EMERGING RISKS

BSRI QUARTERLY UPDATE

JULY 2013

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Emerging Risks

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The latest quarterly update of the BlackRock Sovereign Risk Index (BSRI) focuses on emerging markets and highlights Spain, Ireland and Austria among the 48 countries we track. Try our *interactive BSRI* to view individual country scores, compare two countries and sort rankings by index components.

Our main headlines for the quarter ended 30 June:

- The External Finance scores of most emerging markets are worsening as current account balances deteriorate. **China**, **Thailand** and **Malaysia** show some of the biggest declines in the past year.
- **China** fell two notches in the rankings to 19th place in the quarter, mostly as a result of its shrinking current account surplus.
- **Austria** rose three notches to 16th place, due to improvement in its projected structural surplus and stronger external finances.
- **Ireland** and **Spain** also rose. Fiscal austerity is leading to healthier budget outlooks, while current account balances are projected to improve.

Drawing on a pool of financial data, surveys and political insights, the BSRI provides investors with a framework for tracking sovereign credit risk. The index uses more than 30 quantitative measures, complemented by qualitative insights from third-party sources.

The index breaks down the data into four main categories that each count toward a country's final BSRI score and ranking: Fiscal Space (40%), Willingness to Pay (30%), External Finance Position (20%) and Financial Sector Health (10%).

- Fiscal Space includes metrics such as debt to gross domestic product (GDP), the debt's term structure, tax revenues and dependency ratios.
- Willingness to Pay measures a government's perceived effectiveness and stability, and factors such as perceived corruption.
- External Finance Position includes exposure to foreign currency debt and the state of the current account balance.
- Financial Sector Health gauges the banking system's strength.

For full descriptions, see *Introducing the BlackRock Sovereign Risk Index* of June 2011. The BSRI's inputs are updated at irregular intervals, meaning some changes may only reflect the timing of data releases. Small changes in scores can spur big changes in rankings, as many issuers are bunched together in the index (the moves by **Germany** and **Finland** are examples this quarter). The BSRI is not meant to forecast the creditworthiness of countries.

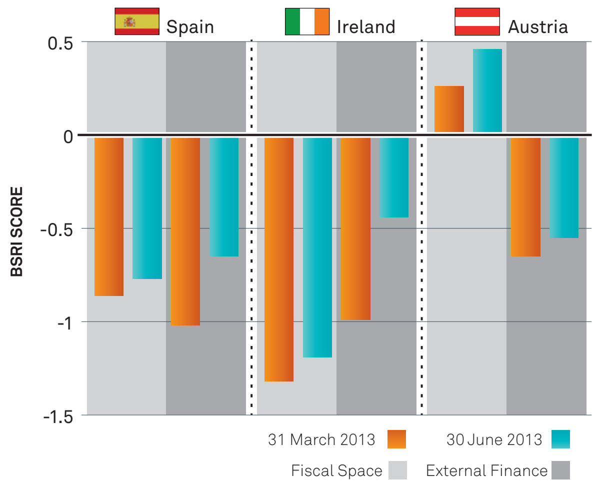
EUROPESSIMISM LIFTS

Is the Eurozone on the mend? The BSRI scores of **Spain**, **Ireland** and **Austria** jumped thanks to improvements in their Fiscal Space and External Finance scores. See the chart on the right. **Austria** stands out for its fiscal rectitude – its primary budget surplus is expected to rise sharply over the next 12 months, boosting its Fiscal Space score. External finances improved for all three countries:

- European countries have been extending the term of their debt. **Ireland** (the poster child for fiscal austerity) has pushed a big chunk of its debt maturities out as far as 2042. This gives governments more fiscal wiggle room, as detailed in *Maturities Matter* of April 2013.
- Current account balances are expected to improve over the coming year, albeit not always for the right reasons. The International Monetary Fund (IMF) expects **Spain** to post a current account surplus in 2013 – its first since the launch of the euro in 1999. The improvement, however, is partly driven by weak domestic demand. Imports have collapsed.

TO A BETTER ZONE?

