Credit FAQ:

What's Ahead For Emerging Market Sovereigns In 2016

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Investors are showing increasing interest in emerging markets (EMs) as concerns about sovereign debt accumulation intensify and the U.S. Federal Reserve (the Fed) is tightening policy. Here Standard & Poor's Ratings Services responds to some of the most frequent questions about EM sovereigns.

After several downgrades during 2015, such as that on Russia and Brazil to speculative grade, will EM sovereign ratings stabilize in 2016?

Probably not. The indications are that negative rating actions might continue to outpace positive ones next year. We base this assertion on the distribution of rating outlooks in the EM sovereign space. In a sample of 20 EM sovereigns with the highest amount of outstanding commercial debt, six of our long-term foreign currency ratings carry negative outlooks (on Brazil, Lebanon, Russia, South Africa, Turkey, and Venezuela) and only three have positive outlooks (on Indonesia, Pakistan and Poland). Should downgrades indeed once again outnumber upgrades next year, this would extend the negative trend that started at midyear 2011. Since then, our average rating on the top-20 EM sovereigns has fallen by approximately one notch to just below 'BB+' (see "Emerging Markets Sovereign Rating Trends Third Quarter 2015 Update," published Oct. 13, 2015, on RatingsDirect).

What are the main risks facing EM sovereigns today, and which are particularly exposed?

In our view, EMs currently face three key risks:

- First, the potential for a faster economic downturn in China than currently anticipated, even if the Chinese authorities appear to have the will and financial means to prevent a slump, at least in the short term. In our view, a hard landing over the medium term would most affect emerging economies that rely heavily on commodity production and exports and/or have strong trade links with China. We believe countries like South Africa, Chile, Peru, Malaysia, Colombia, Russia, Thailand, Brazil, and Indonesia fall into that category. Others, such as Turkey or India, could even benefit from a rapid slowdown in China because their direct trade exposure is low and they are significant commodity importers.

- Second, the need for some EM sovereigns to transition from years of credit-fueled growth to a more self-sustained development strategy, where deleveraging could pose economic and financial stability risks. The 2008 financial crisis demonstrated the negative consequences of excessive domestic financial leverage. Turkey, Venezuela, and China are the most vulnerable sovereigns on this score, followed by Russia and Argentina. At the other end of the spectrum, South Africa, the Philippines, and Poland show the least vulnerability, followed by Chile and Egypt. Both Turkey and China have experienced rapid credit growth in recent years, while state-owned banks are increasingly lending in Venezuela and play a very important role in China. Central banks in Venezuela, Argentina, and Russia appear to have the least power left to ease their monetary stance should financial stress emerge, because the real policy interest rate in these countries is already very negative.
Third, the risk related to tightening international liquidity as the Fed raises interest rates. Turkey, Lebanon, and Venezuela are among the most susceptible to a spike in global interest rates. Turkey is particularly vulnerable because of its reliance on short-term external debt, especially in its banking sector. The Philippines, China, Russia, Brazil, and Peru are the least exposed, since their external balance sheets and financing needs are typically comparatively low (see "Who's At Risk? Emerging Market Sovereigns Are Facing Adverse Global Trends," published Sept. 29, 2015).

Standard & Poor's lowered its foreign currency rating on Brazil to speculative grade in September. What might trigger another downgrade of Brazil in 2016?

We maintained our negative outlook on the 'BB+' foreign currency rating to indicate the possibility of a further downgrade within the next year, due to political and economic risk factors in Brazil. These factors include continued fiscal slippage or key policy reversals, perhaps due to fluid political dynamics, including in the cabinet. We also foresee risks stemming from greater economic turmoil than we currently expect, either due to governability issues or the weakened external environment.

In our view, the ongoing investigations of corruption allegations against high-profile individuals and companies—in the private and public sectors, and across political parties—have led to increased near-term political uncertainty. This, in turn, has reduced the government's ability to implement fiscal and other policy measures to stem fiscal and economic deterioration. President Dilma Rousseff has been weakened by corruption scandals, and the coalition between President Rousseff's own political party (PT) and its key ally (PMDB) remains under pressure. While not our base case, the prospect of the president's possible impeachment contributes to increased policy risks. In our view, there is also internal disagreement within the cabinet about the composition and extent of measures needed to address the slippage in public finances. These factors have limited the ability of the administration and congress to pass measures in a timely manner and staunch the widening fiscal deficit. We expect the general government deficit to remain above 8% of GDP in 2015, as well as in 2016, which will be the third consecutive year. The country's debt continues to mount and rising interest payments are fueling higher fiscal deficits.

