

# Country Risk Overview

July 2011



# Growth forecasts

World growth  
revised upwards  
to 3.3%

## Growth forecasts

**Global 2011 growth now stands at 3.3% against 3.2% in March. Growth forecasts for industrialised countries are almost unchanged at the projected 1.8%, a net slowdown compared to the 2.5% increase recorded in 2010.**

Within industrialised economies, a downward revision in US growth has been offset by an upward revision in euro zone forecasts. US growth has been revised to 2.2% against 2.5% previously. Q1 2011 recorded a sharp slowdown (0.4% quarterly). This disappointing figure results from sluggish consumer spending, the still-poor state of real estate sector and unremittingly high unemployment. This revision is consistent with the “return to reality” of US growth, with consumer spending no longer being driven by debt. Nevertheless, Coface is not expecting a double dip, but anticipate weaker growth over the longer term (around 2%), based on a fundamental shift in growth trends.

In contrast, outlook for the euro zone has improved (1.8% against 1.3% previously) on account of strong Q1 2011 performances in Germany and France, which posted respective quarterly growth of 1.5 and 1%. France will record growth of 2%, and Germany, 3.2%, for 2011. However, the Franco-German tandem represents a healthy tree masking damaged

forest: peripheral countries are still deep in recession (Portugal -1.6%, Ireland -0.9% and Greece -3.9%). Spain should record slow growth of 0.8%, but its recovery from recession has become increasingly apparent every quarter since Q2 2010. The most worrisome news comes from Italy, which recorded very flat Q1 2011 performances (0.1%). Growth for the full-year could reach 0.9%, but is hindered by industrial sector activity failing to take off. Outside of the euro zone, the UK (1.2% forecast for 2011) is providing cause or concern: the economy has stagnated over the past six months (-0.5% in Q4 2010 and +0.5% in Q1 2011 q/q), with very weak domestic demand exacerbated by an austerity plan coupled with a reduction in household leveraging. The UK therefore can only rely on its export dynamic. Euro zone growth outlook nonetheless strictly depends on the development of the sovereign crisis and the series of sovereign defaults that could occur later in the year and are likely to lead to a sharp downward revision.

Coface	2002	2003	2004	2005	2006	2007	2008	2009e	2010f	2011f	Coface
<b>World production</b>	<b>2.1</b>	<b>2.7</b>	<b>4.0</b>	<b>3.7</b>	<b>4.3</b>	<b>4.2</b>	<b>2.0</b>	<b>-1.6</b>	<b>4.2</b>	<b>3.3</b>	<b>World production</b>
<b>Advanced countries</b>	<b>1.4</b>	<b>1.8</b>	<b>2.9</b>	<b>2.4</b>	<b>2.8</b>	<b>2.4</b>	<b>0.1</b>	<b>-3.5</b>	<b>2.5</b>	<b>1.8</b>	<b>Advanced countries</b>
United States	1.8	2.5	3.6	3.1	2.7	1.9	0	-2.6	<b>2.8</b>	<b>2.2</b>	United States
Japan	0.3	1.4	2.7	1.9	2.0	2.4	-1.2	-5.2	<b>4</b>	<b>0.3</b>	Japan
<b>Euro zone</b>	<b>1.2</b>	<b>0.8</b>	<b>2.1</b>	<b>1.7</b>	<b>3.2</b>	<b>2.8</b>	<b>0.4</b>	<b>-4.0</b>	<b>1.7</b>	<b>1.8</b>	<b>Euro zone</b>
Germany	0	-0.2	1.2	0.8	3.4	2.7	1	-4.7	<b>3.5</b>	<b>3.2</b>	Germany
United Kingdom	2.1	2.8	3	2.2	2.8	2.7	0.1	-4.9	<b>1.3</b>	<b>1.2</b>	United Kingdom
France	1.0	1.1	2.5	1.9	2.2	2.4	0.2	-2.5	<b>1.4</b>	<b>2.0</b>	France
Italy	0.5	0	1.5	0.7	2.1	1.4	-1.3	-5.2	<b>1.2</b>	<b>0.9</b>	Italy
Spain			3.3	3.6	4.0	3.6	0.9	-3.7	<b>-0.1</b>	<b>0.8</b>	Spain
<b>Emerging countries</b>	<b>4.4</b>	<b>5.7</b>	<b>7.2</b>	<b>6.7</b>	<b>7.6</b>	<b>7.9</b>	<b>5.6</b>	<b>1.8</b>	<b>6.9</b>	<b>5.7</b>	<b>Emerging countries</b>
Emerging Asia	6.5	7.1	7.9	8.3	9.3	10.1	6.9	6.1	<b>9.0</b>	<b>7.4</b>	Emerging Asia
Latin America	0.5	1.9	5.9	4.5	5.6	5.6	4.2	-1.7	<b>6.2</b>	<b>4.4</b>	Latin America
Emerging Europe	4.0	4.6	6.9	6.0	6.6	5.7	3.0	-4.1	<b>4.4</b>	<b>3.8</b>	Emerging Europe
CIS	5.3	7.8	8.1	6.8	8.2	8.6	5.5	6.6	<b>4.5</b>	<b>4.7</b>	CIS
Middle east	2.5	6.3	6.9	5.8	5.5	5.5	5.8	1.5	<b>4.0</b>	<b>3.6</b>	Middle east
Africa	6.3	6.4	6.0	6.0	6.9	6.9	5.7	1.6	<b>4.6</b>	<b>4.9</b>	Africa
China	9.1	10.0	10.1	11.3	12.7	14.2	9.6	9.1	<b>10.3</b>	<b>8.8</b>	China
India	3.8	8.5	7.5	9.5	9.6	9.3	6.7	8.0	<b>8.6</b>	<b>7.8</b>	India
Brazil	2.7	1.2	5.7	3.0	4.0	5.7	5.2	-0.6	<b>7.5</b>	<b>4.0</b>	Brazil
Russia	4.7	7.3	7.2	6.4	7.4	8.1	5.6	-7.9	<b>4.0</b>	<b>4.5</b>	Russia
<b>World trade</b>	<b>3.4</b>	<b>5.4</b>	<b>10.3</b>	<b>7.0</b>	<b>7.4</b>	<b>7.3</b>	<b>2.8</b>	<b>-10.7</b>	<b>14.5</b>	<b>6.5</b>	<b>World trade</b>

Growth in emerging economies remains at a healthy 5.7%, but is slower than in 2010 (6.9%). Growth in China and India is forecast to slow down moderately (8.8% and 7.8% respectively). Latin America is handling its soft landing skilfully (4.4% against 6.2% in 2010). Growth in Emerging Europe is still more moderate than before the crisis (3.8%). In the Middle East, growth stands at 3.6% against 4% in 2010 on account of the political upheaval which has offset the beneficial effects of a firmer oil price (albeit slightly

weaker recently). Available Q1 data from emerging economies still generally reflects highly dynamic growth but which is slightly weaker, particularly in India and Brazil. This may be an indication that restrictive monetary policies are beginning to impact the real economy. There may well be a very gentle slowdown effect, which still needs to be confirmed in China and in Turkey. In any case overheating, and how to deal with it, remain relevant issues.



# Euro zone

Good German and  
French performances  
in the first quarter  
this year

The peripheral countries  
remain in recession

# Rating modification

## Luxembourg

### Withdrawal of the negative watch (since March 2009) on the A1 rating

The economy recovered thanks to strong investment and exports. Although highly dependent on the international economic and financial context, the banking sector held up better than expected.

#### The recovery has continued this year

The economy rebounded in 2010 driven by the strong growth of public-sector demand and exports. GDP growth benefited from the increased confidence of households and the rise of real wages. Low interest rates contributed to the recovery of investment. Construction, non-merchant services, and temporary employment were the main economic drivers. Manufacturing began to grow again, spurred by the dynamism in the steel industry. Financial services were relatively lifeless once again with investment funds alone achieving good performance spurred by the rebound in financial markets. Repercussions of the crisis nonetheless continued to affect companies with the bankruptcy rate remaining high throughout 2010. The recovery is expected to continue this year with growth above the euro-zone average. The key economic drivers will include major investment projects undertaken by large companies and also exports of financial and B2B services. Fiscal policy is, however, expected to be slightly tighter.

#### Continued high sensitivity to changes in the international financial context

The financial sector (30% of value added) has come through the crisis relatively well and is expected to

begin to grow again, benefiting from the increase in margins on interest income and the growth of demand deposits. The construction sector will likely rebound strongly thanks to the increase in residential and non-residential building permits. Air transport and telecommunications activity will also be dynamic. The economy nonetheless remains sensitive to shifts in the world financial context as a result of its specialization in financial services, a strongly internationalised sector in terms of both its activities and its ownership. They would also have to adapt to any changes apt to affect financial transparency and governance.

#### The extent of the deterioration in public sector finances remains limited

The moderate growth of the deficit in 2010 is attributable to the delayed effect of the crisis on public revenues and the implementation of a stimulus plan. It is expected to be partly eliminated this year thanks to the growth of tax receipts (particularly proceeds from personal income tax) and a slowdown in spending. Reform of the health system (carried out in 2010) and of pensions (expected this year) will contribute to consolidating public finances. Public-sector debt represents less than 19% of GDP, one of the lowest ratios in the euro zone.

# Rating modification

## Greece

### Downgraded from A4 (since June 2010) to B

Domestic demand is strongly undermined by the fiscal adjustment process. In 2011, and for the third year in a row, economic activity will decrease. The new austerity measures voted by the Greek parliament have broken the deadlock in the payment of the fifth instalment of the loan IMF and EU have granted to Greece in May 2010. Greece has again avoided payment default. Nevertheless, and according to Greek fundamentals, this lull looks temporary.

#### High financial risks

The financial crisis exposed the unsustainable nature of the growth regime founded on a bubble in public and private debt. The doubts of investors about the payment capacity of the Greek government necessitated implementation of an initial €110 billion rescue plan in May 2010 in conjunction with drastic fiscal measures and structural reforms focused on the pension system, the job market, and an overhaul of the tax system intended to improve collection effectiveness and reduce the influence of the grey market. This plan will not suffice, however, to enable the country to regain access to financial markets by 2012 as initially expected. With the economic, financial, and social situation continuing to deteriorate, long-term bond rates have reached new heights and creditors have grown increasingly sceptical as European authorities struggle to arrange a new rescue plan. The IMF and EU have made both the release of the fifth instalment on the loan they granted to Greece in 2010 and the implementation of the new plan subject to adoption by Parliament of a new austerity programme including massive privatisations and new cutbacks on spending. The amount of the plan, which includes voluntary participation by private creditors through

repurchase of Greek bonds at maturity, could exceed €100 billion. The reshuffling of ministerial portfolios just carried out by the Prime Minister Georges Papandreou to close ranks within the government party facilitated the adoption by Parliament of the new measures in June and the European authorities have given themselves until mid-September 2011 to validate the second rescue plan. Greece avoids again defaulting on its debt, which would have had severe effects on Greek banks and investors, in view of their holdings in government securities. However, this respite seems precarious, taking into account Greek fundamentals.

#### Persistence of the recession in 2011

In 2010, the recession deepened under the combined effect of slumping domestic, external, and public demand. The contraction of GDP is expected to persist in 2011: after shrinking at a 7.4% rate year-on-year in the 2010 fourth-quarter, it contracted 5.5% in the first quarter this year. Investment and private consumption remained in decline. Although exports were flat, foreign trade nonetheless made a positive contribution to economic activity as a result of the sharp decline in imports. The sacrifices expected from households will

undermine consumption, likely to fall over 6% in 2011 squeezed by declines in jobs and incomes, and increases in taxes. Corporate investment will continue to suffer from a double-digit contraction attributable to a loss of confidence, higher taxes, and the tighter credit policies adopted by banks suffering themselves from a lack of liquidity and the rise of nonperforming loans.

