia). For each region, they show a map with the Adjusted Country Risk Premium (with a color code: dark green for very low risk to dark red for very high risk), and a graph combining the level of pre-existing vulnerabilities (the original RRECC before adjustment) and the relative change induced by the short-term impact of Post-Covid Transition on overall country risk.

- Central & Eastern Europe (CEE)-



Source: TAC ECONOMICS

The Central and Eastern European region presents the lowest regional average for the ACRP (283bp in March 2021). However, the favorable level of pre-Covid vulnerabilities (RRECC) was steadily rising between 2018Q2 and 2020Q3; noticeably the average RRECC for Europe started to improve marginally in 2020Q4, thanks to a significant reduction in the average Economic & Financial Risk ratings.

The map confirms the favorable panorama for the emerging Europe, as a majority of EMs (11 out of 16) exhibits a *very low* or *low* ACRP (dark and light green); **Belarus** and **Russia** are in the bottom of the *medium risk* category (353bp and 362pb respectively). In addition, **Montenegro**, **Ukraine**, and **Turkey** stand in the *high risk* category (orange), associated with Watch List Indications for the former two, suggesting likely significant shock on Payment up to 2002Q2, especially if Ukraine cannot reach conditions for disbursements under IMF's financial program.

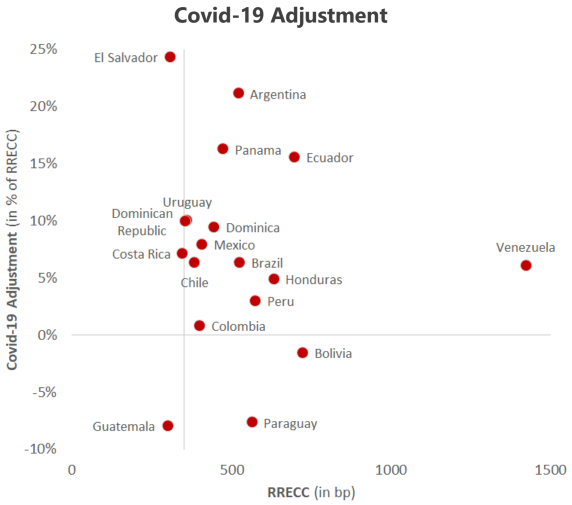
Turkey's early warning signal on payment was switched off given the materialization of the crisis (on the activity and currency) while nascent resurgence in forex reserves and recent turn-around in economic policies should prevent significant shock in the coming quarters.

The Covid-19 Adjustment related to the *Overall Index of Sensitivity to Post-Covid Transition* has a major impact only on a limited number of countries: four countries register an upward revision above 10% in their RRECC: **Croatia**, **Albania**, **Turkey** (+52bp), and **Armenia** (+54bp); while **Russia** is the only country to register a sizeable downward adjustment (-68bp). Indeed, Russia's level of short-term macro risks is much lower post-Covid, mainly supported by rising global oil prices.

On the opposite, several *low risk* countries (**Croatia**, **Albania**, **Armenia**, and to a lower extent **Hungary**), along *very low risk* **Czech Republic** register higher risk in the short-term (cf. upper-left quadrant of the Covid-19 Adjustment graph). In particular, the component of Growth Sensitivity to Post-Covid Transition is generally mediocre because of the critical health situation (notably Albania), stringent restriction measures (Hungary and Czech Rep.), low fiscal support (Hungary as well as Armenia), and substantial international transmission factors (Albania, Armenia, and Croatia). In addition, while Resilience factors are neutral (expect for Armenia), Credit Risk factors are negative for Croatia, Albania and Armenia, as they have two very high risk components (among Liquidity, Corporate and Sovereign Risks).

Meanwhile, *very low risk* countries – **Poland**, **Romania**, and **Bulgaria** – benefit from a favorable Covid-19 Adjustment, thanks to favorable contributions of two factors (Credit Risk Sensitivity and Resilience in 2020) offsetting significant drag of Growth Sensitivity due to still worrying health situation, persistence of intermediate level of restrictive measures (high in Romania) and for Bulgaria, relatively higher international transmission.

