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The 2017 Risk Map: Greater uncertainty in the "every-man-for-himself" era

Produced by the Economic Analysis and Research

EXECUTIVE SUMMARY

- *“Falling out of love” with globalisation and discontinuity with the past model will be felt soon. Protectionist measures are increasing considerably and international trade is growing a lot less than in the pre-crisis period.*

- *The two 2016 core risks are confirmed as the main critical issues for 2017: debt (public and private, now 225% of global GDP) and the geopolitical variable. Amongst debt-related components, the main worrying factors are the bank risk (SACE index up 2 points at global level) and the currency transfer risk.*

- *Countries affected most by the increase in bank risk include important economies like Brazil and Mexico in South America, India, Turkey, and Mozambique, Nigeria and Angola in Africa. Geographical areas where the currency transfer risk has increased considerably still include Mozambique and Angola, in addition to Cuba, Egypt and Oman; while Iran and Argentina bucked the trend.*

- *There is no perfect recipe. However, in-depth knowledge of the potential dangers is fundamental to overcome fear and keep on growing. The awareness of companies operating on international markets must be enhanced, now even more than before.*

- *The regional integration areas, especially between the EU and the Andean countries (like Colombia, Peru, Chile), of the Sub-Saharan area and Asia (like South Korea) can become ecosystems to be explored. In 2015, these countries imported over EUR 27 billion of Italian exports.*

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- On the other hand, the Export Map enables the identification of the best opportunities for Italian exports globally. The index is calculated on a scale from 0 to 100 where 100 is the maximum opportunity.

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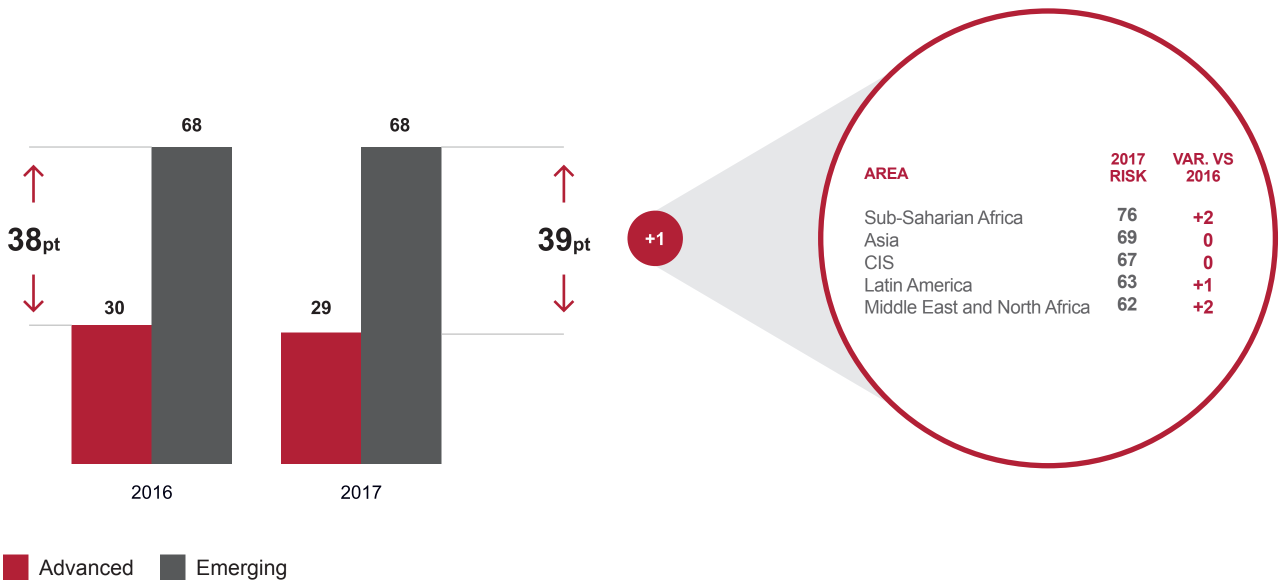
The 2017 global risk framework is complex as well; because of an international context suffering growing instability and high volatility. The upcoming elections in several European countries, public and private indebtedness that has reached 225% of global GDP[01], the uncertain recovery of raw material prices and the US monetary policy are elements of caution together with the unknown factors linked to the new US presidency and the consequences of Brexit. In addition, the pressure on banking systems of these last few years has resulted in a general worsening of asset quality and credit granting policies becoming more prudent. While the credit risk[02] remains about constant globally, there has been a slight improvement for advanced countries. The risk increases in the emerging countries of Sub-Saharan Africa (the area with the highest average risk), in the Middle East, North Africa and Latin America. It remains stable in Asia and in the Commonwealth of Independent States (Figure 1).

FIGURE 1: *Advanced and emerging countries: SACE credit risk average*



Source: SACE

In the meantime, the decisions made by the Federal Reserve could cause negative impacts on the flows of capital in emerging markets (Figure 2); especially related to the currency transfer component[03].