Although expected to drive the economy, the export rebound will be held back by the limited recovery of growth in the European Union, which provides a market for 63% of sales abroad. The increasing technology content of Greek exports constitutes a competitive advantage. But the proportion of manufactured products has remained moderate with the country also a supplier of food and chemical products. The large tourist sector is likely to benefit, meanwhile, from the deteriorating political situation in North Africa. And the current account deficit will, on balance, be likely to continue to contract thanks mainly to the weakness of imports.

## Companies faced with difficulties in obtaining financing

Greek companies have been affected by the tight economic and financial conditions, the reduction in orders from the public sector, and higher taxes. Late payments could become more commonplace. The construction and retail sectors in particular have been weakened by the deterioration of domestic demand. Sea transport remains an economic strongpoint. Companies could also be faced with a shortage of financing with Greek banks skittish on lending to either households or companies - all the more so where they had been excessively generous in the euphoric economic period: After recording peak annual growth of 25% in October 2008, corporate credit contracted 8% in the 12-month period through end April this year.



# Focus on main economies

## Germany

**A2 rating (since December 2009) unchanged**

### **Good performances in the first quarter this year; a slowdown is expected in the second quarter**

In the first quarter this year, the economy grew 1.5% compared to the 2010 last quarter. And the economy grew an even greater 5.2% in comparison to the first quarter last year. While it is true that this quarterly performance is partly attributable to the marked slowdown suffered in the baseline quarter due to poor weather, it is nonetheless remarkable.

From the second quarter this year, economic activity will doubtless slow down as the catch-up effect wanes. The margin for squeezing more growth out of existing means of production and markets will narrow. This is reflected in the decline in the latest indicators of confidence in the economic outlook even if they bear out the excellence of the current situation. Confidence in the future has nonetheless remained high and economic growth will doubtless be strong once again in 2011.

### **Exports, still Germany's economic lynchpin grew 20%**

Sales abroad achieved record performance in the 2011 first quarter, up 20% year-on-year. One reason for this is the country's specialization in high-growth

market segments: luxury private vehicles; utility vehicles; machinery; chemical products; electrical, electronic, and optical equipment. These sectors represented a combined 66% of German exports in 2010. Another explanation of the strong progression resides in the geographic distribution of exports, largely focused on emerging countries, which absorb 37% of German exports including 6% by China alone. In coming months, the situation will grow slightly dimmer with foreign demand slowing slightly not only in the euro zone but also in Japan and the United States, three major markets absorbing a combined 55% of Germany's sales abroad. And demand from emerging countries will also decline but to a lesser degree. Imports, meanwhile, will also decline, but not as sharply due to the firmness of investment and consumption. In total, foreign trade will make a slightly less positive contribution to the economy.

### **Domestic demand continues to be dynamic**

The completion of the restocking process and the slowdown in public spending will be offset by the continuing strength of both investment and private consumption.

### **Corporate investment, although easing, will remain strong**

The production capacity utilisation rate climbed back to 86% early this year, just two points below its pre-crisis level. Easy credit conditions continue to prevail with 78% of the companies surveyed this past April considering that their access to financing was easier now than in 2010. And most of them generate cash from their operations they can draw on to help cover investment spending.

### **Construction: a sector that will continue to grow this year**

Benefiting from a bright job picture and still easy credit conditions, residential property is expected to continue the moderate recovery underway since 2010. The strong performance of private non-residential property, including factories, warehouses, shops, and offices, will remain strong considering the backlog built up during the crisis and the still strong growth in this segment. The only cloud on the horizon: public-sector construction, which will be constrained by the fiscal tightening measures.

### **Mitigated indicators in household consumption**

#### **Three indicators have been pointing up:**

- Unemployment, which represented only 7% of the working population in April, will likely decline further by year-end.
- Working hours and exceptional wage items have been increasing.
- General wage increases have nonetheless remained moderate, a trend likely to be reinforced moreover by the arrival of workers from new European Union countries entitled since May to seek employment in Germany.

### **But two other indicators are pointing down:**

- Inflation reached an annualized 2.7% rate in May.
- The various measures of fiscal economy (increases in health insurance contributions, cuts in benefits to the long-term unemployed and civil service wages, reductions in subsidies for investments in renewable energies) could represent 0.7% of GDP this year. These measures have been taken in the framework of the mechanism for reducing public debt (Schuldenbremse), which was inserted in the Constitution in 2009 and is being implemented starting this year. With the general deficit of 1.8% expected this year, a substantial portion of the work to be done has already been accomplished. The authorities are nonetheless resolutely maintaining their effort especially with the ultimate cost of support for outlying countries still uncertain.

### **The profitability of German companies will improve once again**

Corporate profitability has recovered thanks to increases not only in production and sales but also in productivity, which has, however, yet to return to pre-crisis levels. Profits, before dividend payments, represented 21% of GDP in 2010 compared to 24% before the crisis. The number of bankruptcies along with the amount of the claims arising from insolvency procedures has nonetheless eased back to pre-crisis levels. Despite the increases in production costs (wages and especially raw materials) expected this year, profitability is nonetheless likely to continue to recover with the gains in productivity expected to increase faster.

# France

**A2<sup>+</sup> rating (since December 2009) unchanged**

## **Economic recovery in 2010 driven mainly by domestic demand**

Private consumption, steady throughout 2009 and 2010, has underpinned the economy during the crisis thanks to cushioning mechanisms and stimulus measures. The upsurge in consumption benefited almost every economic sector in 2010, particularly food, clothing, and catering/hospitality. After growing strongly in 2009, spurred by the introduction of the scrapping incentive, new vehicle sales sagged slightly in 2010 with the incentive losing some of its lustre. Investment only began to improve in the second quarter last year and the trend has been relatively uneven since then. The recovery has also been fuelled by a technical factor: a reduction in the proportion of sales companies made from stock. Although exports contributed to the economic rebound in 2010, the net contribution of foreign trade to GDP growth was slim with consumption mainly benefiting imports.

## **An acceleration of growth expected in 2011**

Economic growth is expected not only to accelerate this year, but also to become more balanced, which will particularly benefit investment. GDP grew strongly in the first quarter compared to the fourth quarter last year, driven in particular by stronger consumption (a rebound in spending on services and the good performance in manufactured product sales.). Corporate investment spending increased markedly especially in information-communication. Public administrations also invested more as a result of the recovery in spending on construction. Variations in stock levels also provided a strong boost to economic activity. Conversely the trade balance deteriorated as a result of the

rebound in imports. The pace of the recovery appears to have peaked in the first quarter and growth will likely slow for the rest of the year reflecting the tightening of fiscal policy (prompted by the need to limit growth of public-sector debt estimated at over 80% of GDP), the expiry of the scrapping incentive (whose residual effects were very noticeable early in the year), the slower growth of foreign trade, and a relatively strong euro. High prices for oil, food, and raw materials will also undermine consumer purchasing power and inflate production costs for companies.

## **Loss of market share**

High corporate debt and low cash flow do not augur well for a significant increase in productive investment. Financing conditions remain difficult. Corporate bond risk premiums have increased and credit flows remain below pre-crisis levels, with bank feebleness primarily affecting smaller companies. There is a general lack of corporate innovation and companies are not exporting enough, due more to lack of ambition than competitiveness issues. With little presence in emerging countries, they take insufficient advantage of the economic dynamism in those markets. Despite the contraction of profit margins, industry has lost market share.

## **Improved payment behaviour and an easing corporate bankruptcy trend**

After initiating a decline, payment incident index continued to ease to a very low level notwithstanding a slight increase in late payments in construction, traditionally the sector where defaults are most likely to occur. In general, companies have managed their cash positions and stocks more effectively and reduce

their payment times in the framework of the economic modernization law. They have benefited moreover from extensive public support (industrial support fund, credit insurance aid mechanisms). The corporate bankruptcy rate has remained high, however, compared to the years preceding the crisis. But the trend has been clearly towards easing since September last year. The decline in the number of bankruptcies reached 4% for the full year in 2010 and 5% for the 12-month period ending 30 April 2011. And the reduction in the cost of these failures to suppliers, which has trended down since autumn 2009, has

been even more substantial. The decline reached 15% year-on-year through end April this year after reaching 22% in 2010, reflecting the sharper fall in bankruptcies for large and very large firms than for very small companies. Six sectors will bear watching: distribution, services to private individuals and services to groups (where bankruptcies have continued to rise), means of transport, B2B services, and media & leisure, which suffered a significant downturn. Public works, which contributed nearly 1/3 of business nationwide and was one of the fastest-growing sectors during the crisis, has taken part in the general decline thus far.

## Italy

### A3 rating (since March 2009) unchanged

#### Modest growth driven by exports and investment

In 2011, growth will remain modest and below its albeit moderate pre-crisis pace. Performance in the first quarter has been disappointing, below forecasts and the euro-area average. The crisis seems to have durably weakened the economy's potential. Exports and investment will remain the growth engines. Despite a recurrent lack of competitiveness and an economic slowdown among the country's main trading partners, exports will still make good progress. Demand from Germany and emerging countries in Asia will remain buoyant. Corporate investment will continue to make moderate progress thanks to growth in exports and an obsolescence effect. It will, however, continue to be constrained by low production capacity utilization (71% end 2010 compared to the 76% histo-

ric average) and corporate financial health that has yet to return to normal. Property investment is expected to pick up, while investments by public authorities are expected to stagnate due to budget restrictions. Household consumption will remain sluggish. Unemployment will stay above 8% as companies strive to bring working hours back to normal levels before recruiting new staff. Real disposable income will increase little, as wage earners gradually cease to receive compensation for partial unemployment via the Cassa Integrazione Guadagni and because of the public sector wage freeze. Furthermore, revenues from informal business activities will struggle to recover.

### **Growing anxiety over public-sector finances despite tighter fiscal policy**

Fiscal policy will be moderately restrictive. During the crisis, the authorities were well aware of the already high level of debt (119% of GDP in 2010) and consequently adopted a cautious stimulus plan. After remaining below 5% of GDP last year, the deficit will likely ease to 4% in 2011 and 3% by 2012 with a near-zero primary balance. Reductions in transfers to the regions and municipalities, cuts in spending on drugs, and in operating costs are planned. The campaign against fraud will be intensified. Despite these measures, the political setbacks suffered by Silvio Berlusconi in May and June this year — loss of his political stronghold in Milan, crushing victory of the no vote in the referendum on water, nuclear energy, and the legal system — could slow the pace of reforms. Reflecting the growing unease, the rating agencies recently downgraded the quality of Italian debt.

### **Italian companies still in a shaky position**

The payment incident index for Italy reflects an above average frequency of non-payment incidents. Although tending to improve, corporate financial health will generally remain precarious. Up 25.5% in 2009 and 19.8% in 2010, bankruptcies surged another 20.6% year-on-year through end March this year. Renewing credit lines has become more costly and more of a hassle, with banks preoccupied with improving their profitability and the perspective of an increase in their capitalization ratios. Smaller companies, which have already experienced rough going in the crisis, have been the first to feel the effects of this trend. Some sectors like the food, pharmaceuticals, and IT sectors have nonetheless remained in good shape. Others have apparently overcome severe crisis-related difficulties as has been the case in metallurgy, electrical equipment, machinery, and textiles. And some sectors are still convalescent, including the wood industry, paper, printing, rubber and plastic processing, as well as transport equipment.