- Latin America -



Source: TAC ECONOMICS

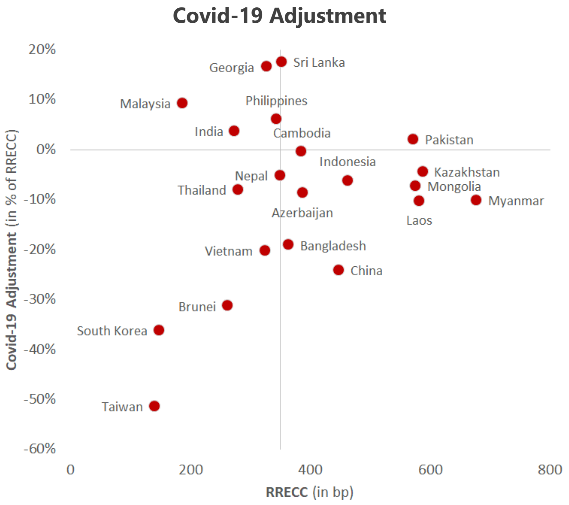
Average ACRP in Latin America is high (561bp in March 2021) as more than half of the countries (10 out of 18) displays *high* or *very high risk* levels. The pre-existing average RRECC registered a substantial deterioration over the last two years (+50% between 2018Q3 and 2020Q4), hence pointing very well the actual period of sharp vulnerabilities in the region.

Similarly, the regional map highlights the mediocre risk situation in Latin America as no country has *very low risk*, and only **Guatemala** is in the *low risk* category (light green). On the opposite, **Venezuela**, **Ecuador**, **Bolivia**, and **Honduras** are classified as *very high risk* countries, while **Argentina**, **Peru**, **Brazil**, **Panama**, **Paraguay**, and **Dominica** are *high risk* EMs. Noteworthy, Venezuela's extreme risk situation is evidenced by the presence of one Crisis Signal (on Activity) and one Watch List Indication (on Exchange Rate) up to mid-2024. Conversely, Brazil's Watch List Indication on Exchange Rate was switched off as fx difficulties actually materialized in 2020 (sharp depreciation of the BRL against USD by -30% between early-Jan. 2020 and mid-May 2021).

When looking at the Covid-19 Adjustment by level of pre-existing vulnerability, there is a massive grouping of *medium* to *high risk* countries recording short-term upward adjustment due to unfavorable *Sensitivity to Post-Covid Transition*. Because of still difficult heath situation (alarming Covid-19 dynamic and stringency of partial lockdowns) in **Argentina**, **Brazil**, and **Mexico**, Post-Covid Transition will significantly accentuate their short-term risks. Moreover, Argentina and **Ecuador** (along with Belize and Suriname also in the region) defaulted last year, highlighting the critical level of indebtedness and massive shocks on activity.

Only **Paraguay**, and **Bolivia** to a lower extent, benefit from lower level of short-term risk thanks to significant adjustments during the Covid-19 crisis (low Credit Sensitivity for both and favorable index of Resilience only for Paraguay). Since **El Salvador** has very high Credit Sensitivity and high Growth Sensitivity, the consequent large upward Covid-19 Adjustment pushed the country into the *medium risk* category.

- Asia -



Source: TAC ECONOMICS

Asia's average ACRP (355bp in March 2021) is close to the lower end of the *medium risk* category. Indeed, the number of *medium risk* and *high risk* countries (11) almost tally equally with *very low risk* and *low risk* countries (10) among the total 21 monitored in the region. Although the underlying RRECC recorded a gradual deterioration (+100bp) since mid-2018, it reserved favorably in 2020Q4, pointing to the nearing end of maximum vulnerabilities in the coming quarter.

The above color map displays level of ACRP in the region. What works in Asia's favor is that its largest economies and the drivers of economic growth for the region are now in *low risk*: **China** and **India** (light green); while **South Korea** and **Taiwan** (dark green) have *very low risk*. The export-driven continent will witness a resurgence in economic growth powered by strengthening regional trade.

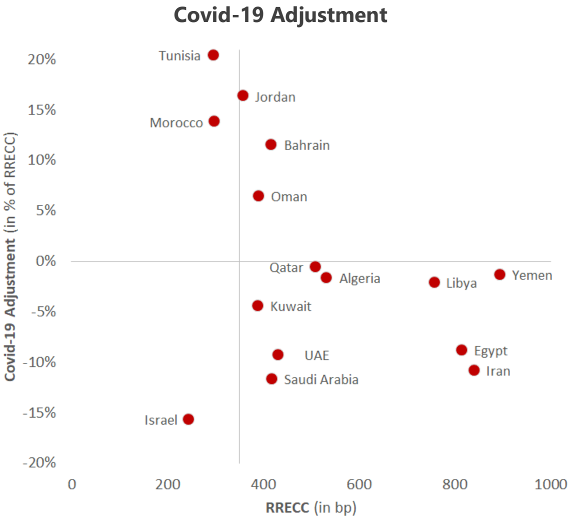
Meanwhile, the map put evidence *high risk* countries (orange): **Laos**, **Mongolia** and **Kazakhstan** (both elevated commodity risk premium and Watch List Indications on Payment), **Pakistan** (high Liquidity Risk and very high Political Risk), and **Myanmar** (Crisis Signal revealing the likely substantial shock on Economic Activity, while political risk remains obviously elevated). **Indonesia** faces *medium risk* due to an ambiguous combination of high Economic & Financial Risk rating (overvalued currency, and persistent current account deficit) and vulnerability to volatility in global commodity prices on one side, and high growth potential and favorable economic resilience on the other side.