[01] *IMF estimates (October 2016). The percentage is calculated without considering the financial sector.*
[02] *The risk of suffering a non-payment by a sovereign, bank or corporate counterpart.*
[03] *This risk implies great difficulty, or even impossibility, for a company to repatriate profits or receive payments in strong currency.*

FIGURE 2: *Net flow of capital in emerging countries**

*2015 figures are estimates. Those in 2016 and 2017 are forecasts.

Source: SACE processing of IFF data (December 2016)

INTERNATIONAL TRADE: THE REAL UNKNOWN FACTOR FOR 2017

2017 is unlikely to be a favourable year for global integration. Several 2016 occurrences will reveal their effects in the year that has just begun, generating growing volatility: the election of Trump, his commercial policy choices and the countermeasures of partners; the downsizing or definite demise of certain international treaties, like TTIP or TPP; the internal events in several risky countries (Brazil, Iran, Mexico, Turkey, Venezuela, just to mention some) which will modify the risks of great powers and regional balance; the launch of Brexit and relative repercussions. Military expenditure, stable around USD 1,700 billion in 2015[04] (also due to the lower revenue in the oil and extraction sector), started to grow again in 2016 and will continue increasing in 2017, even due to the traditional US "umbrella" disappearing.

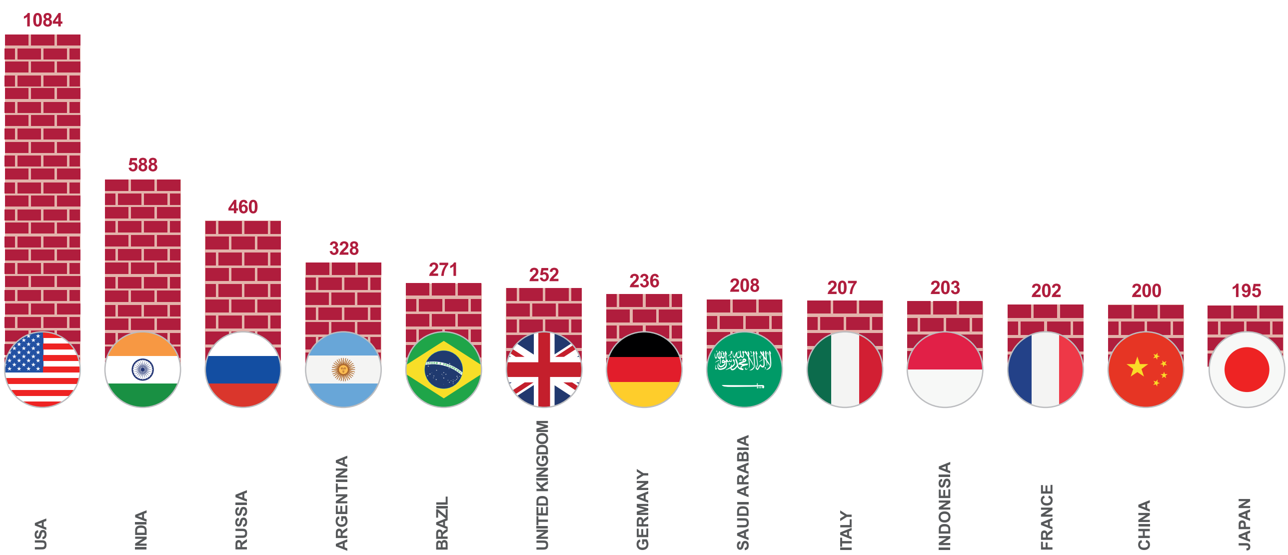
The radicalisation of the political debate in risk areas and the continuing uncertainty in Europe could highlight further disruption. Over the next few months, several Italian partner countries will be holding elections. 2017 will be especially hot in Europe with elections in the Netherlands, France and Germany.

[04] *Sipri, Yearbook 2016*

In March Hong Kong will be choosing its chief executive. In July and August several Sub-Saharan Africa countries will be holding elections, while in autumn the electoral focus will be on Latin America (with elections in Argentina and Chile). In the Middle East there will be a constitutional referendum in Turkey, expected by the end of the first semester, and presidential elections in Iran in May. All these events are potentially negative for the demand in these countries, for their operating context and for the international activities of Italian companies.

Protectionism has not only increased in the recent months, but has peaked in this last year. Over 3500 barriers were raised from 2008 to the first few months of 2016. Almost a quarter of these barriers impose the obligation to have a certain percentage of a product or service made in the country (local content requirement, LCR) especially for electronic goods and vehicles. These measures are chosen especially by G20 countries: the United States (third market destination for our goods), for example, have introduced a protectionist measure every 4 days since 2008 and are the first country for measures adopted (Figure 3). The ten sectors most concerned by protectionism are almost 41% of world trade[05] which, obviously, is being affected. **International trade represents a measure for the global demand our products: the less the trade, the harder the context is for Italian firms**. From the start of the financial crisis until 2016, the growth in trade (+2.9% annual average) was less than half of that recorded in the period 2000-2007 (+7.3%). The other variables negatively influencing trade are the drop in investments, less participation in global value chains (also because of the LCR) and the economic difficulties of several emerging countries. International trade is a measure for the global demand of our products: the less the trade, the harder the context is for Italian firms.