## Spain

### **A3 rating (since March 2009) unchanged**

#### **Feeble recovery**

The country emerged from recession in the first half of 2010. Consumption recovered, partly supported by the anticipation of increased VAT rates in July and the car scrapping incentive. The slow recovery of growth has been confirmed in the fourth quarter of 2010 and at the start of 2011. Investment however continued to be handicapped by the lack of upturn in the residential construction sector. Accordingly, domestic demand

remained on a downward trend. Nevertheless, foreign trade contribution to growth remained positive, with exports reviving more than imports. In 2011, consumption is expected to grow sluggishly because of the ongoing fiscal consolidation, record unemployment figures (20% of the working population) and continuing household deleveraging. Investment will remain in decline because of continuing adjustments in the construction sector, difficult funding conditions,

low production capacity utilisation rate and declining government expenditures. Foreign trade is expected to remain the main engine of growth. Fuelled by the increase in commodity prices and the gradual upturn in domestic demand, inflation will remain above the eurozone average in 2011.

### A now vital adjustment

The economic boom the country enjoyed from 1997 to 2007 brought with it an excessive increase in private debt and property investment, a significant loss of competitiveness and a widening current account deficit. Companies and households alike are now being forced to deleverage. The fall in property prices continues although it has until now been limited thanks to fiscal measures and the fact that the banks, which own a significant proportion of the country's real estate, are holding back on sales. As the number of unsold residential properties remains high, the adjustment process in this sector is expected to continue. In addition, because of lower tax revenue and growth support measures initially implemented by the authorities, public finances have moved into deficit since 2008 and the weight of public debt, which until then had been only moderate, has increased sharply (from 36% of GDP in 2007 to around 60% in 2010). In the current crisis, within the eurozone, this means a sustained recovery effort must be made even though debt

levels remain lower than the European average. In addition, the financial sector has been weakened. Savings banks (50% of the total) have been particularly exposed to property loans granted to developers and have been forced to merge and raise capital. Moreover, banks hold a significant volume of government securities and are exposed to the Portuguese debt. However, the central government alone is responsible for deficit reduction while local authorities struggle to meet fiscal objectives. And the setback suffered by the Socialist Party in the municipal and regional elections this past May raised fears moreover of the existence at that level of fiscal situations actually worse than those announced.

### Companies in convalescence

Since peaking in summer 2009, the number of payment incidents recorded by Coface has declined considerably, tending to return to pre-crisis levels. And the number of bankruptcies recorded by the national institute of statistics eased 3% in 2010 after soaring a spectacular 97% in 2009. The very gradual easing process stayed on track early this year. The bankruptcies particularly affected the construction and property services sector, hammered by nearly a third of the failures, and, to a lesser extent, industry and commerce. The regions affected most included Catalonia, Valence, Madrid, and Andalusia.



# Ireland

## A4 rating (since December 2010) unchanged

### The recession may well continue in 2011 for a fourth straight year

The crisis, triggered by a severe correction in the property market and exacerbated by the global financial crisis, has resulted in a sharp contraction in GDP, down nearly 12% from 2008 to 2010. With the loss of confidence by investors (affected by the slippage in public sector finances), the upward revision in the losses suffered by the banks, and the flight of deposits, government authorities had no choice but to turn to the IMF and the European Union late 2010 (ultimate rescue package of €85 billion including a contribution by Ireland itself. To benefit from this support and avert the failure of its banks Ireland had to resign itself to accepting a new austerity plan, even more severe than its predecessors. The rise of unemployment, the negative wealth effect resulting from the fall of property prices, the pay-down of household debt, the collapse of the construction sector, and the credit crunch continued to depress consumption and investment in 2010. The economy performed poorly in the fourth quarter with exports sagging despite increased competitiveness. The recession is very likely to continue this year. Private consumption is even expected to suffer a more severe slowdown than it did in 2010 as a result of a sharp decline in household disposable income attributable to the reduction in pensions and wages in the public sector and a further increase in unemployment. Investment will continue to suffer from the slump in the construction sector even though capital goods purchases appear on the verge of recovery. Exports will likely remain the crucial economic engine. And further out, Ireland doubtless has the

capacity to re-establish a relatively dynamic economy thanks to productivity gains and its specialization and high value-added sectors (pharmaceuticals, other chemical products, equipment and machinery, IT services).

### Default risk warded off in the near-term

Ireland has above all been the victim of a property and banking crisis attributable to the low interest rate levels prevailing in the country since it joined the euro zone and to ineffective oversight of the financial sector. It was, however, the inflation of the public sector deficit generated in large part by the exceptional support granted to the banking sector that pushed the country to the brink: In 2010 that support represented nearly 2/3 of the total public deficit (32.4% of GDP). Starting from a low level, the public debt has been rising sharply and is expected to represent 115% of GDP this year. As things stand now, Ireland may still not be in a position to return to the bond markets even by 2013, which could prompt it to seek additional aid, or even a restructuring of its debt. Thanks to government intervention in the form of recapitalization of the banks and establishment of a defeasance structure for non-performing loans and to cash infusions by the ECB, the banking sector avoided a massive collapse. After the last capital injections, in amounts based on stress tests carried out in March this year, the domestic banking sector will henceforth be entirely nationalized. The foreign debt of banking and financial institutions is considered high even after subtracting the portion owed by the international financial centre in Dublin. Were the financing difficulties to persist beyond 2012 the banks would also be faced with the crucial ques-

tion of restructuring the debt. The new government, set up jointly by Fine Gael and Labour, took office this past March. It hopes to obtain agreement on a lower interest rate set for the rescue plan but has made a commitment to honour the objectives of the programme negotiated with the IMF and EU by its predecessor. Although the coalition has been benefiting to some extent from a grace period, continuation of the austerity programme could ultimately erode the sense of common purpose currently binding the country.

### A two-track economy

The persistent weakness of domestic demand has resulted in a decline in prices that has squeezed

corporate margins despite reductions in wages. Their financial position has been severely undermined in many sectors that focus on the domestic market, like property (which is unlikely to recover before 2012), home furnishings, merchandise transport and car trade. Conversely, an export industry dominated by subsidiaries of multinationals has performed well. Pharmaceuticals, chemicals, food and the internet have benefited from the decline in wages and rent, their still advantageous tax regime and the buoyancy of demand from non-euro zone European countries and from emerging markets.

## Portugal

### A4 rating (since March 2011) unchanged

#### The economy slips back into recession in 2011 as a result of a tightening austerity regime

Tax hikes, reductions in social transfer payments and civil service wages as well as tighter credit conditions had a negative effect on domestic demand in the second half of last year that resulted in a decline in economic activity in the last quarter. Exports alone maintained a role as an engine of growth. The tightening of fiscal austerity measures will lead to a recession in 2011. GDP has already suffered a decline in the first quarter. In a context already marked by high household debt and substantial unemployment, consumption begins to decline. Moreover, sluggish credit, and low corporate profitability and cash flow offer little hope for a recovery in investment, which will remain in negative territory for the fourth year in a row. And, although demand from abroad will likely weaken somewhat, the contribution of foreign trade to growth

is expected to be highly positive due to shrinking imports.

#### Severe macroeconomic imbalances forced Portugal to seek aid abroad

The cost of the initial measures of economic support, compounded by the impact of a severe recession, resulted last year in a widening of the fiscal deficit and a very sharp increase in public sector debt to levels exceeding 90% of GDP. Compared to Greece, Portugal was quicker to implement fiscal consolidation measures and, unlike the situation in Ireland, there was no speculative property bubble and thus none to burst and inflict losses on banks. But the tensions rose sharply on the Portuguese debt market with interest rates reaching record levels (over 11% on 10-year bonds in June this year). After the rescues of Greece and Ireland mounted earlier by the EU and IMF, Portugal in

turn had no choice but to seek aid from abroad. And the country ultimately obtained a three-year €78 billion loan including €52 billion from the European Union and €26 billion from the IMF. Despite the progress made, the Portuguese economy has nonetheless remained handicapped by low productivity, a lack of competitiveness, and a high overall level of debt. The low productivity is attributable to a relatively inflexible labour market, a cumbersome regulatory framework, a lack of competition, and a relatively unskilled labour pool. In conjunction with a sharp rise in wages, the prevailing low level of productivity has undermined competitiveness. Portugal has lost market share and has been running one of the largest current-account deficits in the euro-zone. The country's foreign debt has grown sharply as have household and corporate debt. Portuguese banks have become dependent on financing extended by the ECB and have considerably increased their holdings in public debt securities. The economic and financial deterioration has been compounded by a political crisis: The refusal of the opposition to approve a new austerity plan led to the resignation of the Socialist Prime Minister José Socrates. The ensuing elections early June this year resulted in victory by the Social Democrats, which, as the leader of a centre-right coalition, are now responsible for carrying out the austerity programme and implementing the reforms at the risk of undermining the sense of common purpose currently binding the country.

### Weakened companies

The bankruptcy rate remained high last year. The sectors most affected included ready-to-wear clothing, textiles, leather, construction, and furniture. The slow-down in construction has persisted, while turnover continues to fall in the retail sector, except in food. Textile production continues to trend down. And it will have to make further investments in new production methods and technologies to be able to meet competition from India and China. Only food, Portugal's main industrial sector, seems to be holding up relatively well in the crisis. Major efforts have been made on modernization and innovation. The sector moreover has the capacity to explore new markets and to make necessary adjustments. It nonetheless remains very fragmented, dependent on raw materials, and subject to pressure exerted by mass distribution with which it has to cope. And in the automotive sector (subsidiaries of foreign groups) although the outlook for exports (97% of output) has appeared relatively bright, domestic sales will suffer this year from the recession.





# Countries outside the euro zone

Clouds looming over  
the United States and  
the United Kingdom

Sharp slowdown  
in Japan

## Focus on main economies

### Japan

**A1 ↘ rating (since March 2011) unchanged**

#### **Strong growth in 2010 driven by a spectacular rebound in exports**

Japan surprised everyone with the acceleration, albeit limited, in household consumptions (1.9%), spurred by the very reactive fiscal policy pursued by the authorities and the spectacular rebound in exports (up 24%) in 2010, which benefited from strong demand from the other Asian economies (54% of shipments). Exports thus made back ground lost during the crisis. Economic growth surged in 2010, up 3.9%, a pace not achieved since 1991.

#### **The effects of the earthquake and the tsunami will persist until the end of 2011**

In the fourth-quarter 2010, economic growth stalled, affected by the contraction in both exports, hobbled by the appreciation of the yen, and household consumption, affected by expectations that the disposable income might begin to stagnate, or even decline, again. It was in that context of economic weakness that Japan was hit by the earthquake and tsunami in March 2011. Compounded by nuclear fears, the two cataclysms subjected the country to a shock of unprecedented violence, reflected by a growth contraction of 0.9 per cent in the first quarter of 2011. Breakdowns in the supply of electricity and water, in conjunction with the destruction of road, port, and rail infrastructure have affected production not only by factories operating in the stricken regions (the four counties affected represent 6.2% of GDP) but also in administrative sub-

divisions supplied with energy by nuclear power plants located in north-eastern Japan and which are more industrialized (Kanagawa and Shizuoka). The sectors that have suffered most include automotives, electronics, steel, pharmaceuticals, and food. So exports, where a slowdown was already expected before these dramatic events, should decelerate for months to come. This particularly concerns sales to China, South Korea, and Taiwan of electronic components and other intermediate products essential in the assembly of finished products notably intended for Japan, the United States, and Europe. The existence of excess production capacity in Japan could nonetheless partially mitigate that negative effect. The price competitiveness of Japanese products moreover continues to suffer from the strength of the yen. This trend could be curbed, however, by the monetary policy pursued by the Bank of Japan, which has very large foreign exchange reserves at its disposal for use in limiting the Japanese currency appreciation and thereby supporting exports. Households suffer from this new and unprecedented crisis, which should have a lasting effect on their confidence even if national solidarity and cohesiveness will ensure that support will be provided to those that suffered most. Their spending is thus also expected to decrease this year especially with household savings having declined considerably in past years to a level in 2010 representing about 2.5% of disposable income. However, the negative effects should fade, at the best, by the end of the year, and

give way to an economic rebound driven by reconstruction. Nonetheless, the intensity of the recovery will depend on Tepco's ability (Tokyo Electric Power) to limit the radioactivity contamination on the environment and to restore electricity supply. The supply of energy should actually remain erratic, especially in summertime when air-conditioning is extensively used. The reconstruction financing is unlikely to be a source of concern with Japan possessing the financial means to cope with the situation. Although public-sector debt is currently very high (225% of GDP), 95% of the amount outstanding is owed to residents. And the archipelago holds considerable assets abroad (60% of GDP). The government could also draw on the substantial reserves accumulated at all levels of the national economy (25% of GDP) mainly by companies. In this context, the 2011 outlook for economic growth has been revised downward (-0.3%).