Brazil's lack of growth exacerbates the risk of fiscal slippage. We now expect a cumulative real GDP contraction in 2015 and 2016 of 5.2% before the economy returns to modest growth of 1.2% in 2017. Stabilization of the economy first requires easing of the political uncertainty, in our view. It also depends on a credible fiscal strategy that slows the growth of government debt, a sound monetary policy that helps anchor inflation expectations, and structural measures to help restore sustainable economic growth. Brazil's growth prospects are, in our view, weaker than those of other countries at a similar stage of development. Failure to combine macroeconomic adjustment with effective growth policies could contribute to a higher government debt burden and deterioration of Brazil's economic profile that is worse than we currently envisage, leading to a downgrade (see "Brazil Foreign Currency Ratings Lowered To 'BB+/B'; Outlook Is Negative," published Sept. 9, 2015).

Why did you change the rating outlook on South Africa to negative last week? What would prevent a downgrade to speculative grade?
The outlook revision reflected South Africa's still-slow economic growth. We revised our GDP per capita growth forecasts for 2015 to zero from our June estimate of a modest 1.2% expansion. This was due to a combination of weak external demand, low commodity prices, and domestic constraints, including an inadequate electricity supply and generally weak business confidence that is inhibiting substantial private-sector investment. This situation highlights a prolonged period of low per capita growth in South Africa, which we expect will average only 0.6% per year between 2010 and 2016, and drop to 0.2% including the 2009 recession.

Economic growth over the next few years will also depend on the absence of prolonged labor strikes, and limited negative spillover effects from a likely U.S. interest rate hike or the impact of lower demand from China on commodity prices and export volumes. We believe that South Africa might be among the EM economies most affected by a China slowdown (see: "Who's At Risk? Emerging Market Sovereigns Are Facing Adverse Global Trends," published Sept. 29, 2015).

We think that President Jacob Zuma's second administration will maintain broad policy continuity, although there have been legislative delays and policy direction still lacks clarity in some areas, in our view. Legislation that has been delayed includes those related to mining sector investment, much-needed labor market reforms, trade negotiations, and industry interventions. In our view, this impairs business confidence and ultimately leads to weak private-sector investment.

The negative outlook also reflects that South Africa's fiscal flexibility might reduce, owing to contingency risks from nonfinancial public enterprises with weak balance sheets, which may require more government support than we currently assume.

We could revise the outlook back to stable and affirm the ratings in the low-investment-grade category if we observe more consistent policy implementation, leading to improving business confidence and higher private-sector investment that ultimately contribute to stronger GDP growth. Currently, we foresee growth of an average 0.7% per capita per year in 2016-2018. Business confidence may improve if government takes the necessary steps to reinforce policy coordination and implement delayed legislation, which may help bolster private-sector investment.

China's economy is slowing and concerns about its financial sector are mounting. Is the 'AA-' sovereign rating safe?

A moderate slowdown of China's economic growth will likely stay consistent with our sovereign rating over the medium term. So far, the deceleration to below 7% of GDP has stemmed largely from reduced investment spending, which has helped ease the weight of capital spending on China's GDP, contributing modestly to economic rebalancing. However, at more than 44% of economic output in 2015, capital spending remains the highest of all 130 rated sovereigns, except Mozambique and Congo where numbers are inflated by exceptional and transitory foreign direct investment in the commodities sectors.

We maintain a stable outlook on our rating on China because we expect that the contribution of consumption to economic growth will increase over the next three years. In line with this, we expect the gross domestic investment rate to fall below 40% of GDP, which–although still the highest ratio outside Africa–would be more in line with
sustainable growth that supports China's creditworthiness.

In addition, as demand for credit to fund investment eases, we foresee credit growth slowing to levels in line with nominal GDP growth. We believe that the increase in the credit-to-GDP ratio in China since 2009 also intensifies risks to the country's financial stability. China's large domestic savings and the associated strong level of banking system liquidity have so far helped mitigate the risk. Nevertheless, the buffer will thin as credit growth continues to outpace savings growth. Should the threats to China's financial and economic stability continue to mount, we would likely review the sovereign ratings (see "China 'AA-/A-1+' Sovereign Ratings Affirmed; Outlook Remains Stable," Nov. 23, 2015).