FIGURE 3: *Top countries for protectionist measures adopted**



*Figures at end November 2016, number of protectionist measures. Source: Global Trade Alert Database

[05] *Global Trade Alert. Global Trade Plateaus, July 2016.*

OUR SUGGESTION

If international trade has difficulty returning to past rhythms and we do not know what will happen to some free trade treaties, **the regional integration areas**, in particular between the European Union and the Andean countries (like Colombia, Peru, Chile), the Sub-Saharan area and Asia (like South Korea) can become ecosystems in which to develop best practices to explore less common realities for our export, despite highly different risk profiles. As a matter of fact, these countries imported over EUR 27 billion of Italian exports in 2015, more than double than China and India together, and can be a first frontier for new exports as well as a consolidation area for operators in riskier areas.

DEBT: WHO IS SCRAPING THE BOTTOM OF THE BARREL

Besides protectionist fears, 2016 confirmed a critical issue that had already emerged last year and, which, as time goes by, shows its more negative effects: indebtedness.

In 2016 the overall global debt reached 325% of global GDP: the sum of public, household and corporate debt grew to over USD 11 thousand billion in the first nine months of 2016, reaching USD 217 thousand billion[06]. If we exclude financial sector, debts have more than doubled since the start of this century, reaching USD 152 thousand billion at end 2015; about 2/3 of this in the private sector[07] .

Naturally, there is a certain difference between countries. They are not all in the same stage of the debt cycle, but what weighs on its sustainability is the dynamics of interest rates, expected to grow due to a more restrictive monetary policy by the Fed and, consequently, fiscal stimulation plans coming from the more mature economies.

The indebtedness of advanced countries, fed mainly by the state component, is higher than that of emerging ones compromising, in the case of some economies, consumption and investment dynamics.

In several emerging countries, easy credit dragged the indebtedness level upwards: **among the top 10 geographical areas with a higher debt dynamics China, Brazil, Malaysia, Turkey**, all countries of a certain weight. In China, public debt is not particularly worrying (about 60% of GDP), but the imposing private debt and that of local bodies and state companies raises indebtedness to 240% of GDP. There are then Egypt and Mozambique, with two of the highest public debts (respectively over 90% and 110% of GDP), countries which, in fact, are in the higher part of the SACE scale of risk[08].

At this point, we need to examine the effects triggered respectively by critical levels of public, corporate and bank debt; and the solutions SACE offers companies in the different scenarios considered.

[06] *Source: IIF Global Debt Monitor, gennaio 2017.*
[07] *Source IMF, Fiscal Monitor October 2016.*
[08] *The risk of sovereign counterpart non-payment by Egypt and Mozambique is respectively 75/100 and 100/100.*

A. High public debt: what risks might be run by Italian companies operating with foreign counterparts?

Payment delays

In countries with high debt problems there may be delays in payments (like what happened in the Republic of Congo) or, in the worst hypothesis, a real technical default, as in Mozambique[09]. Some studies[10] show how high indebtedness, public or private, is associated with low growth even in non-crisis periods: parties indebted, with less ability to repay, tend to invest and consume less. This reduces the capacity to have new access to credit and affects economic growth.

Drop in foreign demand in the countries concerned

The downstream effect, besides the difficulty to honour obligations (including non-burdensome trade debts), is a lesser capacity to finance imports. In a lower demand context, the negative effect on operators who export their goods and services in these countries appears natural. The demand can drop both through the mechanism just described and because the firms playing the role of intermediates in the value chain go bankrupt; based on their businesses, they can represent a client but also a supplier of the exporting company. In this latter case, the exporter suffers the interruption of the value chain due to bankruptcy of its supplier and will be forced to find another supplier, or else production will be slowing down or, at worst, stopping.

Increase in the funding cost

The effect on the private sector of high public debts goes through the bank channel. How? A worsened creditworthiness of the sovereign counterparts reflects in a higher risk premium to those counterparts and, consequently, in an increased funding cost. The balance sheets of banks, which hold state securities as collateral for loans granted, record capital losses (like what happened to Greece at the start of the financial crisis). The resulting deterioration of bank profitability might cause an inefficient allocation of credit and an increase in its cost.

[09] *A gennaio 2017 Il Paese ha dichiarato l'impossibilità di rimborsare le prime cedole dei bond emessi ad aprile 2016 e con scadenza nel 2023*
[10] *Krugman 1988; Sachs 1989; Cecchetti, Mohanty, e Zampolli 2011; Baum, Checherita-Westphal, e Rother 2013; Reinhart e Rogoff 2010*

OUR SUGGESTION

In these cases, the financial package offered by SACE and SIMEST can make the exporter competitive as it can offer its clients better financial conditions to finalise the purchase. In particular, firms facing an increase in the cost of financing can count on SIMEST support through the contribution on loans at the interest rate. This enables the foreign debtor purchasing Italian investment goods (and goods and services connected to the main supply) to obtain a deferral on payment of the supply at a facilitated rate (CIRR) for any debts it contracted to pay the Italian supply.