### **Smaller companies seem to be the most vulnerable**

Large Japanese and foreign groups have production units in the regions affected by the earthquake and tsunami. But many smaller subcontracting companies and high technology hubs also have production facilities there. The Japanese just-in-time production model, which eliminates the accumulation of stocks, tends to amplify the impact of production stoppages. The lack of essential production inputs can lead to the shutdown of assembly lines while the electric-power rationing put into effect could result in losses, particularly in the manufacturing of products for the electronic component sector where Japan provides 21% of world production and which entails very high precision work. Subcontracting companies may, furthermore, be faced with increases in input costs they will be unlikely to be able to pass on to customers since they are locked in by annual contracts. The pressure on their margins will

consequently increase. Even before the onset of the financial crisis, companies in this category had been giving signs of serious weaknesses (low profitability, overdependence on one large customer, difficult access to credit). This situation contrasts with that of large companies, which have largely been able to reconstitute their cash flow (up from about 60% mid-2009 to over 115% late last year). The continuing strength of the yen in conjunction with lessons drawn from this latest catastrophe could serve as a catalyst to the already broad movement to delocalize manufacturing facilities abroad, which would tend to weaken subcontracting companies even more. And even if the risk of nuclear contamination either fails to materialize or remains limited in scale, consumers might nonetheless be likely to remain wary of any product whatsoever "made in Japan". That will particularly be the case for agri-food industries. The impact of the massive catastrophe on the environment (radioactive radiation, petrochemical complexes in flames), besides the public health issues it will generate, will have a long-lasting effect on farming activity. The number of bankruptcies has decreased in 2010 (-12.4 per cent) and in the first quarter of 2001 (-5.3 per cent), but has not recovered its pre-crisis level. Coface payment incident experience is satisfactory.

## United States

**A2<sup>+</sup> rating (since March 2010) unchanged**

### **Economic growth in 2011 made up the ground lost in 2010 but was disappointing in the first 2011 quarter**

Supported by very reactive fiscal and monetary policies in 2010, economic growth is expected to come to about 2.9%, driven by household consumption, restocking, and capital investments. But major negative trends persisted throughout the year prompting the Federal Reserve and the Obama administration to adopt pragmatic policies in support of the economy. Growth has slowed down to +0.4% (t/t) in the first quarter, following a rather encouraging 2010 last quarter (+0.7%).

### **Prudent attitude of households and companies all through 2011**

The \$900-billion agreement concluded late in the year between the Republican Party and the Obama administration will enable the United States to limit the growth slowdown (+2.2%). This stimulus package, intended for households and companies alike, supplements the Federal Reserve's unconventional monetary easing measures (QE2). These measures aimed to improve inflation anticipations and to bring down long interest rates through purchases of Treasury bills by the Fed. Initiating a QE3 or any other form of monetary stimulus to the economy is at stake while intense debates between the Democrats and the Republicans are still going on at the Congress on the debt ceiling increase. An agreement should be reached by the 2nd of August deadline date, whereas the Fed could be pushed to initiate expansionary measures, several factors continuing to affect economic activity: completion

of the restocking process, still gloomy employment outlook, depressed property market, debt repayment by American households (with the balance outstanding declining from over 131% of disposable income in 2008 to over 117% in 2010), and continuing replenishment of their savings (around 6% of disposable income). Households are likely to remain cautious on spending as long as the measures intended to consolidate public-sector finances have not been spelled out. In this context, residential investment is remaining sluggish with the stock of homes slightly decreasing from 7.5 months in January to 6.5 months in April, but likely to jump back with the resumption of foreclosures by banks. The situation will continue to undermine prices, which have contracted by 20 per cent on the average since the first quarter of 2007 and could decline another 10% this year. And this trend limits the geographic flexibility of workers with the balance due on their mortgage loans remaining higher than the value of the underlying property. Strengthened by increased profits and by tax credits, companies will continue to invest in capital assets arrears due prudence as long as demand has not really come back to life. Job creation will only resume very gradually with unemployment remaining high at over 9%. Exports, meanwhile, will still benefit from favourable dollar exchange-rates, even if the currency may appreciate once again in 2011 due to its role as a safe haven as was the case in November 2010 with the turbulence in Europe swirling around the euro. Sales abroad could also derive support from Asian demand (20% of sales), which would offset expected slowdown in demand from industrialized countries, which constitute a majority of the US export market.

### **Smaller companies weakened by the strong exposure of regional banks to the property market**

According to the Federal Reserve, large US companies generated \$2 trillion in cash flow last year, a record unequalled in the past three decades. But this surge is attributable more to the drop in unit costs and the decline in investment than to increased turnover. And the situation is entirely different for smaller companies. Weakened by the slowdown in sales, they have limited access to bank credit, which failed to revive

due not only to a lack of demand but also to the weakened financial health of many regional banks, which are the main financial partners of smaller American companies. Corporate bankruptcies decreased significantly by 15.3 per cent in the first quarter 2011, compared to the same 2010 period, but the bankruptcy rate remains high, twice the pre-crisis level. According to Coface monitoring records, corporate payment behaviour has been well orientated in the United States since the recovery of the economy.

## United Kingdom

### **A3 rating (since March 2011) unchanged**

#### **Growth was well orientated in 2010, but household confidence sagged in both last year fourth quarter and in the first quarter of this year**

After the deep recession in 2009, economic activity recovered last year (+1.3%), driven mainly by the good performance of domestic demand associated with the restocking process. Exports benefited from the pound sterling depreciation, but the growth was not as strong as expected, especially in the services sector. The tightening fiscal policy seriously affected consumer confidence late last year and in the first quarter of this year. After a decline of 0.5% in the last quarter of 2010, the 2011 first-quarter GDP recovered only by 0.5% (q/q), hampered by the drop in households' consumption and in businesses' investment, along with the inventory rebuilding fading away. With the slowdown in imports, and the still good orientation of exports, trade has been the main contributor to growth.

#### **A modest GDP growth in 2011**

Economic activity should go on slowing slightly all through the year (+1.2%), undermined by the severe economic measures implemented by the government coalition. Many headwinds compel households to reduce their consumption: The deep cuts made in public spending, the 2.5% VAT increase in January 2011, high food and energy prices pushing inflation up above 4% in April, wages remaining quasi flat, unemployment due to stay at a high level (8%). With debt burdens exceeding 150% of their disposable income, households have initiated a debt repayment process. As a result of these negative trends, households could draw on their savings again this year (5.4% of disposable income in the first quarter of 2011). This trend has actually been confirmed in May. Property wealth remained more or less on an even keel in 2010. The sluggishness of property transactions this year is

expected to drive prices down about 10% from their peak in 2010. Public-sector investment is suffering a marked decline while corporate investment, which has slumped in the first quarter, should improve only very moderately. The current account deficit will narrow thanks to a marked slowdown in imports in phase with less dynamic domestic demand. Despite the likely persistence of favourable exchange rates, the strength of goods and services exports will be partly cancelled out by the expected slowdown in demand from the United Kingdom's main client markets, the euro zone notably accounting for 50% of shipments abroad. Thanks to the reduction in spending, the fiscal deficit will contract. Public-sector debt will, however, continue to grow, reaching over 80% of GDP compared to 52% before the crisis. In this dire context, monetary policy should remain expansionary (0.5 per cent interest rate), despite the rate hike by the ECB. In case of a more severe deterioration in economic activity, the Bank of England could decide to maintain its quantitative easing in order to pump cash into the economy, despite the high rate of inflation.

## **Bank credit is slow to recover and bankruptcies should remain high**

The financial consolidation of the banks and the prospect of new Basle III regulation still limit the expansion of credit. That particularly affects smaller companies with tight cash positions, and increases the risk of breakdowns in restocking and deliveries. Retailers of consumer durables, restaurants, travel agencies, distribution of leisure products could be hit hardest by the slowdown in private spending and could decide to adopt more aggressive commercial policy, which would squeeze their margins. Manufacturers are facing high oil and input prices, and that could undermine their margins too, as they probably will not fully have the ability to pass the rise on consumers. Moreover, the events in Japan cause some sectors (electronics and automotive) problems with disruption in supply. Residential and commercial construction is suffering from much weaker demand and thus bears watching. Bankruptcies have reaccelerated in the first quarter (+2.1 per cent compared with the same 2010 period) and remain at the high level.



# Emerging Europe

Recovery still slower  
than in the other  
emerging economies

# Rating modification

## Cyprus

### Downgraded from A3 (since March 2011) to A4

Recovery is sluggish in the wake of both households and Cyprus banks difficulties triggered by the lasting bursting of the property bubble. Cyprus financial institutions are not only exposed to the Greek sovereign, but having granted a large part of their loans to Greek households and companies, they also face the growing risk of default of these clients.

#### Economic recovery impeded by high private debt and weakened public sector finances

In 2011 GDP growth will stay sluggish, below 2%. It will fail to match the 4% average rate maintained from 2004 through 2008. Those years of economic overheating, financed by the build-up of private debt, which reached 280% of GDP in 2009, culminated in the bursting of the property bubble to which banks and households were highly exposed. The rise in unemployment, the tightening of credit and the burden of household debt will undermine private consumption. Investment will remain weak due to the difficult recovery of the property and construction market. Competitiveness in the pharmaceuticals and chemicals sectors will continue to erode. Tourism, which has suffered from the deterioration of infrastructure, could benefit, however, from the current tendency of tourists to shun North African destinations. And public spending will be squeezed by the low level of fiscal revenues and the impact of measures taken since 2010 to reduce the public sector deficit. Pension contributions were raised in 2009 and the 15% VAT could be increased by 1% in 2011. But the government will be highly unlikely to take action on increasing the corporate tax rates (10%) since such a move could jeopardize the country's position as a regional business services hub. And unless an adjustment is made in the current

growth regime founded on a low tax rate, the fiscal deficit will continue to grow and the public-sector debt could exceed the 60%-of-GDP threshold this year. The banking sector's exposure to Greek debt (a risk that represents 1.7 times Cypriot GDP) could, if Greece defaults, give rise to an additional annual cost to the Island-nation's government, representing 10% of GDP in each of the three coming years, for the recapitalization of the banking system.

#### The growing vulnerability of the financial sector

The banking system proved more resilient to the crisis in Cyprus than it was in the other euro zone countries. Cypriot banks remained profitable and well capitalized in 2010 with good liquidity ratios. But in view of its size and relatively high concentration, it exposes the Cypriot economy to relatively high risks: With the sector's total assets amounting to over 10 times the country's GDP, its high exposure to the Greek economy notably constitutes a substantial source of vulnerability. Cypriot commercial banks hold bonds issued by the Greek government and banks. They also lend to Greek households and companies via their subsidiaries and branch offices. Late 2010, the exposure to Greece of the three largest Cypriot commercial banks amounted to as much as 53% of their assets, including €23 billion in loans granted to Greek house-

holds and companies. 40% of the loans detained by Cypriot banks have been delivered to Greek households and corporate businesses. Therefore, the Cypriot banking sector appears very fragile in the wake of the Greek recession. Actually, it could be jeopardized by a Greek public debt restructuring and by a sharp contraction of the activity in Greece. Cypriot commercial banks and cooperative/mutual institutions are also exposed to the slowdowns in the domestic property and construction sectors. In that perspective, the situation in the sector will likely deteriorate considerably in 2011 despite the measures taken - belatedly - by the oversight authorities especially as regards the level of reserve requirements.