The upward Covid-19 Adjustment related to the Overall Index of Sensitivity to Post-Covid Transition is elevated for only a handful of countries: **Sri Lanka** (high Credit Sensitivity and precarious health situation), **Georgia** (high Liquidity Risk) and **Malaysia** (high lockdown stringency and elevated Liquidity Risk). Malaysia and **India** register higher short-term risks, but their country risk premium remain favorable in the long run.

On the contrary, countries like **Kazakhstan**, **Mongolia**, **Myanmar**, and **Laos** display elevated structural country risk premium given their dependence on commodities, weak governance of economic policies, and fragile domestic political climate. Also located in the quadrant of a downward adjustment (much lower short-term risk), **Indonesia**, **Azerbaijan**, **Bangladesh**, and **China** which are recovering at a significant pace from the global shock.

Lastly, *low risk* **South Korea** and **Taiwan** registered the largest downward adjustment (-53bp and -72bp respectively), confirming the positive impact of very low Credit Sensitivity and very strong Resilience in fostering a sustained post-Covid economic recovery.

- Middle East and North Africa (MENA) -



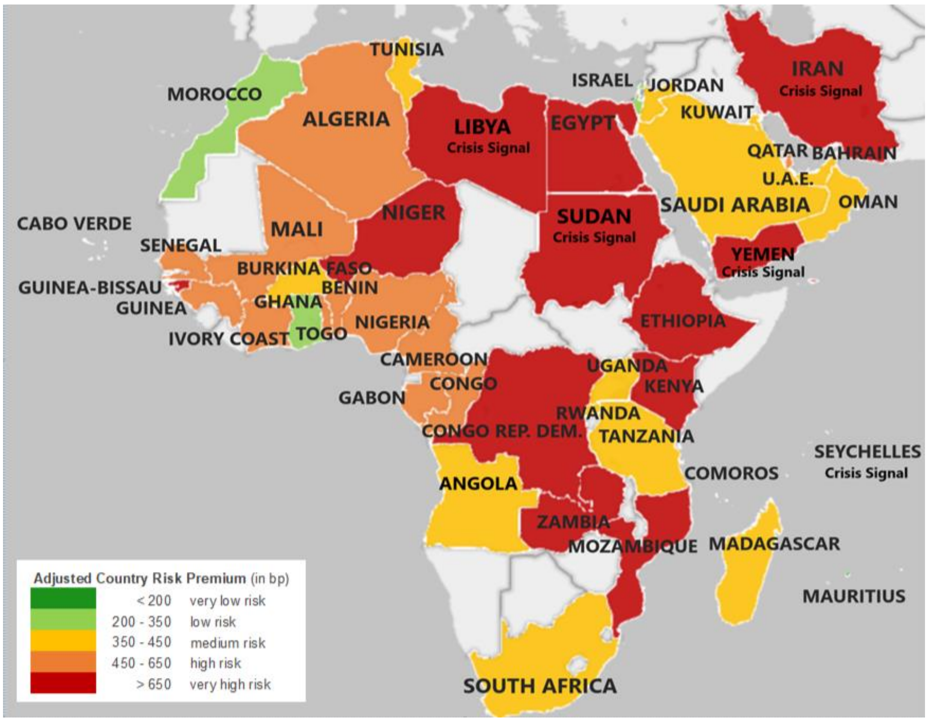
Source: TAC ECONOMICS

The average Adjusted Country Risk Premium for MENA countries is at a *high risk* level (500bp in March 2021); when looking back, the average RRECC deteriorated rapidly in the first half of 2020 (+22%) on account of surging global risk aversion and massive economic recession induced by the Covid-19 pandemic.

When looking at the map for the dispersion of ACRP in the region, countries are ranging from *low risk* (**Israel** and **Morocco**) to *very high risk* (**Yemen**, **Iran**, **Egypt**, and **Libya**). Moreover, war-torn Libya and Yemen are each affected by Crisis Signal confirming that the massive shock on Economic Activity shall extend over the long-term (up to 2024-2025). Also, Iran is affected by both a Crisis Signal (on Economic Activity) and a Watch List Indication (on Exchange Rate) pointing to the massive macro vulnerabilities beyond the short-term post-Covid recovery.