B. Worrying Corporate debt: two examples

After the financial crisis, many firms increased their financial leverage in emerging countries thanks to low interest rates and facilitated conditions. In 2015 company leverage[11] had reached about 75%. At the same time, as growth had slowed down in emerging countries, the ability to repay trade and financial debts came under pressure. According to the IMF, the risk debt amount (company debt with revenue below interest expenses) in emerging countries is currently estimated at around USD 430 billion or about 11% of corporate debt. A high corporate debt inevitably has repercussions on the bank risk. As a matter of fact, most of the corporate debt stock in emerging countries, about USD 19.6 thousand billion out of 25, can be found in the financial statements of local banks[12]. However, the cases of Brazil and Turkey (see Appendix 1) show that in contexts that have grown fast the risk is more concrete than elsewhere.

OUR SUGGESTION

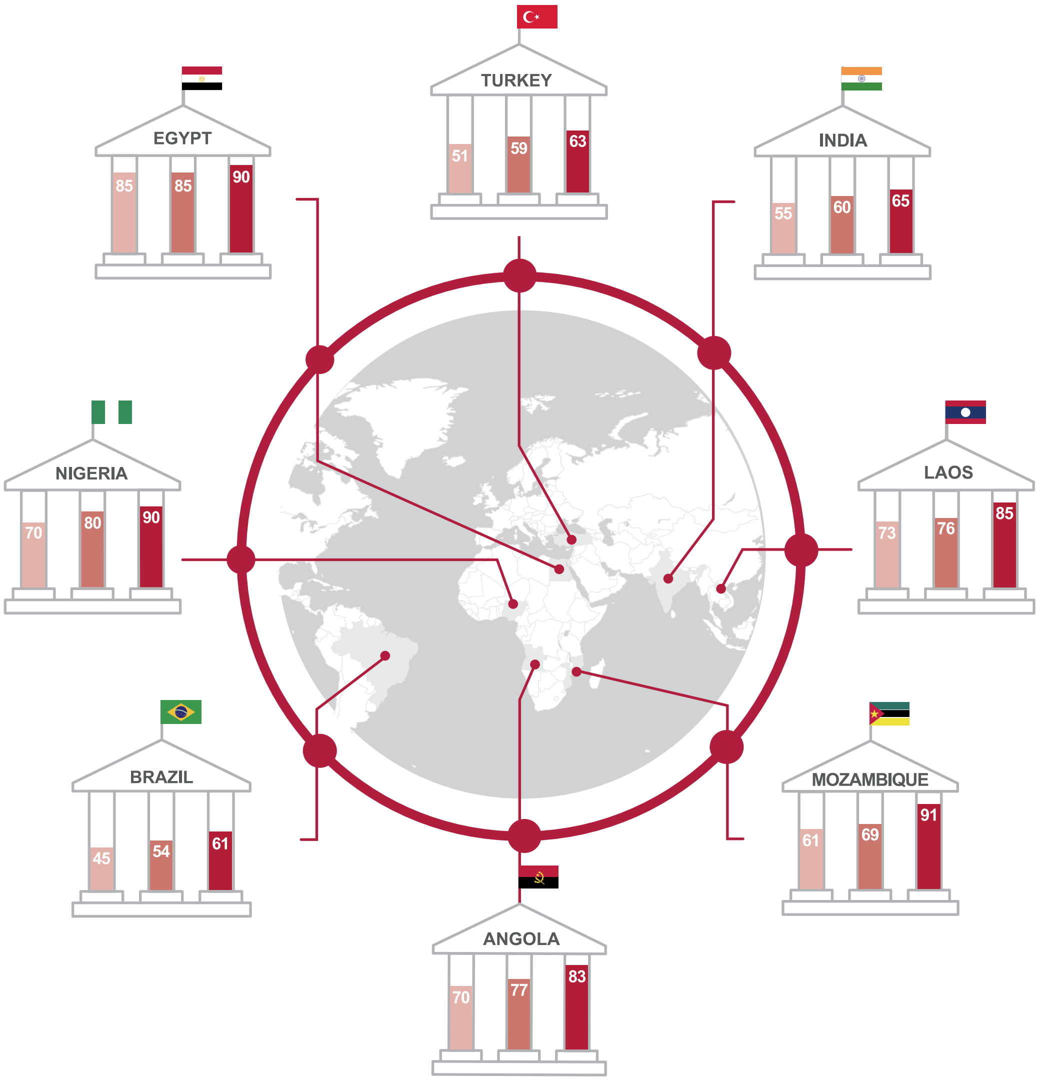
With the Supplier Credit tool, the client insures itself against the risk of not being paid, for both commercial reasons, that is linked to the debtor's ability to pay, and political reasons, for example wars and social unrest. Furthermore, by transferring insurance coverage to its chosen bank or SACE, the Italian company can obtain the discounted supply amount straight away, without waiting for the natural due date of the credit.