### **A very slow negotiation process on reunification**

Little progress has been made in the negotiations on the Island's reunification, which resumed in September 2008. And the northern part of the island remains occupied by 25,000 Turkish soldiers. Despite the efforts made thus far by the Greek and Turkish presidents, much work remains to be done to smooth the divergences (power-sharing, settlement of the despoiled property question). Moreover, since the victory in the Turkish Cypriot presidential election in April 2010 of Dervish Eroglu, leader of the Nationalist Party, there is little likelihood of the reunification process coming to a successful conclusion in the near. And this will come to pass notwithstanding the efforts of the current Greek Cypriot president, Demetris Christofias, who has been preparing his country to assume the presidency of the European Union in the second half next year.





# Emerging Asia

Slight slowdown  
expected  
in China and India

# Focus on main economies

## Hong Kong

**A1 rating (since September 2010) unchanged**

### **Strong growth expected this year but the risk of a property market bubble will bear watching**

Economic growth rebounded sharply in 2010 fuelled by the recovery in international trade and an upturn in domestic demand underpinned by expansionary policies. Exports — which represent 350% of GDP — have begun to trend up again, especially capital goods and electronics. Investment has benefited from vast infrastructure projects, easy credit, and a construction boom. Private consumption, the main economic engine, has been bolstered by improvement in the job market, by measures in support of households, and by the positive wealth effect generated by the rise of the Hong Kong stock market's Hang Seng Index and the property market.

Despite a very good first quarter this year (7.2% GDP growth), the economy is expected to decelerate for the full year due to the completion of the restocking process and to the measures taken by the authorities to limit the boom in the property market. Private consumption will remain dynamic, driven by the rise of nominal wages, especially since the introduction of a minimum wage in May 2011. Investment will continue to trend up, buoyed by on-going infrastructure projects like the Hong Kong-Macau-Zhuhai Bridge and continuing low interest rates. And exports will moreover benefit from the strong economic growth in mainland China. On the supply side, financial services, sea transport, logistics, retailing, and tourism will continue to enjoy rapid growth. Inflation, particularly the increase in property prices, will bear watching. To stem the rise of prices, the authorities have very little

room for manoeuvre with the dollar-pegged fixed exchange rate regime in force and the absence of controls on capital movements constraining monetary policy. In this context, Hong Kong has tended to follow the United States' lead in adjusting monetary policy, with interest rates remaining low in consequence, spurring growth of the money supply on which the availability of credit depends. In 2010, the property sector was the beneficiary of half the total amount of the loans granted. When property prices surged 20%, government authorities intervened to limit speculation and protect banks from a sharp decline in mortgage values. The risk of the property bubble bursting will thus bear watching this year.

### **Solid financial position and robust banking sector**

The current account surplus remained stable in 2010 and could grow in 2011 as a result of the dynamism of continental China and the boom in services (tourism, financial services, merchandising, and logistics). In this context, foreign-exchange reserves will remain at satisfactory levels. Besides, the Hong Kong dollar is expected to remain pegged to the US dollar in 2011, even though the chief of the executive evoked the long-term possibility of establishing a link between the yuan and the Hong Kong currency. The banking system meanwhile has remained solid as evidenced by its good capitalization ratios and low proportion of non-performing loans. And it benefits from effective oversight.

## Reforms under way

In the political arena, 2010 was marked by a start in the reform of the electoral system, which paves the way for instituting universal suffrage in the long-term. This reform represents the first major change in the election code since the 1997 retrocession. The reform will increase the number of seats in the assembly from 60 to 70, of which 40 will be chosen directly by the electors. The majority of the deputies seated in the

assembly will thus be elected in the voting scheduled in 2012. The composition of the commission responsible for naming the chief of the local executive will moreover be increased from 800 to 1200 members. However, the pressure exerted by democratic parties for the institution of direct universal suffrage is nonetheless expected to continue to weigh on relations with Beijing, which is not ready to envisage such reform before 2017.

# China

## A3 rating (since September 2009) unchanged

### Slight growth slowdown in 2011

China came through the crisis in remarkable fashion thanks to the effectiveness of the economic policies implemented: strong expansion of credit (up 33%), stability of the Yuan, and broad stimulus plan. Nonetheless, in a context of rising inflation (5.5% in May 2011) and soaring credit, the authorities undertook to tighten economic policies: withdrawal of the fiscal stimulus, increases in interest rates and banks' reserve requirement ratio, re-introduction of quotas on the amount of loans that banks can grant. Measures were moreover implemented to limit speculation in the wake of sharp price increases in the high-end property market, particularly in China's major cities. And the People's Bank of China re-introduced a degree of flexibility in the yuan exchange rate regime with the currency consequently appreciating 5.3% from June 2010 to June 2011. Despite these measures, economic growth remained strong in the first and second quarters, up respectively 9.7% and 9.5%. For the full year, however, the growth will be down slightly due to the continued tightening of economic policy. Public-sector investment, especially by local governments is expected to decelerate. Private corporate investment will,

however, remain dynamic, bolstered by the solid performance of private consumption spread by the improvement in the job market and the wage increases obtained after the strikes in 2010.

### Persistent weaknesses in companies, banks, and local governments

Companies have been contending this year with several shocks: withdrawal of subsidies and fiscal support measures, inflation and rising input prices, tighter monetary policy and a slowdown in bank credit (up 18% in April), appreciation of the yuan and substantial wage pressure. Although these changes will allow rebalancing growth towards higher consumption levels in the medium term, they nonetheless entail exposure to risks in the short term. Weaker private companies, particularly those of smaller size, will bear watching. These measures — needed to increase the proportion of GDP represented by Chinese wages — will especially affect low value-added sectors (textiles, shoes, toys) and sectors suffering from overcapacities (automotives, construction, steel). The indebtedness of local governments, meanwhile, has increased substantially in the wake of the stimulus plan. Unable to

assume debt in their own right, sub-sovereign entities have resorted to borrowing via local financing platforms (LFPs) with opaque operations. Banks have granted massive loans to LFPs despite the platforms' limited capitalization. Any risk of a chain reaction of defaults in 2011 is likely to be avoided thanks to intervention by the central government with substantial funds at its disposal and limited public debt. This would not exclude, however, individual cases of default by local governments: To avert any risk of moral hazard the government may be tempted to make a few isolated examples. The rapid development of off-balance sheet loans and informal credit will bear watching in 2011. Small unofficial banks proliferated in

2010 and have been granting loans to companies without any controls. The main risk associated with these alternative sources of financing are the usurious rates they charge. And intercompany loans also constitute a major risk since a corporate bankruptcy may spread through this channel with suppliers and customers failing in succession.

### Deficiencies in the business environment

In the political arena, the degree of inequality between rural communities and cities remains substantial. And despite recent progress on regulations, major governance shortcomings persist.

## India

### A3 rating (since December 2004) unchanged

#### After strong GDP growth in 2010/2011, a slight slowdown likely in 2011/2012

The Indian economy rebounded in 2010/11 thanks to the recovery of domestic demand supported by economic policies that have remained accommodating, interest rate hikes notwithstanding, with 7.8% GDP growth recorded in the first quarter. Investment benefited from vast infrastructure projects while consumption was driven by the rise of wages associated with the good performance achieved in a farm sector on which 70% of the population depends. On the supply side, the secondary and tertiary sectors proved very dynamic with private Indian companies enjoying comparative advantages in services (information technology, outsourcing) and industry (capital goods, retail sales, pharmaceuticals, automobiles, electronics, home appliances). Inflation has increased meanwhile due to the persistence of negative real interest rates, the rise of raw material prices, and the reductions in price subsidies for oil, diesel, kerosene; and gas. The rise of food prices is transmitted to the core inflation

rate (exclusive of energy and food prices) via wage growth, which ultimately leads to increases in the final prices. The high inflation, in conjunction with the widening of the current account deficit reflects the evident overheating of the Indian economy. The rapid growth of domestic demand cannot be met by domestic supply alone, and the economy has been growing above potential: India's shortcomings in terms of education and infrastructure constitute major economic bottlenecks. In 2011/12, the Central Bank is expected to continue to raise interest rates, which could slow the economy. Growth will nonetheless remain at satisfactory levels thanks to India's solid fundamentals notably including a large domestic market, high savings and investment rates, favourable demographics, balanced growth jointly underpinned by investment, exports, and the rapid development of middleclass consumption. Inflation, meanwhile, will remain high: the interest rate hikes will attract an influx of speculative capital with the expansion of credit accelerating and prices rising in consequence.

### **Public-sector finances continue to limit infrastructure development**

In 2010/11, the fiscal deficit declined slightly with the gradual withdrawal of the stimulus plan. Although this trend will likely continue in 2011/12, the deficit will nonetheless remain substantial, adding to an already high public debt. Furthermore, the heavy debt service is expected to continue to penalize public sector capital investments, particularly in infrastructure, which are crucial to further acceleration in economic growth. Conversely, India's external financial position remains solid. The current account deficit will likely widen slightly with the recovery of imports, driven by strong domestic demand, proceeding at faster pace than that of exports. Financing needs will nonetheless be largely covered by FDI. Foreign debt ratios will thus remain

moderate. Meanwhile, the massive influx of volatile capital in 2010/11 drove up the Indian rupee and poses challenges for monetary policy. Capital controls could be instituted in 2011/12. And foreign exchange reserves are expected to remain high providing the country with good capacity to cope with sudden capital flight.

### **Persistent shortcomings in the business environment**

The economy continues to suffer from governance shortcomings especially as regards corruption. Several scandals came to light late 2010 and early 2011, particularly in the organisation of the Commonwealth Games and the granting of mobile telephony licences.

## Indonesia

### **B rating (since March 2004) unchanged**

#### **Dynamism unabated in the crisis**

Indonesia proved very resilient to the crisis thanks to strong household consumption and expansionary economic policies. In 2010, economic activity returned to pre-crisis levels thanks to a rebound in both investment (fuelled by a credit recovery, exports upsurge to Asia, and an influx of FDI) and household consumption (underpinned by improvement in the labour market and by wage increases). Conversely, agriculture recorded its poorest performance in three years due to adverse weather conditions. Despite the tightening of monetary policy, economic activity will continue to trend up this year, driven by domestic demand. In the first quarter, the economy grew 6.5%. Private consumption will remain the main growth engine and will underpin retail sales. Investment will stay very strong (especially in the construction and infrastructure

sector). Exports will benefit from the recovery of Asian economies and the steadiness of raw material prices at satisfactory levels. Export industries (especially rubber) have nonetheless been affected by the repercussions of the earthquake in Japan, second largest market for Indonesian sales abroad. However, the initial figures reported for 2011 augur well for very strong business activity in the automotive industry and low value-added sectors. Inflation, meanwhile, will likely remain at high levels, spurred by tensions in the energy market and strong domestic demand. In this context, the Coface payment monitoring records will likely remain stable in 2011. But weaknesses persist in terms of corporate transparency. The accounts are rarely available and when they are their reliability is questionable. Moreover, problems with corruption persist, and the legal system remains slow and costly.

## Solid financial position

Despite the economic stimulus plan, sovereign risk has continued to improve as reflected by the decline in the ratio of public sector debt to GDP and in the proportion denominated in foreign currencies. Furthermore, foreign debt ratios are expected to remain under control even if the current account surplus were to decline in 2011 as a result of the very rapid growth of imports in a context of a recovery of domestic demand. After extensive capital flight in the 2008 fourth quarter, portfolio investment rebounded significantly in 2009/10. Since these volatile capital inflows involve some risks (rupiah appreciation undermining export competitiveness, rapid expansion of the money supply), the authorities instituted capital controls (minimum holding period for Central Bank certificates) in June 2010. These measures will, however, have only a marginal impact on the destabilizing financial inflows. Foreign exchange reserves will nonetheless remain at satisfactory levels in 2011, which will limit Indonesia's

vulnerability to sudden flight of volatile capital. The crisis notwithstanding, the country's banking system has remained solid thanks to a reduction in the proportion of non-performing loans, the protection provided by the deposit insurance system, good capitalisation and profitability ratios.