How long does it typically take for an EM country to regain an investment-grade rating once it has been lost?

On average, this reversal takes close to eight years. To date, there are seven examples of EM sovereigns on which we raised the foreign currency sovereign credit rating to investment grade ('BBB-' or higher) after having lowered it to speculative grade ('BB+' and lower). The eight-year average masks quite diverse factors for individual sovereigns, however. It took Korea only two years to get back to investment grade in 1999 and Latvia three (in 2012). On the other hand, other sovereigns required much longer for that turnaround, such as 16 years in the case of India (2007), 12 years for Colombia (2011), and 10 years for Uruguay (2012). Slovakia and Romania lie somewhere in between: The return to investment grade took between five and six years.

Conversely, we observe that losing an investment-grade rating, after being upgraded to it, takes an average of 10 years, which was the case for Russia and Bulgaria. It took Hungary almost 15 years to lose the investment-grade status after having obtained it, but Brazil only seven years. To date, no sovereign rating has crossed the investment-grade divide more than twice (see "Sovereign Rating And Country T&C Assessment Histories," published monthly).

With the recent general election in Turkey, a period of domestic political instability has ended. Yet, the outlook on the 'BB+' rating is still negative. What would cause you to revise it to stable?

The election in Turkey in November 2015 restored the majority that the Justice and Development (AK) party lost at the polls earlier in the year. Uncertainty following the June election regarding the unsuccessful formation of a coalition has diminished, but geopolitical and policy uncertainties remain. Particularly important for our ratings analysis is the implementation of long-delayed reforms that could rebalance the Turkish economy. The country depends on foreign debt-creating inflows, largely intermediated through the banking sector, to finance its current account deficit and boost domestic growth. This has resulted in high net external debt and large refinancing requirements.

In our view, Turkey has one of the weakest external profiles among the EM sovereigns we rate, and it is very susceptible to shifts in investor sentiment and global liquidity. We estimate that Turkey's gross external financing needs (current account payments plus external debt repayments) as a share of current account receipts and usable receipts were 2.5x that of Brazil and 1.7x that of South Africa. We estimate Turkey's narrow net external debt, which is
our preferred external liquidity measure (gross external debt less liquid external assets by the public and banking sectors as a share of current account receipts) was 5x that of Brazil and South Africa.

Therefore, the implementation of effective reforms to reduce the economy's reliance on foreign debt financing, while sustaining economic expansion sufficient to absorb most of the fast growth of the labor force, could lead us to revise the outlook to stable. Previously proposed reforms include those to stimulate household savings and reduce dependence on external energy. In our opinion, the process of rebalancing could also be aided by the easing of pressures on independent institutions—such as the central bank, the banking supervisor, and the judiciary—which we perceive to have increased in recent years.

In October, Saudi Arabia was downgraded. Why was that country singled out while the rating on other oil producers in the region remained unchanged?

We apply our criteria consistently across the 130 sovereigns we rate. In February 2015, we reviewed our ratings on 13 oil-exporting sovereigns, including those in the Gulf Cooperation Council (GCC), and lowered the ratings and/or assigned negative outlooks in eight instances (see "Plummeting Prices Weigh On Ratings For Some Oil Exporting Sovereigns," published Feb. 11, 2015). For example, we lowered our long-term ratings on Bahrain and Oman, among other oil exporters outside the GCC. Among the actions taken back then was also the revision of our outlook on our 'AA-' rating on Saudi Arabia to negative from stable. That negative outlook preceded the downgrade of Saudi Arabia by one notch to 'A+'. So, clearly, the lowering of our ratings on Saudi Arabia was not an isolated case.

We lowered our ratings on Saudi Arabia due to the pronounced negative swing in Saudi Arabia's fiscal balance. We expect that Saudi Arabia's general government fiscal deficit will increase to 16% of GDP in 2015, from 1.5% in 2014, primarily reflecting the sharp drop in oil prices. Hydrocarbons account for about 80% of Saudi Arabia's fiscal revenues. Absent a rebound in oil prices, we now expect general government deficits of 10% of GDP in 2016, 8% in 2017, and 5% in 2018, based on planned fiscal consolidation measures. We expect the government's fiscal consolidation plan will have several aspects, including postponing some capital spending projects, increasing non-oil revenues, and controlling current expenditures.