C. Bank debt: the true source of concern in emerging markets

The asset quality of global banking system has deteriorated in the last two years. This worsening of the bank outlook reflects on the bank credit risk index drawn up by SACE, which is growing. The areas affected worse are Sub-Saharan Africa, where the risk increased from 73 in 2015 to 76 in 2016, the American continent from 61 to 63, the Middle East from 60 to 61 and Asia from 64 to 65.

[11] *Ratio between debts and equity.*
[12] *FMI, Global Financial Stability Report, October 2016.*

FIGURE 4: *SACE bank risk in some emerging countries**



Source: SACE * Values range from 0 to 100.

Mozambique, Nigeria and Angola are the main economies in Sub-Saharan Africa that have been affected by an increased bank non-payment risk (Figure 4). All three of them are closely linked to revenue from raw materials: coal and aluminium for Mozambique and oil for Nigeria and Angola. In Nigeria, where the risk has gone from 80 to 90, the bank system is affected by a stagnating economy due to the drop in oil revenue. The NPL ratio[13] is increasing and is around 12%.

In the Latin American area, the bank risk of the two main economies has risen: in Brazil it has gone from 54 to 61 and in Mexico from 34 to 36[14]. With the recession, the end of the credit bonanza and the drop in profitability for many companies, Brazilian banks were hit by a drastic drop in the quality of loans granted. At the end of 2016, NPLs increased and are now around 4%. In Mexico, the NPL ratio was over 2.5% at end 2016, due mostly to consumer credit and the construction segment.

[13] *Non-performing loans (NPL) are activities that can no longer repay the capital and interest owed to creditors. The NPL ratio is the ratio between impaired and total loans.*
[14] *Brazil is about 1% of Italian exports whilst Mexico is 0.8%.*

In India[15], where the risk goes from 60 to 65, the banking system is suffering from weak industrial activities, below potential profitability and high leverage in some sectors. Forecasts for 2017 are of an NPL ratio of around 8.5%-9%. The worst-hit sectors are steel, with companies still having to deal with low prices and excessive capacity, and the energy generation segment, where companies have to cope with high losses along the electric distribution network and continual thefts.
In Turkey[16] , where the risk has gone from 59 to 63, the portion of loans renegotiated as a percentage of total loans has dropped. Furthermore, banks have a good “buffer” for dealing with credit losses, considering their capitalisation. The quality of banking system assets is good and in 2016 the NPL ratio is around 3%. However, the weakening economy and exchange volatility will lead to weakening in asset quality and profitability.

OUR SUGGESTION

In the light of a worsened bank outlook in emerging markets, SACE support can mitigate the risk for exporters using the bank channel to operate abroad. With the Documentary Credit Confirmations policy, the bank, which confirms the "letters of credit" for payment of its client’s exports, is insured against the risk of the credit not being paid for the political or commercial occurrences involving the foreign issuing bank.

POLITICAL RISKS: CURRENCY AND SECURITY MAKE THE DIFFERENCE

In 2010, the then Brazilian Finance Minister, Guido Mantega, declared that the weak dollar risked causing a “currency war” damaging emerging country exporters. With the dollar recovering that scenario has now changed; yet the emerging countries are in a relatively disadvantaged position.

Even though, over time, emerging countries have become less sensitive to dollar movements, thanks to a considerable increase in currency reserves and the gradual transition towards flexible exchange policies, **the outflow of capitals from emerging countries towards safe “havens” has started to eat into the currency reserves of these economies**, restrict the credit market and the supply of capital in these countries and, in general, decrease their medium-long term growth prospects.

Like the previous year, **there is an increased risk of currency non-transfer in some emerging markets**. And it is not limited to the “small” emerging countries: China, for example, following the 7% loss of the renminbi against the dollar in 2016, has begun to set up mechanisms to stop the currency falling and the loss of currency reserves (down from four to three thousand billion dollars between 2014 and 2016). Iran and Argentina are amongst the few countries that have shown a considerable improvement (Figure 5).