## Persistent shortcomings in the business environment

The legislative elections in April 2009 followed by the presidential election in July resulted in the strengthening of the Democratic Party of President Yudhoyono who won re-election by a very wide majority. But lacking an absolute parliamentary majority, a coalition government was nonetheless formed. Dissensions within the coalition are expected to slowdown the implementation of structural reforms, the fight against corruption, and will prevent the authorities from taking steps to remedy the major shortcoming in the business environment.



# Latin America

Soft landing

## Focus on main economies

### Brazil

#### A3 rating (since September 2010) unchanged

##### More moderate growth in 2011

The rebound in private consumption and private investment was particularly strong in the first half of 2010, underpinned by tax incentives, better access to credit, and by increased public spending in the run-up to presidential elections in October. The economy has shown signs of overheating in the second half, with a rise in inflationary pressures. With the withdrawal of some tax incentives, the increase in the Selic rate in July, and the implementation of credit tightening measures, economic growth eased to more reasonable levels. The new administration has pursued monetary and fiscal tightening that seems bearing fruits. Year on year, the activity continued to slow in the first quarter 2011 but it should recover a more sustainable pace throughout the year. Inflation has declined. However the labor market has remained tight, which has contributed to the persistence of inflationary pressures. In view of the lack of infrastructure, economic activity will derive support from investments in preparation for the 2014 World Cup of football and the 2016 Olympic Games. Private consumption is affected by higher interest rates that are increasing the debt burden of households, 60% of them being indebted.

##### The payment behavior of companies is maintained at the global average

All sectors recorded good performance in 2010, particularly the industrial sector and distribution, which drove growth. They are thus more directly affected by the economic slowdown in 2011. Large companies will likely continue to finance their operations in international markets while smaller companies unable to self-finance could have more difficulty in view of the credit tightening carried out. Export companies penalized by the Brazilian real appreciation will tend to focus more on domestic market where the outlook is still bright despite the slowdown in domestic demand. The payment behaviour of Brazilian companies has in general suffered less from the crisis than the world average. The improvement in payments recorded in 2010 correlates with the world average, a trend likely to continue in 2011.

##### Brazil's financial position bears watching

The objectives set by the new administration as regards controlling inflation and public-sector debt are expected to result in a slowdown in current fiscal spending. It may nonetheless prove difficult to make a

clean break with policies that resulted in increased domestic consumption. The fiscal deficit may thus remain at levels comparable to those prevailing in 2010. Brazil's external financial position will continue to bear watching. Including amortization of the debt, financing needs remain very large and continue to grow sharply. Although the country will be unlikely to experience any great difficulty in covering those needs, a high proportion of the foreign capital generally involved is volatile in nature and vulnerable to a crisis of confidence in the markets. A sudden flight of capital could cause the real to depreciate. Although Brazil's ample foreign exchange reserves would provide it with good capacity to cope with such a situation, the risk nonetheless bears watching in view of the implications for the capacity of private Brazilian companies to repay the debts.

### Political continuity

As was generally expected, the candidate of the Partido dos Trabalhadores (PT), Dilma Rousseff, won the presidential election on 31 October 2010. The new president will be likely to maintain the continuity of prudent economic policies, which is reassuring to the markets. She has inherited a country now ranked as the world's 8th largest economy and as one of the four leading emerging economies with Russia, India, and China, the so-called BRIC countries. As regards reforms, the policies will be likely to remain conservative. Brazil's temporary seat at the United Nations until the end of 2011 is expected to contribute to enhancing its stature and geopolitical influence even more.

## Mexico

### A4 rating (since March 2010) unchanged

#### Slowdown linked to economic activity in the United States

After a deep recession in 2009, the rise in oil prices and renewed demand from the United States, which cover about 80% of Mexican exports, facilitated the rebound of the economy in 2010. The recovery in demand from United States boosted manufacturing and tourism. With the increase in goods and services imports, however, external accounts nonetheless had a neutral impact on GDP growth. Economic activity was driven by domestic demand and especially by a positive trend in domestic and foreign investment. Household consumption has benefited from lower

unemployment and higher wages, but remained constrained due to weak recovery in emigrant-worker remittances. In 2011, the recovery is going on, despite an expected slowdown in growth. Rising fuel prices and a moderation in growth in the United States has curbed the export of automobiles to that country. This sector, which registered strong growth late 2010 and early 2011, has also suffered from Japanese plants supply disruptions. The activity has remained driven by domestic demand and investment. Consumer confidence is improving although the retail sales have remained below pre-crisis levels. Industry and construction are the most dynamic sectors.

## Stable payment behaviour

The employment has improved but the jobs offered are often temporary, reflecting the uncertainty surrounding the corporate outlook in conjunction with U.S. activity. Faced moreover with Asian competition, low value-added sectors (especially among maquiladoras) are hobbled by a loss of competitiveness attributable notably to the inflexibility of the job market. Smaller companies remain handicapped by the restrictive policy of banks as they continue to give preference to large firms in developing their portfolios. In this context, payment behaviour is expected to remain stable and near the world average, a trend reflected in Coface payment monitoring records.

## A financial position that bears watching

The upturn of oil prices in 2010 in conjunction with the growth of the economy prompted the authorities to revise public spending upward, particularly investment by the national oil company Petroleos de Mexico (Pemex) with FDI excluded from the sector. Maintaining the production capacity of PEMEX is of strategic importance since the revenues it generates represent about a third of government receipts. Buoyant oil prices should help reduce the public deficit around 2.5% of GDP in 2011. Public foreign debt has been growing with Mexico taking advantage of the appetite in the markets for emerging countries to cover its

financing needs via long-term — even very long term — borrowing. The current account deficit meanwhile could widen slightly in 2011 as a result of deterioration in the invisibles balance in the absence of a recovery in transfers by emigrant workers. To cover large and growing financing needs, Mexico will likely be able to count on inflows of foreign direct investment and long-term loans from abroad. But in view of Mexico's vulnerable external position, the authorities have taken the precaution of requesting a two-year extension of the flexible credit line granted by the IMF in April 2009 (when the peso was depreciating). The credit line has been extended and increased from \$43 billion to \$73 billion, which is improving Mexico's capacity to withstand a liquidity crisis.

## Lagging pace of reforms and persistent climate of insecurity

In the July-2009 midterm legislative elections, President Calderón conservative PAN party lost its majority to the rival PRI party. Before the next presidential elections (July 2012), the progress on reforms will thus come up against stiffer political and social resistance. Meanwhile the worsening climate of insecurity and violence attributable to organized crime linked to drug trafficking represents a growing challenge to government authority.



# CIS

Growth has not  
recovered  
its pre-crisis trend

## Focus on main economies

### Russia

#### B rating (since September 2010) unchanged

##### **Economic growth has remained below pre-crisis levels despite a boost from high oil prices**

The Russian economy began to grow again in 2010 after suffering a very severe recession in 2009. Spurred initially by the rebound in oil prices and foreign demand and then strengthened by very favourable base effects, GDP growth is now underpinned by the upturn in household consumption. But investment has been slow to recover. The summer heat wave and fires have had a temporary and relatively limited impact on growth, which benefited early in the year from the income effect of rising oil prices and from the strengthening of domestic demand. Although undermined by the increase in social contributions and inflation in the first half, domestic demand will benefit from the government's active policy on pensions (up 10% in April 2011) and civil service wages, the recovery of consumer credit, and the decline in the savings rate. GDP growth will nonetheless fail to return to pre-crisis levels. It will likely suffer in the short-term from an upsurge of inflation and in the medium term from its overdependence on oil. Persistent structural weaknesses (deficient banking system, difficult business environment, aging demographics, and so on) have continued to undermine investment and impede modernisation of the economy. And at this juncture an investment recovery will only be likely to develop gra-

dually with private investment remaining constrained despite the gradual easing of domestic credit conditions and the coming into force of tax measures making foreign debt less attractive. The inflow of FDI is moreover expected to remain limited amid the relative instability of the political environment in the run-up to the next elections.

##### **Public-sector deficits and privatisations**

In 2011 the government is expected to launch a vast privatisation program involving over 850 companies including a few flagships of the economy like Rosneft, RusHydro, Sberbank, VTB, and Russian Railways. The partial privatisations planned are expected to pump \$10 billion a year into government coffers over a five-year period and thereby cover 15% of public deficits in coming years: Public finances have been in deficit since they deteriorated in the wake of the crisis. The increase in spending, which reflects the government's social policy and its support for key economic sectors, will not be called into question before the elections scheduled in 2012. It will only be offset slightly by the new fiscal revenues envisaged. Excluding oil, the fiscal deficit has continued to grow. In 2011, a price of \$110 per barrel will be necessary to balance the budget whereas the comparable threshold price was just \$34 in 2007. The government has

drawn heavily on sovereign funds to finance the deficits (over \$100 billion on the reserve fund) and has returned with increasing frequency to capital markets, particularly the domestic market. Though the impact on the outstanding debt has been limited, the eviction effect on the private sector has been substantial with Russian banks preferring the liquidity of sovereign debt.

But lacking concentration and consolidation, however, the banking system has remained weak and polarized. Despite a still high level of nonperforming loans, the banking sector nonetheless seems relatively stable at this juncture. The banks have emerged from the crisis well capitalized, debt-free, and with new assets on hand. Meanwhile, the credit market gradually recovered in 2010. The sector is, however, still exposed to high risk and polarized by the excessive number of banks clustered around five leading public or quasi-public banks with some 20 to 25 private banks still exposed to liquidity risks (ineffective banking market, lack of confidence) and nonperforming loans, handicapped by their relatively small size in relation to the market been affected by endogenous shortcomings: lack of long-term strategy, poor risk management, own funds lack of transparency, inadequate oversight, and so on.

### **Persistent governance shortcomings**

Although President Dmitry Medvedev policies have in practice strayed little from the course set by Vladimir Putin, the run-up to presidential elections in 2012 could be conducive to discord between the two political leaders: especially since they will have to deal with the growing discontent of an active middle class that feels increasingly squeezed by the repressive methods deployed by the central government. Domestically, a considerable resurgence of violence in the Russian Caucasus attests to the growing unrest in the region against the background of the several autocratic regimes pilloried by the Arab spring and of the rapid approach of the 2014 Sochi Olympic Games. Meanwhile the reset policy initiated by President Barack Obama has paved the way for improved diplomatic relations with the West that Russia hopes to leverage in attracting the investments and transfers of technology necessary for the modernization of the economy considered crucial by President Medvedev. Achieving that objective will be handicapped by deficiencies in the business climate and the lagging pace in making the necessary improvements in governance. In May this year, Russia nonetheless adopted the OECD-sponsored agreement on combating corruption. According to Coface payment records, moreover, after the frequent incidents observed in 2009 payment behaviour has improved with the resumption of economic growth. Payment incidents have nonetheless remained high due to the lack of transparency among companies and the deficiencies in the legal protection afforded creditors.