Fiscal Space and External Finance Scores

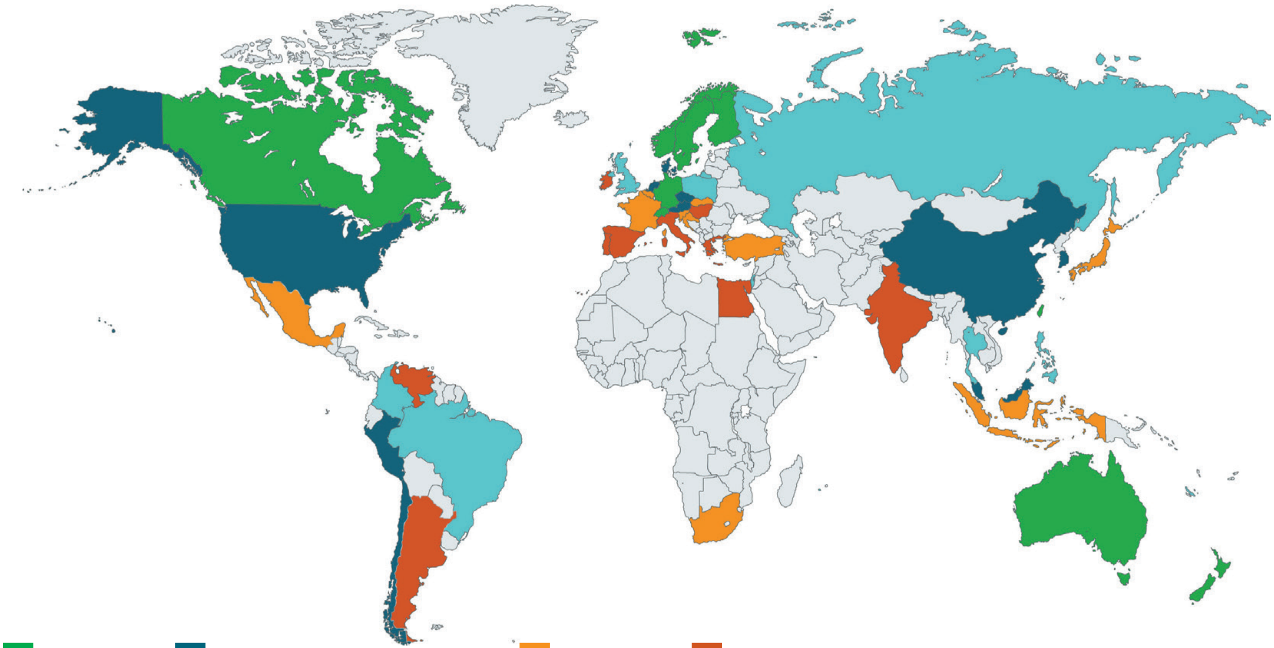


Source: BlackRock, June 2013.

Bottom line: The European recovery is likely going to be a slow and painful process.

MAPPING SOVEREIGN RISK

BSRI Country Rankings by Quintile, June 2013



Top ten	11-20	21-28	29-38	Bottom ten
1 Norway	11 Chile		29 Slovakia	39 India
2 Singapore	12 Denmark		30 Belgium	40 Spain
3 Switzerland	13 South Korea	21 Russia	31 France	41 Hungary
4 Sweden	14 Netherlands	22 Israel	32 Mexico	42 Ireland
5 Taiwan	15 USA	23 Philippines	33 Japan	43 Argentina
6 Germany	16 Austria	24 Poland	34 Turkey	44 Italy
7 Canada	17 Malaysia	25 United Kingdom	35 South Africa	45 Portugal
8 Finland	18 Peru	26 Thailand	36 Indonesia	46 Egypt
9 Australia	19 China	27 Brazil	37 Croatia	47 Venezuela
10 New Zealand	20 Czech Republic	28 Colombia	38 Slovenia	48 Greece

Click for interactive charts

Source: BlackRock, June 2013.

The opinions expressed are as of July 2013 and may change as subsequent conditions vary.

EXTERNAL PROBLEMS

Emerging market investors got a wakeup call in June, with currencies, debt prices and equities tumbling on fears of a funding crisis. The vulnerability of many emerging markets can be seen in the External Finance component of their BSRI scores. Most have worsened over the past 12 months, with Asian nations including **China**, **Thailand** and **Indonesia** among the biggest decliners. See the chart on the right.

Projected current account surpluses are shrinking fast in countries such as **Russia** and **Malaysia**, while deficits are growing in **South Africa** and others. See the chart on the top right of the next page. The causes are varied:

- A slowdown in global growth locomotive **China** and anaemic demand in the developed world are hurting emerging market exporters.
- Falling commodity prices are hitting the revenues of resource countries such as **South Africa** and **Malaysia**.
- Strong domestic demand (in some cases fuelled by excessive credit) is stoking import growth in some emerging markets.

Most emerging markets rank higher than **Ireland**, **Spain** and **Italy** on External Finance (although the Eurozone nations show an improving trend). See the chart on the right. Bottom-quintile emerging markets such as **Turkey**, **South Africa** and **Argentina** are the exception. This highlights an important point. Emerging markets cannot be painted with a broad brush; disparities between countries are huge. For details, see *What's Developing: Investing in Emerging Markets* of April 2013 and BlackRock's *Currents* of July 2013.