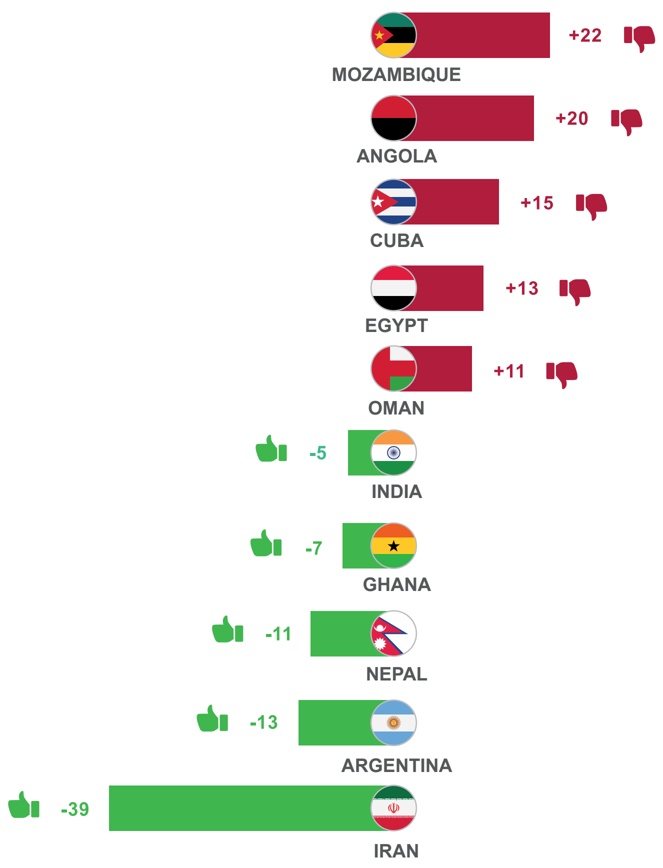
In general, **investors have to consider a higher risk, that financial transfers in strong currency** (international payments but also capitals and dividends repatriated) **suffer restrictions or delays, in particular by countries**

[15] *India is about 0.8% of Italian exports.*
[16] *Turkey is about 2.4% of Italian exports*

where foreign currency is scarce. The reduction of financial resources in commodity exporting countries has caused some governments to make access to the strong currency more difficult for local operators (Nigeria, Mongolia, Tajikistan) adopting more expensive document procedures and lengthening conversion and transfer times. In other countries, though with no regulatory changes, during the year there was a lengthening in the average currency exchange and transfer times (Argentina and Ethiopia). It is different for countries where, due to a persistent lack of strong currency, restrictive strong currency payment measures have been introduced - or increased - (Angola, Greece, Ukraine) limiting the strong currency amount that operators could obtain (firms and banks) and the possibility to transfer currency abroad.

That situation has had a significant impact on operators (exporters and investors) working in those countries who have recorded and are still dealing with lengthened payment terms and difficulties over repatriating capital and dividends.

FIGURE 5: *Transfer risk: top worsener vs improver (2017 on 2016)*



Source: SACE Risk Map 2017

With regards to other risks, whilst maintaining substantial stability in all geographical areas for the expropriation risk, **the most "viscous" of the three political risks, there is an upward trend in the political violence component, discounting the complicated international geopolitical balances**. A well-known think-tank called 2017 the G-Zero World, a world orphan of global leadership, at the mercy of populist anti-global currents towards a "geopolitical recession". In that context, regional conflicts and "proxy wars" (Yemen, Syria) are being even more fuelled. Moreover, there is an exacerbation of terrorist threat and resulting economic-institutional repercussions, with business sentiment, tourist and investment flows suffering worse.

A branch of economic research has concentrated on studying the impact of terrorism on investment flows, proving that **FDIs are particularly sensitive to terrorist episodes, more than portfolio and indebtedness certificate investments**. Acts of terrorism generate uncertainty and increase the perception of the general riskiness of countries affected. Therefore, it is not by chance that political violence risks move in parallel with both transfer and commercial risks.

OUR SUGGESTION

The advisory services for currency transfer and convertibility, as well as the assessment of risks connected to foreign investments and protection against acts of violence, can provide a substantial contribution when defining the internationalisation strategies of Italian companies. SACE and SIMEST, by providing specific instruments structured to defend foreign sales and investments from the risks of non-payment and business disruption, offer a competitive advantage for Italian companies. They can thus neutralize the risk component, which is intrinsic in operating on international markets.

CONCLUSIONS

There is no perfect recipe. However, in-depth knowledge of the potential dangers is fundamental to overcome fear and keep on growing. The awareness of companies operating on international markets must be enhanced, now even more than before. The uncertainty context and ongoing weak growth is visible in 2017 in the increased bank sector risk and the transfer risk in some countries. Knowing where risks come from and where they are concentrated helps operators find mitigation instruments enabling them to continue doing business even in difficult markets.