## Belarus

### D rating (since March 2000) unchanged

#### Significant deterioration of the financial situation and devaluation of the ruble

After achieving strong growth in 2010 thanks to the highly expansionary fiscal policy pursued in the run-up to presidential elections, the Belarusian economy is now saddled with major macroeconomic imbalances that have spawned a severe liquidity crisis. Structurally imbalanced external accounts — attributable to over-investment (exceeding 30% of GDP), inadequate savings (about 2% of GDP), and poor economic specialization — are currently deep in deficit. The current account deficit widened further in 2010, reaching 15.6% of GDP largely due to the higher cost of energy bill after the new oil agreement with Russia came into effect: oil imported from Russia to be refined in Belarus and re-exported to Europe is henceforth wholly subject to Russian customs duties from which it had been previously exempt, thereby putting an end to the flow of secure income derived from the large margins available on the transport of oil. The government reacted by drastically reducing imports, particularly by replacing oil purchased from Russia by imports from Venezuela. But these measures were still not enough to eliminate a trade deficit inflated even more in the run-up to the December 2010 presidential election as a result of the government's generous hand-outs to civil servants and retirees, which sparked a consumption boom, especially in imported goods. By the end of the 2011 first quarter the country's trade deficit thus reached \$2.4 billion with its foreign debt up to \$10 billion and current account deficit among the highest in the world. At the same time Belarusians went on a buying spree to build up emergency stocks, thereby generating shortages and driving up prices in distribution

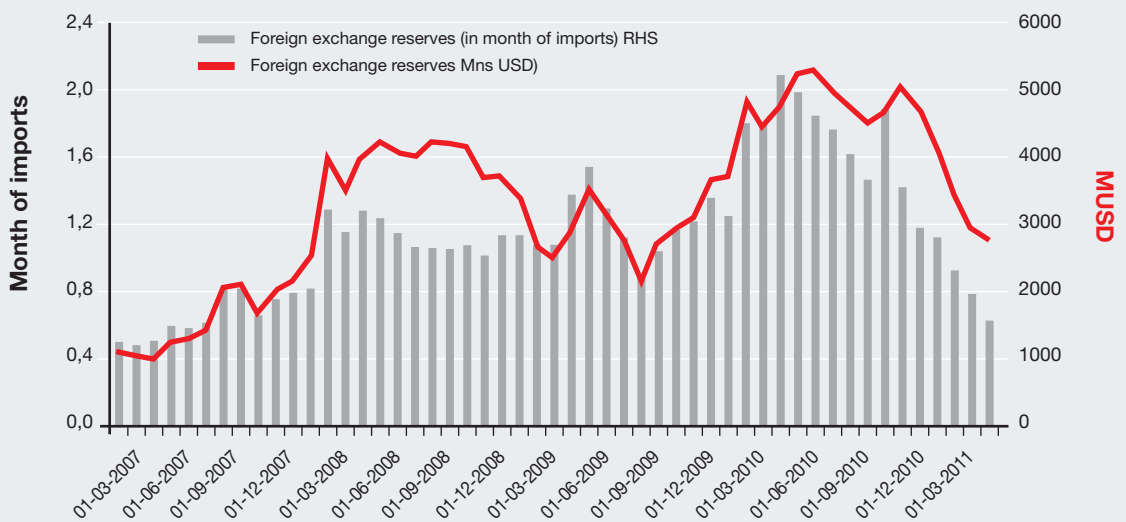
channels. This trend is expected to continue in 2011/2012 with the energy trade balance destined to represent a growing proportion of the current account balance and with petrochemical products (19% of exports) and metals (8%) moreover sensitive to trends in world prices. Due to the limited inflow of FDI (under 5% of GDP) Belarus has been dependent on access to financial markets to balance its external accounts. Thus, despite a successful Eurobond issue by Belarus in 2010, its financial position became unsustainable in the first months of the year. Foreign exchange reserves sank to precariously low levels (\$4 billion early March, or an estimated six weeks of imports) with the country consequently incapable of covering its short-term commitments (current account deficit plus short-term debt). The capital control measures implemented these past months (foreign exchange purchases by local banks 30 days in advance, ban on foreign exchange sales by local banks since March 22) have not succeeded in easing the pressure on the exchange rate. The spending commitments made by the government during the December 2010 presidential election (large wage increases in the public-sector, increase in the minimum wage, granting of loans targeted on sectors in difficulty) put pressure on the fiscal deficit and spurred inflation. In the first half of 2011, the consequent increase in macroeconomic instability in conjunction with repayments due on loans granted by the IMF and Russia during the crisis prompted the authorities to devalue the Belarusian ruble by 53% against the dollar on 23 May with the objective of gradually aligning the various exchange rates in force in the country.

**Teetering on the edge, Belarus received \$3 billion in aid from the Eurasian Economic Community**

Through the rest of 2011, the substantial current account deficit in conjunction with debt service (estimated at \$1 billion for the year) and soaring inflation (a 30% annual rate expected) could ultimately trigger a severe economic crisis and a sovereign default. Moreover, with companies no longer enjoying access to foreign currency, payment defaults are thus expected to be more commonplace. After the wave of public unrest sparked by the increase in petrol prices — announced and later suspended — the government has attempted to stem inflation by tightening monetary policy and instituting controls on price increases exceeding 5% especially on prices for basic necessities (coffee, sausages, and so on). Belarus’s financial and economic situation has thus been extremely precarious. Sovereign spreads have increased sharply,

significantly raising the cost of new Eurobond issues. To break out of the slump the country needs over \$9 billion in financing this year. But the IMF and the EU have turned a cold shoulder to Belarus as a result of the flagrant human rights violations observed especially in the wake of Alexander Lukashenko’s re-election. Reluctant at first to provide any support whatsoever, Russia ultimately granted a \$3 billion loan to Belarus via the crisis fund set up by the Eurasian Economic Community. An initial \$1.24 billion instalment is to be released in 2011 followed by \$800 million in 2012 and a \$1 billion in 2013. The first instalment was duly paid on 21 May this year. In exchange the Russians have insisted on a further devaluation of about 40% as well as privatisation of Belarusian assets. The privatisation plan calls for the sale over three years of some 150 state-owned companies and the government’s ownership share in mixed public/private companies, representing about \$7.5 billion in assets.

**Collapse of foreign exchange reserves : less than one month of imports**



Primarily at stake is the gas pipeline network owned by Beltransgaz in which the Russian company Gazprom already acquired a 50% interest in 2010. Beltransgaz transports 20% of the Russian gas delivered to Europe and represents on that score a strategic interest for the Russian state monopoly. The other highly coveted assets include oil refineries fed mainly by Russian crude destined for Europe and the fertilizer giant, Belaruskali. Isolated more than ever on the international scene, Belarus no longer enjoys much room for manoeuvre. The government has admitted having

no illusions about the chances of the \$8 billion loan request submitted to the IMF well aware that the Americans and Europeans will likely oppose it. Mr Lukashenko does not appear willing, however, to give up his social-economic model and even denies that his country is gripped by a crisis, blaming the media for instigating the panic. Whether the authoritarian regime in power since 1994 will be able to cope once again with such a shock remains open to question.



# North Africa Middle East

Political uncertainties  
weigh on growth

## Focus on main economies

### Morocco

**A4 rating (since September 2007) unchanged**

**Activity still dependent upon the agricultural sector and the European Union, in the turbulent context of the “Arab Spring”**

Growth in the Moroccan economy in 2011 will continue to be buoyed primarily by internal demand, with relative momentum picking up in non-agricultural activities. Several sectors should benefit from this, particularly the automotive and construction sectors, with construction being driven by the development of social housing by the government, while production of cereals is likely to be maintained. The determining contribution of internal demand partly explains why growth should be sustained, despite Morocco’s dependence on the European Union (EU), where domestic demand will remain sluggish. Nevertheless, the direct and indirect effects of the “Arab Spring” on the Moroccan economy – consequences for tourism, the return of Moroccans from countries experiencing popular revolts – lead us to anticipate a lower growth rate than that forecast by the authorities (4.6%). Added to this is the sudden leap in international commodities prices.

Against this turbulent background, the economy continues to rely on the performances of the agricultural sector and consequently on climatic fluctuations, despite increasing diversification in the sectors with higher added value.

**Deterioration in twin deficits, but relatively moderate external debt**

The country has made efforts to put its public finances in order over recent years and this has resulted in a manageable national debt which is essentially domestic. 2011 is likely to be marked by a degree of austerity, with the reforms underway aiming to effect a sustainable reduction in the budget deficit and the national debt. However, in the wake of the “Arab Spring”, budgetary extras are in the pipeline in order to buy social peace - social welfare measures, compensation for the increase in oil bills - and the result of this will be an increase in the budget deficit and the national debt during 2011.

Exports should receive a boost, particularly from the increase in sales of phosphates, but the weakness of demand from the EU and high international energy prices will have a negative effect on the commercial balance sheet. In addition, revenues from tourism and expatriate remittances could experience a downturn, resulting in an increase in the external accounts deficit. This is likely to be covered only in part by foreign direct investment flows, although Morocco seems to benefit from a transfer in its favour of projects which would have been realised elsewhere before the Arab revolutions.

These investments, arising principally from the EU or the Middle East, are being made more frequently in the framework of public-private partnerships in the case of highway, rail, port or tourist infrastructures. A large part of the external debt, which is essentially public and which is sustainable, is concluded at concessional terms, which constitutes a definite advantage. The country's ability to meet its external commitments seems therefore to be ensured, despite the unfavourable shocks the economy has to face. Furthermore, with a managed exchange rate regime and a comfortable level of reserves, the country can be confident about its ability to withstand a sudden withdrawal of capital. Moreover, the banking system is the most developed of all African countries (apart from South Africa); it is still well-capitalised, liquid and profitable, and the improvement of macro-prudential regulations continues.

### Reforms planned in the wake of the "Arab Spring"

In response to growing political and social dissatisfaction and to the riots, against the background of the "Arab Spring", King Mohammed VI announced in March and presented in June 2011 plans for constitutional reform that aim to rebalance the Sharifian monarchy by reinforcing the powers of the Prime Minister and of Parliament, to increase the independence of the judicial system as well as regionalisation. Almost all the political parties support the project, which will be subject to a referendum in July 2011 and which does not call into question the basic prerogatives of a monarch who is still popular, since the protests do not challenge his primordial role. Much will depend, however, on the timeframes and on the implementation of these measures, as well as the advancement towards greater social justice.

In this context, the progress made in terms of the business environment appears insufficient, with the population complaining of corruption, clientelism and bad governance; in this respect, the protests have challenged, by name, some members of the king's close entourage.

## Tunisia

### A4 rating (since March 2011) unchanged

**Political uncertainties are likely to have a negative effect on economic activity and lead to a further deterioration in public finances and external accounts.**

#### Political uncertainties and many social and economic challenges to overcome

After the eviction in mid-January 2011 of the ex-president Ben Ali, who had been in power since 1987, an interim national union government was formed with the particular aim of organising elections for the formation of a constituent assembly.

The outcome of these elections, postponed until the end of October 2011, is uncertain, insofar as around 80 parties have been formed in the vacuum left by the dissolution of the ex-presidential party, the Democratic Constitutional Assembly, with the possibility that the Islamist party Ennahda could become the main beneficiary of the situation.

Furthermore, the new authorities are faced with multiple social and economic challenges. Unemployment, which affects around 15% of the population and particularly young graduates, is still a major issue. This fuels a considerable sense of frustration and led to the protests which caused the fall of the old regime. In addition, the fruits of growth are unequally distributed, not only socially but also geographically, and a regional development programme favouring the interior of the country, which is underprivileged in relation to the coastal areas, is planned by the authorities.

### Activity dependent upon the changes in the political situation

Activity has dropped significantly since the beginning of 2011 due to the political uncertainties, even though the transfer of assets of the Ben Ali Trabelsi family (commercial and automobile distribution, hotel management, air transport, banks) is being realised without paralysing it. By sector, the most notable decline is in tourism (which represents directly or indirectly the livelihood of 1.5 million Tunisians), with a fall of around 45% in the first quarter; then comes industry, with a drop of nearly 10% in production. Furthermore, foreign direct investments decreased by a quarter over the first four months. Conversely, the agricultural sector (8% of GDP) stood up well, with good harvests forecast. Overall, the Tunisian economy could narrowly escape the recession in 2011 (+ 0.5%), assuming a gradual recovery in activity during the second half of the year, with private investment in particular, which had been curbed by the nepotism of the ex-presidential clan, possibly picking up.

