Sovereign Postcard: The New Fragile Five

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(Editor's Note: Each month, a sovereign postcard addresses a specific question that investors or other users of our sovereign ratings have asked S&P Global Ratings.)

Global liquidity remains exceptionally accommodative. As monetary conditions inch ever so gradually toward normalization, which emerging market (EM) sovereigns could be vulnerable?

In descending order, Turkey, Argentina, Pakistan, Egypt, and Qatar make up the new "Fragile Five." In our view, these sovereigns could be the most at risk when global financial conditions eventually tighten. On the other hand, Thailand, China, Russia, Saudi Arabia, and Malaysia appear to be the most resilient.

When, in 2013, then-Federal Reserve Bank Chairman Ben Bernanke indicated that the Federal Open Market Committee could soon start winding down its quantitative easing program, capital markets reacted apprehensively. The now famous "taper tantrum" ensued as fear spread about EMs that were at risk from rising interest rates in the U.S. Several EM nations had progressively satisfied their financing needs through international investors, who in their continuous search for yield pushed out the investment boundaries.

At that time, the so-called Fragile Five consisted of Brazil, India, Indonesia, South Africa, and Turkey. All five showed sizeable current account deficits, signposting a national savings rate that was insufficient to cover national investment. However, little united this quintet and, in the end, it turned out that they were able to defend their positions. Indeed, Indonesia has since gained an investment-grade rating and, although Brazil and South Africa both lost theirs, this was related to economic and political setbacks at home, rather than the Fed's actions.

Four years on, monetary conditions are still exceptionally accommodative and, for some EMs, the funding environment is now the most benign in living memory. Yet the threat from monetary tightening is now more concrete than before. The Fed has begun raising rates and so too has the Bank of England, while the ECB has outlined its own gentle tapering plan.

So how can investors identify which EM's position is fragile and which has formidable defenses against tighter global liquidity?

The answer depends on the variables one considers relevant when ranking the relative vulnerabilities. For example, ranking by current account balances as a share of GDP, which is a ratio investors often consider, ignores sovereigns' ability to generate foreign exchange receipts and neglects transactions on the financial account of the balance of payments. Arguably, in the 21st century, balance of payments crises for many EM sovereigns are more likely to stem from the financial account than from the current account.

No single metric can encapsulate external frailty universally and reliably. Different variables can highlight different facets of vulnerability. We rank sovereigns according to external financial variables we typically analyze when assessing external financial risks; most are flow variables germane to external liquidity. All of them are explicitly referenced in our quarterly Sovereign Risk Indicators (the latest published Oct. 13, 2017; a free interactive version is available at spratings.com/sri).
Seven Variables For Assessing A Sovereign's External Financial Risks

2. Current account balance (% of current account receipts; CAR).
3. Usable reserves (months of current account payments).
4. Gross external financing requirements (% of usable reserves and CAR).
5. Narrow net external debt (% of CAR).
6. Short-term external debt by remaining maturity (% of CAR).
7. Government foreign currency debt (% of total debt).

To identify the EM sovereigns most at risk, we analyzed the 20 largest sovereigns (listed in the Appendix) in terms of commercial debt outstanding (we excluded Venezuela, which is in a crisis due to unrelated issues). Turkey, a member of the original fragile five, is the only sovereign that is always among the most vulnerable, regardless of the variable chosen. To determine the runners up, we calculated the number of times a sovereign appears in the five most fragile, minus the number of times it appears among the five most resilient.

On that basis, Argentina, Pakistan, Egypt, and Qatar joined Turkey to complete the new Fragile Five (see chart).
Qatar has a weak position on most flow variables, but is second only to Saudi Arabia on having a strong external asset balance sheet. Some observers might therefore argue that, because of its deep pockets, Qatar should not be in the new Fragile Five. If we exclude Qatar from that group, Colombia would take its place. The EM sovereigns that appear least exposed to tapering are China and Thailand, reflecting their large savings surpluses and strong external balance sheets. Russia, Saudi Arabia, and Malaysia complete the Formidable Five.

With Turkey the only original Fragile Five member also in the new Fragile Five, where are the other four original members today? Brazil has a vulnerability reading of -2, placing it just outside the formidable five. We are concerned about several factors in Brazil, which is why we have a negative outlook on our 'BB' sovereign rating; but tapering is not high on that list. South Africa is the only sovereign in the sample that does not appear in the top or bottom five of any of the variable rankings. India is in midfield, with Indonesia leaning toward fragility, due to its weak external balance sheet and high share of foreign currency external debt.

Appendix

Sovereigns in the sample: Argentina, Brazil, China, Colombia, Egypt, Hungary, India, Indonesia, Malaysia, Mexico, Pakistan, Philippines, Poland, Qatar, Russia, Saudi Arabia, South Africa, Thailand, Turkey, and Venezuela.
## Monetary Normalization: The Most And Least Vulnerable EM Sovereigns

*(Ranked By Seven External Variables*; 2017 Estimates)*

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<td>5th most</td>
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<td>Turkey</td>
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<td>5th least</td>
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<td>Hungary</td>
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<td>Least</td>
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### Related Criteria

- Sovereign Rating Methodology, Dec. 23, 2014

### Related Research:

- Sovereign Risk Indicators, Oct. 13, 2017 (updated quarterly, a free interactive version is available at spratings.com/sri)
- Sovereign Debt 2017: Global Borrowing To Drop By 4% To US$6.8 Trillion, Feb. 23, 2017

### Previous Sovereign Postcards:

- Sovereign Postcard October 2017: Corruption, Oct. 11, 2017

Only a rating committee may determine a rating action and this report does not constitute a rating action.