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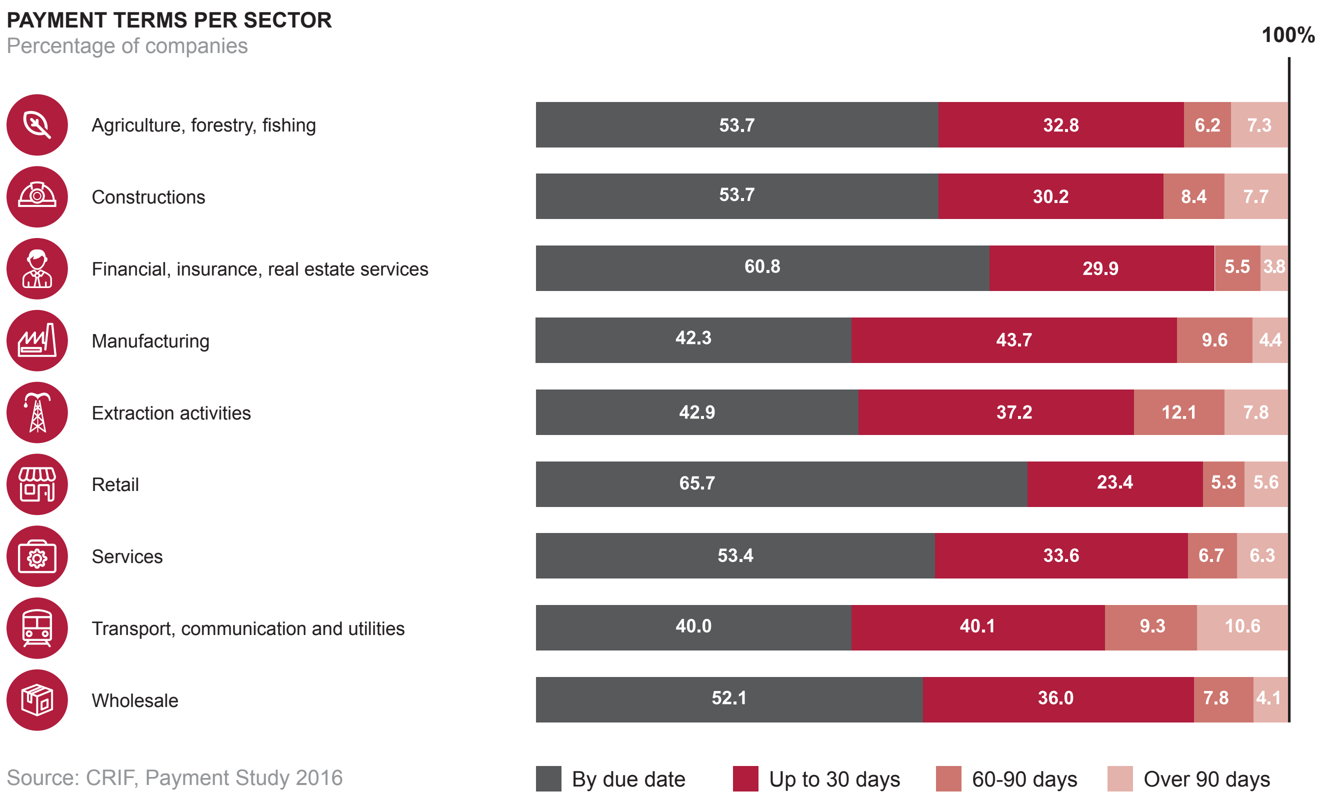
APPENDIX

COMMERCIAL RISK IN SELECTED COUNTRIES [01]

TURKEY

The value of non-performing loans in the Turkish banking system increased considerably in 2016; particularly with regard to small and medium-sized enterprise. Though the general NPL level in Turkey (3.4%) is lower than the European average of 5.5%[02] , its growing trend makes banks more reluctant to open new lines of credit. The creditors of Turkish companies are also concerned by the growing number of requests to suspend bankruptcy proceedings, increased from 484 in 2012 to more than 1000 in 2015[03]. By suspending the bankruptcy proceedings, Turkish companies can postpone payment of existing debts for a year (with no need for creditor approval). In relation to trade debts, average payment terms are 60-90 days, with marked differences based on the activity sector: retail and financial, insurance and real estate services have recorded the highest percentage of companies that pay their suppliers in due time, whereas the transport, communication and utilities sectors, extraction activities and constructions have shown the highest number of companies paying after 90 days (see fig 1).
At company size level, the highest delay percentage has been recorded in large companies.

FIGURE 1: *The transport and extraction sectors record the highest number of companies paying after 90 days*



Source: CRIF, Payment Study 2016

[01] *Contribution from McKinsey*
[02] *Source European Banking Authority*
[03] *Source Baker & McKenzie*

CASE STUDY – AYNES GIDA SANAYI

Aynes Gida Sanayi is a dairy company specialised in the production of milk and its by-products which has applied to postpone the bankruptcy proceedings.
Since the activity started up in Denizli (Turkey) in 1997, the company has kept on increasing its production capacity. In 2014, Aynes Gida was ranked amongst the 500 biggest Turkish companies and won a tender to supply milk to the country's schools. That same year, it obtained approval to export its products to Russia and the European Union. This enabled the company to open to new foreign markets. To handle the foreign demand, the company invested in machinery and enlarged its warehouse, increasing its debt. The economic sanctions introduced by Russia on Turkish imports meant the company could not convert investments made into revenue. In January 2016, faced by serious economic difficulties, the company applied for a deferment of the bankruptcy proceedings to be able to suspend payments of its debts to banks which had started to ask for loans to be reimbursed. Moreover, Aynes Gida could not pay USD 621 thousand owed on a bond of USD 17 million expiring in May 2016. The company, worsened by damage caused by the Russian crisis and by military operations in the south-east of the country, has two more debts open: one for 10 million dollars that expired in November 2016 and the other for 7 million dollars expiring in February 2017.