### Deterioration in twin deficits mitigated by international financial aid

At the G8 summit at the end of May 2011, Tunisia was granted the promise of additional financial support to cover the forecast increase in deficits on its public and external accounts. In this respect, loans totalling \$1.35 billion are planned, with the World Bank and the

African Development Bank having promised \$500 million each; and the French Development Agency \$275 million. Loans from the European Investment Bank and the Arab Fund for Economic and Social Development are expected to be added to this. This mitigates the sovereign risk and the risk of a balance of payments crisis.

The budget deficit will increase, on the one hand because of the drop in activity that must automatically lead to a drop in tax revenues and on the other, because of an increase in expenditure resulting from the various measures taken to improve quality of life and reduce unemployment, subsidies on the prices of some basic commodities and, later on, the possible resumption of public investment. Nevertheless, for several years the level of the public debt – primarily contracted with multilateral institutions at concessional terms – has reduced in relation to GDP and is close to the average for comparable emerging markets (around 45%).

It is likely that there will be a downturn in exports in 2011, due to political uncertainties, weakness of demand from the EU (particularly Italy and Spain) and the war in Libya; these countries are among Tunisia's principal trade partners and the exploration of new markets, particularly in Africa, will probably be delayed. Conversely, the relative robustness of domestic demand could result in an increase in imports, particularly of raw or semi-finished products, and therefore by an increase in the trade deficit. In addition, although expatriate remittances should be maintained, tourist revenues are likely to see a catastrophic fall (of around 50% compared to 2010) and overall the current deficit should deteriorate very significantly. In addition, this deficit is likely to be only partially covered by foreign direct investment flows, with Tunisia running the risk that it will represent a less attractive target for these, at least temporarily.

# Egypt

## **B<sub>N</sub> rating (since March 2011) unchanged**

**Due to the unfavourable repercussions of a relatively uncertain political transition, particularly in terms of economic growth, public finances and external accounts.**

### **Relatively uncertain political transition**

The political transition, initiated by the resignation of President Mubarak on 11 February 2011 under popular pressure, remains uncertain.

The Supreme Council of the Armed Forces, headed up by Field Marshal Mohamed Tantawi, plans to lead the country until free legislative and presidential elections are held, scheduled for September and December 2011 respectively, which will lead to a revision of the Constitution and a civil government. There is likely to be increased participation in the range of political movements, including in particular the powerful Muslim Brotherhood, previously banned. However, the risk remains that popular dissatisfaction will not allow for a peaceful transition; it appears that the army will have to remain the ultimate arbiter.

### **Significant deceleration of growth**

The scale of the repercussions on economic activity will depend on what happens during the transition period. At this stage, it appears that the economy is likely to escape the recession for the tax year July 2010-June 2011, given the growth established prior to the events.

Activity in the tourism sector, which is the country's key sector (6% of GDP in its strictest sense and 12% with indirect effects) will have dropped by half, since the period of unrest coincided with the peak tourist

season. Other sectors were affected during the first months of 2011 – wholesale and retail trade, financial and marketing services, transport, telecommunications and the manufacturing industry. However, the oil and gas sector as well as traffic on the Suez Canal were not really affected.

Most sectors should be able to start up again as soon as things return to normal, but the tourism industry will probably be the slowest to recover.

In this uncertain political and economic environment, pressure on prices should remain high, with inflation staying up in double figures.

### **Public finances out of control, mitigated by international financial aid**

The recent events will give rise to budget deficits that are higher than forecast for the financial years 2010/11 and 2011/12. This is primarily due to the decline in growth, and therefore revenues, and to expenditure that is higher than expected. Income from sales taxes and customs duties will drop significantly, due to the unrest.

At the same time, expenditure is higher than forecast, due to an increase in salaries in the public sector and in social security support, as well as larger subsidies (25% of total expenditure).

However, traditionally, the Egyptian government deficit is primarily financed by the domestic market. In addition, the international financial aid packages announ-

ced at the end of May 2011, at the G8 summit, should provide ample cover for the remaining financing requirement in 2011 and 2012.

### **Pressure on external accounts also eased by international financial support**

Exports of goods are likely to increase at a moderate rate, due to the rise in oil prices, and important sources of currency, such as revenues from the Suez Canal or remittances of workers, are not expected to be significantly affected. The principal reason for the deterioration is the steep drop in tourism in the first half of 2011, leading to a marked increase in the current account deficit.

Foreign direct investment flows relating to the manufacturing industries, tourism and property (half of the total amount) were affected by the events. Conversely, those relating to the oil and gas sector were less affected. In addition, given the level of uncertainty, there have been capital flights and non-residents have also repatriated capital sums, selling Treasury bills.

However, external debt ratios should be maintained at moderate levels and the external accounts deficit should be largely covered by the anticipated international financial aid; support from Saudi Arabia and loans from the United States, the World Bank and the IMF (the latter being valued at \$3 billion).

### **Egyptian pound put to the test**

Under the current circumstances and in the framework of the floating regime managed with an informal anchorage to the US\$, maintaining stability of exchange rates will be a major challenge. However, the risk of significant depreciation of the Egyptian pound should be tempered by interventions from the Central Bank, which has accumulated foreign

exchange reserves and also has significant currency deposits in the banking system. The authorities have had to draw on these reserves and deposits to sustain the currency and the official foreign exchange reserves will decrease considerably.

### **Banking sector relatively unscathed**

The banking sector, dominated by the large State banks, is sufficiently liquid but is still poorly capitalised, inefficient, plagued by a high rate of bad debt (15%) and not very profitable.

Since 2004, however, reforms have been undertaken that aim to improve its efficiency and the rules of governance, particularly in the public sector.

The Egyptian Central Bank has taken steps to avoid any panic in the banking system, by implementing a ceiling on withdrawals against deposits in local currency and hard currencies, and the situation should evolve in a relatively orderly fashion.



# Syria

## rating (since March 2011) unchanged

Due to the unfavourable repercussions of a tense political situation on economic growth, public finances, external accounts and the payment experience.

### **Increasing political unrest against the background of the “Arab Spring”**

President Bashar al-Assad, who began his second seven-year term in 2007, has been facing growing criticism of his regime since the middle of March 2011. The government is trying to contain popular uprisings, which are still localised, with violent repression, whereas until now the size of the security system and the predominance of the Baas party have enabled it to maintain a grip on the country. The announcements at the end of March 2011 of the formation of a new government – charged especially with job creation and combating corruption – as well as, at the end of June, legislative elections scheduled for August 2011 and limited political reforms, did not respond sufficiently to the demands for democratisation of part of the population. Therefore, support for the regime could be eroded.

### **Weak growth due to political tensions**

In 2011, the expected low rate of growth (+ 0.5%) is likely to be bolstered by social measures announced by the government following recent unrest and by investment expenditure planned by the State. In addition, household consumption is likely to profit from the expected recovery in the agricultural sector, which will stimulate revenues in the same way as the planned social measures, and from the remittances of emigrants.

This consumption is likely, however, to be affected by the strong political tensions that are prevalent in the country.

In terms of supply, the hydrocarbons sector, despite a reduction in oil production, should contribute positively to growth thanks to a rise in the price of oil per barrel and to the launch of gas production at a new unit near to Homs, gas destined for fertiliser factories and cement works. On the other hand, the service sectors, the share of which has shifted to 45% of GDP, and particularly tourism, will suffer from the deterioration in the political situation, although the aim was to double hotel capacity over five years, resulting also in expansion of the construction sector. Furthermore, political events are hindering one of the authorities' principal objectives, which is to reinforce Syria's role as a regional hub by strengthening road and rail links with neighbouring countries, improving port infrastructures and easing restrictions on air transport.

### **Deterioration in twin deficits**

In terms of public finances, the authorities are seeking to diversify income due to the decrease in oil revenues. However, because of political tensions, the gradual implementation after 2011 of a value-added tax will be delayed, with food products being exempt. In addition, the authorities have been driven to interrupt, at least temporarily, their efforts to reduce subsidies.

The result of this new, troubled environment is likely to be a deterioration in the budget deficit in 2011. Nevertheless, the cancellation in 2005 of the bilateral debt with Russia made it possible to reduce the public debt ratio to around a fifth of GDP in 2010.

With regard to external accounts, the rise in the price of oil per barrel and a slight rise in the production of cereals and cotton should make it possible to contain the deterioration in the trade deficit, given that the country imports as many oil products as it exports crude oil. Furthermore, the drop in tourism revenues and the possible stagnation of expatriate remittances is likely to lead to a deterioration in the current deficit, while foreign direct investments melt away and the Syrian pound suffers a steep decline due to political tensions.

However, the external financial situation of the country presents no major difficulty, given its moderate debt levels and comfortable foreign exchange reserves.

### **Deficient business environment**

The transformation from a planned economy to a more liberalised economy has made little progress, even though the authorities have begun to reform the commercial and banking sectors and are planning a law on public-private partnerships. Furthermore, the business environment is suffering from significant fragility, poor transparency of companies, bureaucracy, nepotism, corruption, insufficient qualified personnel and the absence of a coherent framework for foreign direct investments. All of these factors, combined with the considerable deterioration in the political situation, could increase payment delays and deteriorate debt collection.



# Subsaharan Africa

Economic recovery  
still shaky

# Focus on the main economy

## South Africa

**A3** rating (since June 2008) unchanged

### Continued moderate growth

After contracting in 2009, the economy recovered moderately in 2010 with household demand offsetting investment sluggishness and a negative foreign-trade contribution. In 2011, the economy is expected to accelerate (+3.5%). Household consumption will sustain its moderate growth buoyed by the higher incomes resulting from recent wage increases. But its future growth will remain constrained by the extent of household debt (77% of their disposable income), a gloomy job picture, and the increase in the cost of electricity and other public services. Investment by private companies, whose financial situation is generally solid, is expected to resume. But the recovery will likely be timid, however, due to the extent of unused production capacity, the uncertainties surrounding both the future trend in domestic demand and in the mine exploitation regime where the authorities have tended to be more interventionist than in the past.

### Tightening fiscal policy

Public-sector investment is expected to be less dynamic. The launch of some large transport and energy projects could be delayed even though the lack of capacity in those areas tends to limit growth potential. Conversely, health and education-related spending is expected to continue to grow. And provision has also been made for further increases in civil service wages, which absorb 47% of fiscal revenues. In the end, however, higher fiscal revenues generated by the growth of corporate profits, the increase in customs revenues, and the measures taken to combat tax evasion are expected to enable a reduction in the fiscal deficit.

### Inflation under control thanks to the firmness of the rand

Inflation continued to ease in 2010 with the decline in prices for imported products. And it is expected to accelerate slightly in 2011 in phase with the increases in wages and electricity prices, thus remaining within the 3% to 6% target. The increasing cost of imported products is expected to be limited as a result of the stabilisation of world energy prices and the support given to the rand by international financial interests seeking higher returns on their investments.

### A current account deficit despite excellent raw-material sales performance

Although the strong rand will continue to undermine manufactured product exports (vehicles, textiles), shipments of minerals and metals will likely further benefit from the strong demand from China and continuing high prices. Despite the growth of imports of machinery, vehicles, and consumer products, foreign trade is expected to be in balance. The current account deficit could nonetheless widen slightly. After the football World Cup, the tourism balance of trade showed its habitual deficit. With the crisis over, repatriation of dividends by foreign investors has been increasing. The same applies to customs-duty clearing payments on behalf of neighbouring SACU member countries. The current account deficit is expected to be covered as in the past by portfolio investments, which are likely to provoke episodes of volatility in the rand, due to their inherent volatility.

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