Saudi Arabia's external accounts mirror, in many ways, its fiscal accounts. Like the fiscal accounts, they shift based on prices of hydrocarbons, which account for four-fifths of exports. After 16 years of current account surpluses, we forecast that Saudi Arabia will post a current account deficit of about 6% of GDP this year and in 2016, before returning to broad balance in 2017 (see "Ratings On Saudi Arabia Lowered To 'A+/A-1'; Outlook Remains Negative," published Oct. 30, 2015).

The outlook on Indonesia has been positive since May 2015. What is Standard & Poor's waiting for to raise the 'BB+' rating to the investment-grade category?

An upgrade would depend on further improvement of Indonesia's policy credibility and track record, stemming from initiatives to bolster fiscal, monetary, and financial sector management, as well as economic performance. Our ratings on Indonesia reflect the balance between the country's low per capita income and developing policy and institutional
settings, and the improved credibility of its monetary policy, buoyant economic growth, and sound public finances.

Indonesia's efforts to improve its fiscal performance include reducing fuel subsidies and earmarking the proceeds for infrastructure investment, boosting revenue collection, strengthening land acquisition laws, streamlining investment licensing, and reforming tax incentives, particularly for foreign investors. Governance has been strengthened through tighter rules for procurement and licensing, expanded financial interest disclosure for members of parliament, and ministry appointments based on merit. The administration has directed other reforms at deepening Indonesia's capital markets and strengthening its financial system.

These are positive trends. Sustaining those trends and continuing commitment and effectiveness to improve the quality of public expenditure could be a precursor to an upgrade to investment grade. We also await Indonesia's further progress on developing critical infrastructure, resolving legal and regulatory uncertainties, and addressing bureaucratic obstacles and entrenched patronage. We believe these factors can enhance Indonesia's growth potential and ultimately its creditworthiness.

The positive outlook also reflects Indonesia's monetary policy settings, which have recently benefited from the central bank's lengthening record of independence, keeping inflation low through the use of market-based policy instruments. There are other initiatives to integrate financial center supervision, strengthen reporting and market conduct, and deepen the capital market through enhancing the clearing and settlement system and implementing an electronic trading platform.

Taken together, we believe these reforms should promote greater policy flexibility and responsiveness, and help build fiscal and reserve buffers to improve Indonesia's external resilience, mainly by containing current account deficits and increasing foreign investment and reserves.

**Is the negative outlook on Russia based on your assessment of geopolitical risks? After all, economic indicators appear to be picking up.**

Geopolitical risk is only one of the factors behind the negative outlook. The negative outlook reflects our view that, over the next 12 months, Russia's fiscal buffers could deteriorate faster than we currently expect. We could also lower the ratings if geopolitical events were to result in foreign governments significantly tightening sanctions on Russia. However, the situation remains fluid and, should EU sanctions ease, one possible consequence could be a modest medium-term boost to the Russian economy and, accordingly, a stabilization of sovereign creditworthiness. We expect the next review of EU sanctions to occur in January 2016.

Economic indicators can be volatile and do not necessarily indicate an economy's medium- and long-term trajectory. The longer-term economic trend in Russia has been one of weakness: Between 2005 and 2015, Russia's growth rate underperformed the EM average by about 3.1 percentage points per year. Looking ahead, we believe that Russia's real GDP per capita will continue to expand slower than that of economies with comparable levels of economic wealth. Apart from adverse demographic trends, a weak business environment is, in our opinion, a key impediment to greater private-sector investment. Without larger investments, efforts to diversify the economy and make it more dynamic are likely to fail, in our view.
We expect the general government deficit will widen to 4.4% of GDP in 2015 from 1.2% of GDP last year. Notwithstanding the severe terms-of-trade shock that Russia is experiencing, we expect that Russia's current account will remain in surplus, at about 6% of GDP over 2015-2018, thanks to import compression and a reduction in the income deficit due to falling debt-interest payments. The relative stability of budgetary performance and the current account is to a large extent also due to the shift to a flexible exchange rate in late 2014, which has acted as an oil-price shock absorber and enhanced monetary flexibility (see "Russian Federation Ratings Affirmed On External Buffers; Outlook Remains Negative," published Oct. 16, 2015).