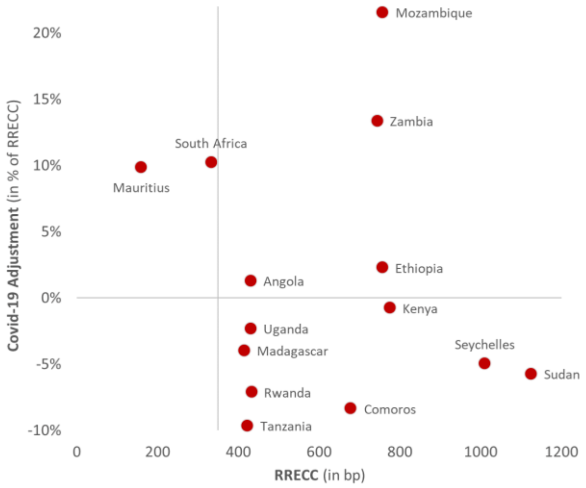
The wide range of positive and negative performances in the MENA region is further evidenced on the scatter plot combining the RRECC and Covid-19 Adjustment, with countries located in each of four quadrants. Most EMs are in the bottom-right quadrant, denoting lower short-term risks during the Post-Covid Transition; this favorable downward adjustment is generally associated with low or very low Credit Sensitivity (**Iran**, **Egypt**, **Saudi Arabia**, **UAE**, **Kuwait**, **Algeria**), fueled by sufficient forex reserves and manageable corporate and sovereign (external and domestic) debt. Yet, low Credit Sensitivity is partially offset by high index of Resilience Algeria and Iran. Overall, given the ongoing hike in global oil prices, commodity producers will benefit from a temporary breather, but not sufficient to circumvent medium- to long-term economic vulnerabilities.

On the opposite, **Morocco** and **Tunisia** see a major degradation in their moderate level of pre-existing vulnerabilities because of high indexes of Credit and Growth Sensitivity to Post-Covid Transition and mediocre Resilience capabilities in 2020 – exacerbated by lingering social and political tensions in Tunisia. Risks of materialization of an economic shock (default / restructuring on corporate or sovereign debt) are therefore present but will clearly depend on potential international financial support.



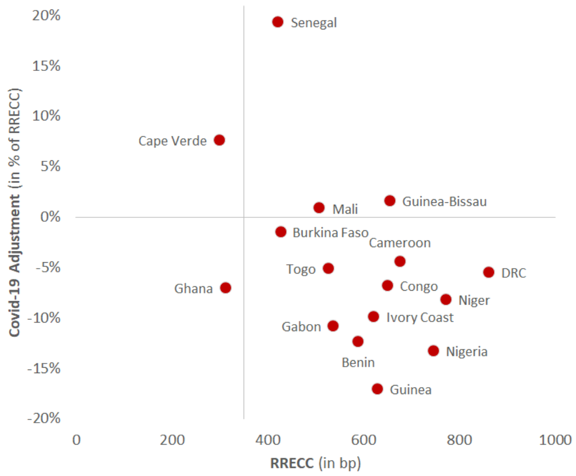
- Sub-Saharan Africa -

Southern and Eastern Africa - Covid-19 Adjustment



Source: TAC ECONOMICS

Central and Western Africa - Covid-19 Adjustment



Source: TAC ECONOMICS

The average Adjusted Country Risk Premium for Sub-Saharan African region is at a *high risk* level (575bp in March 2021). The recent history of the average RRECC for the region show a substantial worsening over the last two years (+40% between 2018Q3 and 2020Q3), notably because of the massive deterioration on the Growth Balance in 2020.

The map reveals the detailed situation, with a large majority of *very high risk* countries (9 out of 30, in red) and *high risk* countries (11) while only **Mauritius** (176bp) is in the *very low risk* category, **Ghana** (291bp) and **Cape Verde** (323bp) are in the *low risk* category. Moreover, the two highest risk countries in the region combine two extra-risk premiums (dependence on commodity exports, history of debt restructurings) along with Crisis Signals: **Sudan**'s prolonged shock on economic activity is expecting to continue in the coming years; **Seychelles**' high external indebtedness creates very strong likelihood of solvency pressures in the short- to medium- term.