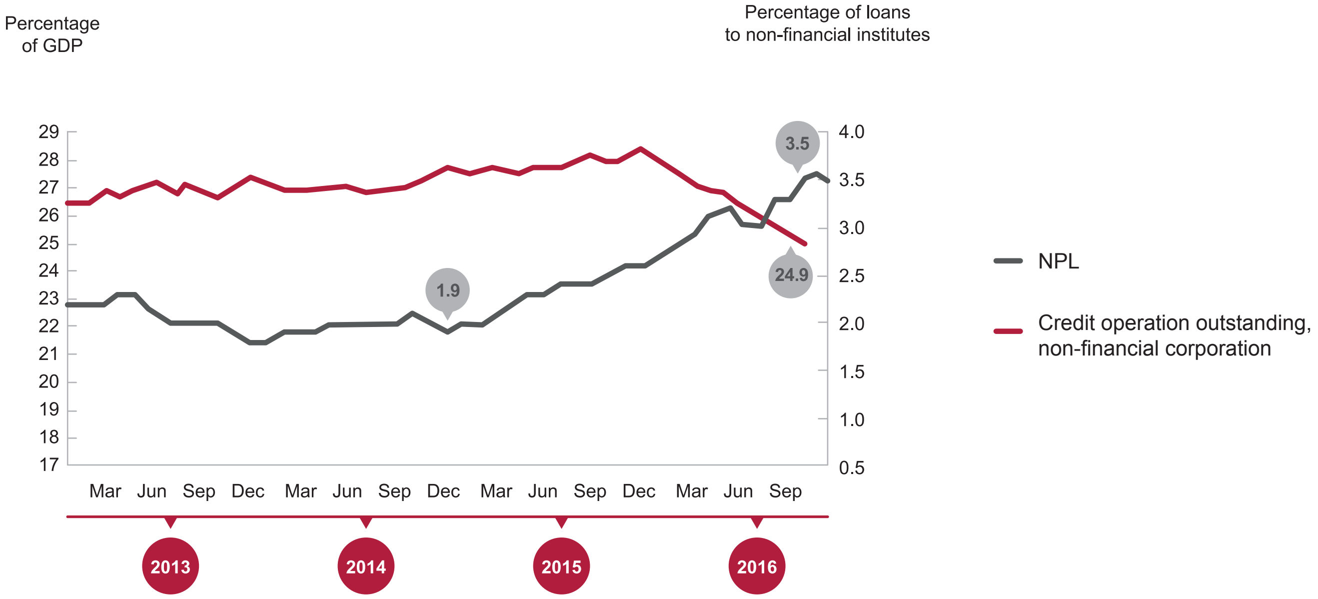
BRAZIL

The effects of the recession on Brazilian companies have become highly visible, in particular in the increase of indebtedness, number of bankruptcies and requests for restructuring. The latter have reached their maximum (1,863) since the current Bankruptcy Law was introduced in 2005. The crisis has hit several sectors, from automotive to consumer electronics, from retail to naval. The micro-small enterprises are the segment showing the highest number of bankruptcy proceedings instances, followed by large and medium-sized companies[04]. A growing number of companies have applied to start restructuring proceedings, which are the preferred choice as it allows them to avoid declaring bankruptcy, and mass dismissals. In this case as well, the micro-small enterprises seem to be hit worse by the crisis.
Despite the percentage of Brazilian non-performing loans, they remain well below the European average. Brazil is one of the countries with the highest NPL level in Latin America, after Peru and followed by Colombia. At the same time, there has been a strong reduction of credit allocated by the country's banks.

[04] *In 2016 there was a total of 1,852 applications for bankruptcy proceedings*

FIGURE 3: *Banks have reduced credit allocated to Brazilian firms*

CREDIT TO COMPANIES AND NON-PERFORMING LOANS



Source: Central Bank of Brazil OECD

CASE STUDY – PROEMA

After a period of strong growth, the car sector suffered a 27% drop in sales in 2015. The Proema group, comprising 19 companies, is a producer of components for the car industry and supplier of clients such as Fiat, General Motors, Honda and Mercedes-Benz, from which it received orders for about 146 million euro per year: the crisis began in mid-2012 and, starting from 2014, the heavy drop in orders (over 50%) worsened the company's financial stability. It accumulated debts for 290 million euro of which about 10-11 to almost 800 employees dismissed without receiving severance pay. In December 2014, after closing two factories, Proema applied for a company restructuring plan, trying to avoid bankruptcy and mass dismissals. In October 2016, the trade union and workers' committee, together with other creditors, refused that restructuring. Following that refusal, in November the Proema group was declared bankrupt, as this was the only possibility to extinguish its debt to ex-employees, which involved closure of all the plants still operational. The Proema case is part of a context of general crisis in the car component sector characterised by revenue dropping (-18% in 2015) and several dismissals (about 30 thousand jobs).