The investment-grade ratings on Colombia and Peru have not changed, despite a serious deterioration of their respective terms of trade. Why is that?

The resilience of our ratings on Colombia and Peru shows that changes to the basic parameters of these economies in recent years have reduced external vulnerability. Both countries would have suffered greater economic hardship, likely leading us to lower the ratings, had they experienced a shock similar to the one in the late 1990s when Colombia lost the investment grade rating (before regaining it in 2011). However, they have gained considerable monetary flexibility over the past decade, reducing the inflation rate, developing domestic capital markets (especially through pension reforms), and shifting to a flexible exchange rate. As a result, they've been able to absorb much of the adverse effects of lower international commodity prices, which led to a decline of 12%-13% in their terms of trade during 2012-2014.

Over the years, the growth of capital markets in Colombia and Peru allowed both sovereigns, as well as resident banks and private firms, to lessen their dependence on external funding. Being able to borrow in the local currency, increasingly at fixed interest rates and for longer maturities, has significantly reduced the economies' vulnerability to sudden spikes in interest rates and movements in the exchange rate. Both countries undertook measures to change the composition of their debt profiles to reduce risk.

In Colombia's economy, the low level of dollarization has allowed the central bank to watch the local currency depreciate substantially over the past year without much fear of it hurting financial institutions and borrowers who may have currency mismatches on their assets and liabilities. In contrast, nearly one-third of loans in Peru are still denominated in dollars, prompting the central bank to attempt to moderate the depreciation of its currency.

The combination of relatively modest general government debt, the central banks' credible inflation-targeting strategies, and flexible exchange rates reduce, but do not eliminate, the damage from previous external shocks. We expect GDP to grow by about 3% in both these countries in 2015 and 2016, which is much slower than in recent years. Slower growth will translate into lower fiscal revenues, posing a challenge to the government, more so in Colombia than in Peru because Peru's debt is lower. We expect that both governments will respond through a cautious fiscal policy that will avoid persistently large budget deficits and rising debt (see "Republic of Peru," published Sept. 30, 2015, and "Republic of Colombia," published July 31, 2015).
If Ukraine fails to pay the $3 billion bonds held by Russia on Dec. 20, will you again lower your sovereign credit ratings on Ukraine to default?

No.

On Oct. 14, 2015, Ukraine completed a distressed debt exchange. Under financial distress, sovereigns often restructure their obligations, offering less than the original promise. We classify such exchanges as a default. In Ukraine's case, the exchange reduced the principal amount owed to commercial creditors by 20%, while redemptions originally scheduled for 2015-2018 were delayed until 2019-2027. Upon completion of the exchange, we considered the default to have been remedied. Therefore, we raised our long-term sovereign credit rating on Ukraine to 'B-' to reflect the forward-looking risk of another default.

At the same time, we maintained our issue ratings of 'D' (default) on Ukraine's outstanding bonds that had been eligible for the exchange offer but were not tendered. This applies to the $3 billion Eurobond maturing Dec. 20, 2015, held by the Russian authorities. In other words, the default on the $3 billion bond had already occurred when Ukraine offered to exchange it for another instrument with less attractive conditions. Since Russia, the sole creditor, did not accept the exchange, the issue rating on the bond remains at 'D'. But nonpayment on Dec. 20 would not constitute another, separate event of default. We would therefore not lower our sovereign credit rating on Russia to selective default (SD).

Is there a common trend behind the falling sovereign ratings in Africa this year?

The average sub-Saharan African sovereign rating has weakened by almost one notch since late 2013 to 'B+' (see "Sub-Saharan Africa Sovereign Rating Trends Mid-Year 2015," published July 13, 2015). The last upgrade occurred in March 2015, when we raised our rating on Rwanda to 'B+'. Before that, we upgraded Nigeria in 2012, although the rating was lowered again a few years later. Considering that sovereign ratings in the region are typically low, the erosion of creditworthiness is significant.