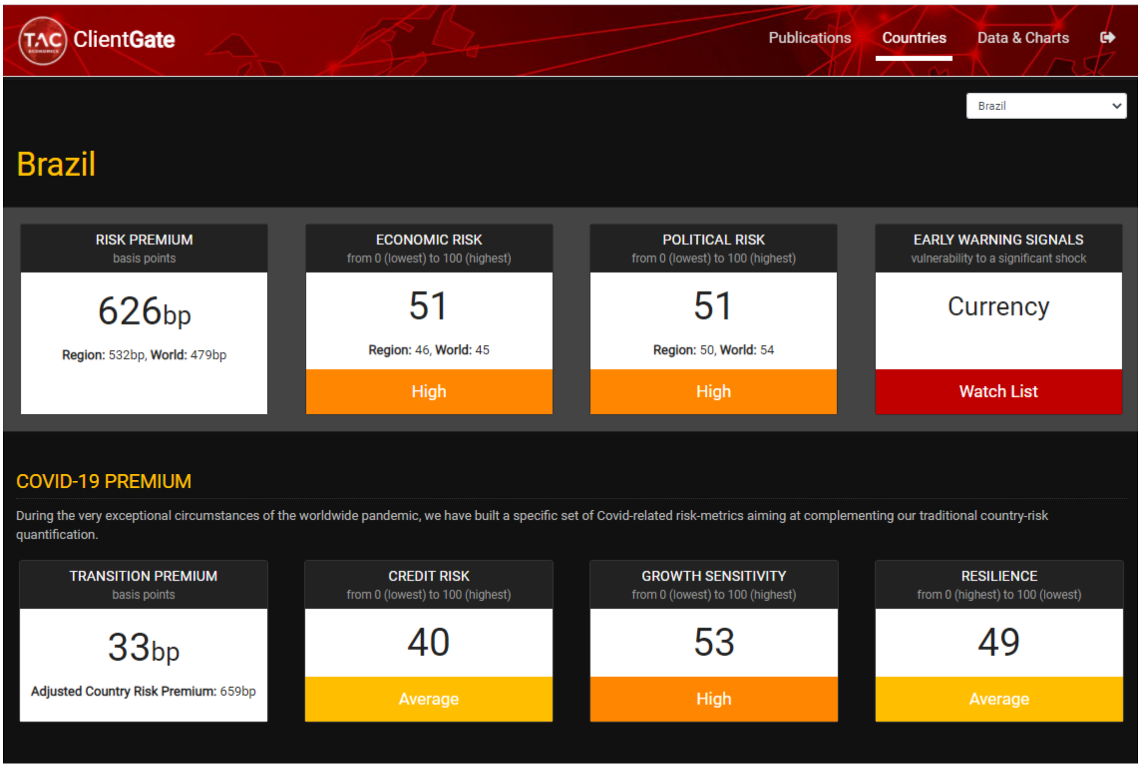
Large number of EMs within the bottom-right quadrant on the two scatter plots for Sub-Saharan Africa highlights the lower short-term risks during the Post-Covid Transition for *medium risk* and *high risk* countries. Very favorable Covid-19 Adjustment in **Benin**, **Côte d'Ivoire**, **Gabon**, **Guinea**, or **Tanzania** reflects each country's relatively strong resilience when confronted with a global shock. In parallel, **Nigeria**'s very low level of Credit Sensitivity and moderate economic recession in 2020 suggest lesser pressures during the post-Covid recovery, even though its *high risk* ACRP confirms the substantial vulnerabilities for investment projects

On the opposite, only three EMs with relatively low level of pre-existing vulnerabilities (**Mauritius**, **South Africa**, and **Cape Verde**) register much higher short-term risk related to the Post-Covid Transition.

Lastly, with an already low overall county risk premium, **Ghana** further benefits from the favorable short-term impact of strong Resilience (positive GDP growth in 2020). Conversely, **Mozambique**, **Zambia**, and to a lower extent **Senegal**, have a substantial deterioration of their RRECC due to adverse combination of very deficient indexes of Credit Risk and Growth Sensitivity, and insufficient Resilience. Noticeably, Zambia was also among the defaulting EMs in 2020, whereas the extra Covid-19 risk premium portends unlikely resolution of restructuring talks and creditors' claims in the short-term. Despite high distress of overall and external debt, Mozambique has so far avoided a default situation given the lifesaving support of international financial creditors (IMF and G20 DSSI), but a debt restructuring will become very likely when these programs expire after mid-2021.

Appendix 1: COVID-19 PREMIUM on TAC ECONOMICS Client**Gate**

When you login on TAC ECONOMICS ClientGate[1], our up-to-date one-stop-shop for country risk profiles, publications and data, you will find a new banner in the Countries section presenting Covid-related risk metrics:



[1] https://clientgate.taceconomics.com/

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