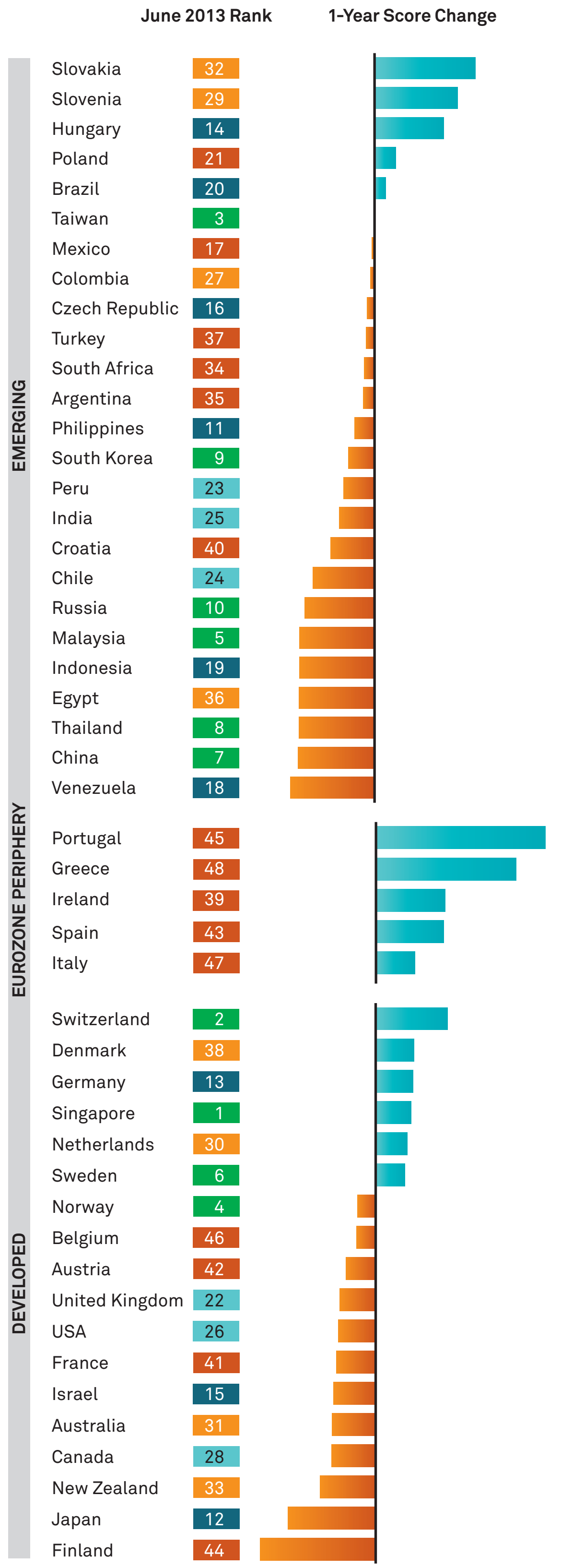
The BSRI External Finance score includes the state of the current account balance and exposure to foreign currency debt – net of foreign exchange reserves. Since the 1997–1998 crisis, many emerging market economies have built up huge war chests of foreign reserves. This reduces the risk of a liquidity crisis in the case of a currency collapse.

China has foreign reserves of $3.4 trillion – nearly five times the size of its outstanding external debt, according to the State Administration of Foreign Exchange. This insulates the country to some extent from external funding pressures – and helps shield the rest of the world from a potential credit bust in China.

China's overall BSRI rank dropped two notches to 19th. The country's current account surplus has shrunk from a peak of 10.1% of GDP in 2007, to just 2.6% of GDP in 2012, according to the IMF. Interbank rates and capital outflows are key indicators to watch for signs of a credit crunch.

EMERGING PAIN

External Finance Rankings and Score Changes



Source: BlackRock, June 2013. Note: Score changes represent the absolute change in the External Finance score in the past year.

STAYING CURRENT

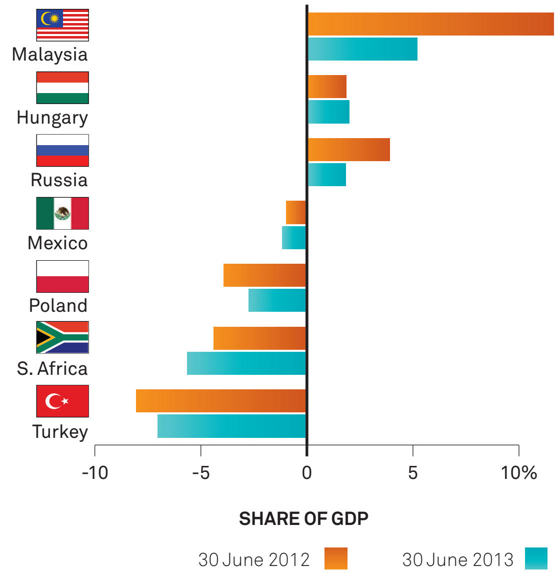
Large external deficits place some emerging market economies at risk of funding crises and currency collapses. **South Africa** and **Turkey** both have projected current account deficits of more than 5% of GDP, as the chart on the right shows. Both countries have suffered capital flight and seen their currencies swoon in 2013.