Commodity dependence is a recurring theme among the reasons for downgrades. More so than in other regions in the world (bar the much richer Gulf countries), African exports remain dominated by commodities. Decreasing demand from China has stemmed the export-led economic growth that many African economies had enjoyed over the past decade. Many African countries have been hit hard by the fall in oil and other commodity prices. Funding conditions have also become more challenging. Investors have been losing interest in EMs and in frontier investment destinations, in particular, in view of the Fed's possible interest rate hike. 2015 will be the first year of net capital outflows from EMs since 1988 (see "The Emerging Market Sovereign Outlook: What's Gone Wrong?," published Oct. 20, 2015). This has been a challenging combination of developments for many African sovereigns.

The lowering of our long-term ratings on Angola, Nigeria, Congo (Brazzaville), and Gabon to 'B+' in February and March this year resulted mainly from the effect of the sharp fall in oil prices. For the same reason, we again took action on Angola by revising our outlook to negative in July. The downgrade of Zambia to 'B' in the same month was partly due to a sharp drop in the price of copper.
Africa's largest economy Nigeria was among the most affected by the oil price slump. Its fiscal revenues rely heavily on oil and have fallen substantially, especially at the state level. The federal government was able to adjust expenditures, but the states' cost bases are less flexible, leading to arrears on wages. Nigeria's external accounts have also deteriorated, and we forecast that it will post current account deficits for the first time since 1998. Elections in April and May 2015 led to the first democratic transition in Nigeria's history: General Buhari defeated incumbent Goodluck Jonathan and is attempting to tackle the oil price crunch via austerity measures.

But not all negative rating actions can be traced back to commodity dependence. We lowered our rating on Mozambique to 'B-' because of concerns about contingent liabilities. For Burkina Faso, the downgrade to 'B-' stemmed from political instability.

**What is your outlook for Islamic Finance in 2016?**

We expect lower growth in 2016 for the Islamic finance industry compared with that over the past decade. After reaching critical mass, with outstanding Islamic finance assets exceeding $2 trillion, the industry faces several challenges, in our view. The drop in oil prices is taking a toll on oil exporting countries' public finances, and most of these sovereigns are centers of Islamic finance. But we also believe there are still unexploited pockets of growth such as Iran, if economic sanctions on the country are lifted.

That said, rapid changes in the global regulatory environment are raising the bar for Islamic financial institutions in terms of developments in conventional finance. What's more, closer integration of the industry is becoming a necessity since it remains fragmented. Standardization of documents and Sharia ruling could enhance the industry's integration and free stakeholders' capacity to focus on innovation. Standardization is slowly taking place, increasingly of legal documentation for sukuk.

**Where can I find the economic assumptions underlying Standard & Poor's sovereign ratings?**

The assumptions can be found in our quarterly publication, “Sovereign Risk Indicators” (The next update will be published in December 2015). This publication includes key economic, fiscal, and external macroeconomic variables and forecasts for all 130 sovereigns currently rated by Standard & Poor's. The data can be downloaded into standard spreadsheet software. A free interactive version is available at http://www.spratings.com/sri/.
## EM Sovereign Ratings Table

### Ratings And Outlooks On Selected Emerging Market Sovereigns

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<td>China</td>
<td>AA-/Stable</td>
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<td>India</td>
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<td>Indonesia</td>
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<td>Lebanon</td>
<td>B-/Positive</td>
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<td>Malaysia</td>
<td>A-/Stable</td>
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<td>Mexico</td>
<td>BBB+/Stable</td>
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<td>Morocco</td>
<td>BBB-/Stable</td>
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<td>Nigeria</td>
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<td>Peru</td>
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### Related Research

- Sovereign Risk Indicators, published quarterly. See also http://www.spratings.com/sri/
- Why Politics Matters To Sovereign Ratings, Nov. 6, 2015
- Islamic Finance To Still Grow In 2016 But With A Sag, Oct. 18, 2015
- Brazil Foreign Currency Ratings Lowered To ‘BB+/B’; Outlook Is Negative, Sept. 9, 2015
- Emerging Markets Sovereign Debt Report 2015: Borrowing To Increase By 6.3% This Year, March 5, 2015
- Plummeting Prices Weigh On Ratings For Some Oil Exporting Sovereigns, Feb. 11, 2015

We have determined, based solely on the developments described herein, that no rating actions are currently warranted. Only a rating...
committee may determine a rating action and, as these developments were not viewed as material to the ratings, neither they nor this report were reviewed by a rating committee.

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