Currency depreciations are a double-edged sword. They could help improve the current account balances of some emerging market economies. They may also stoke inflation and raise the risk of a credit crunch in countries relying on external funding. See *Exit, Entry and Overshoot* of June 2013 for details.

Most emerging market countries also suffer from weak Willingness to Pay scores. This gauges the effectiveness – or impotence – of government. It also measures perception of government's stability, the rule of law and other factors that foster a favourable investment climate. Just five out of 25 emerging markets tracked by the BSRI have a positive score in this area. For details, see *Maturities Matter* of April 2013.

CURRENT AFFAIRS

Projected Current Account Balances

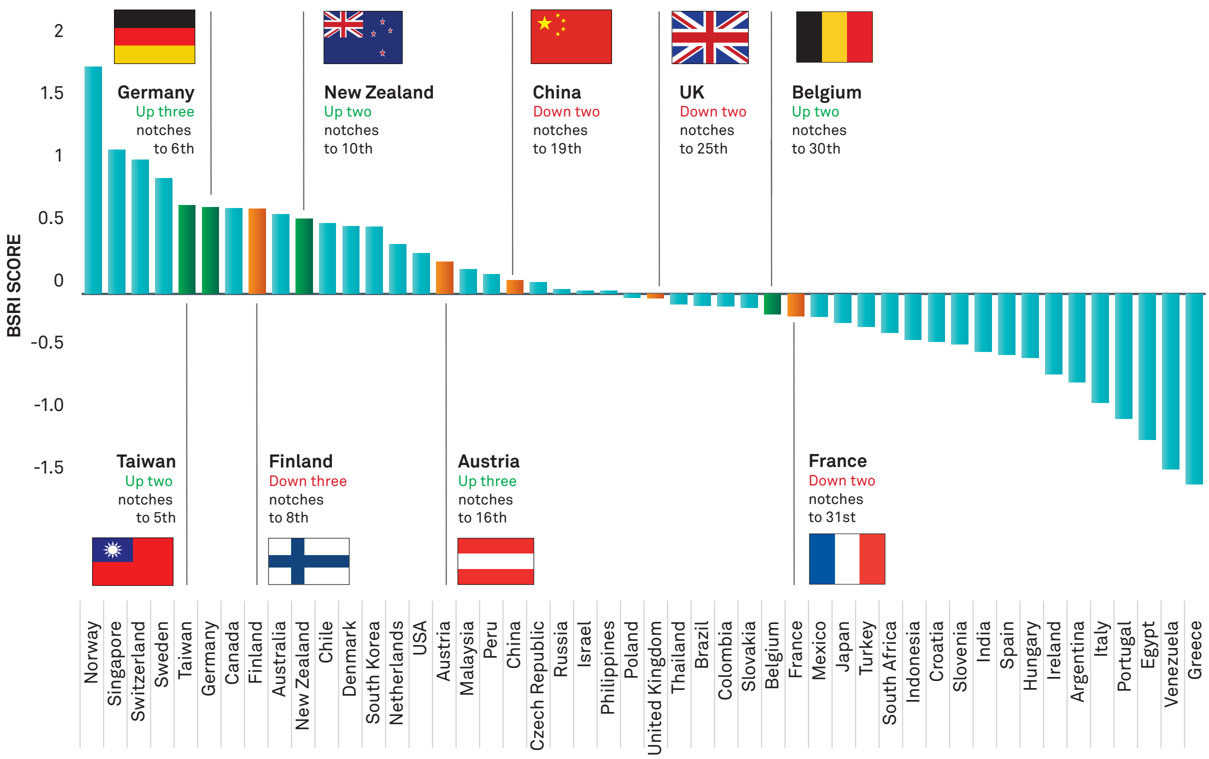


Sources: Consensus Economics and Moody's, June 2013.
Notes: Current account balances are 12-month forward estimates. Countries shown have the largest weightings in the J.P. Morgan GBI-EM Index.

WHO'S UP AND WHO'S DOWN

BlackRock Sovereign Risk Index Rankings, June 2013

Click for interactive charts



Sources: BlackRock, Bloomberg, IMF, World Bank, central banks, Eurostat, BIS, Consensus Economics, UN, Moody's, Standard and Poor's, Fitch, PRS Group and www.euromoneycountryrisk.com.

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