

Coface Country Risk Update

Fall / Winter 2009

The following modifications of the Coface country ratings were implemented in October 2009:

	Country	June 2009	October 2009
Asia	Korea	A2 ↘	A2
	China	A3 ↘	A3
Americas	Honduras	C	C ↘

Europe

- ◆ **Western Europe: Consumption and investment continue to slump**
- ◆ **Emerging Europe: Deterioration of bank portfolios**

◆ Western Europe

The improvement trend that emerged in the second quarter has stayed on track with economic stability and even growth now expected across the entire region. The timid recovery that began mainly in France and Germany has spread to Italy. But Spain, Iceland and Ireland are still mired in a significant economic downturn – the shakeout in the property sector has continued, with the massive debt of economic players consequently amplified by the collapse of their net worth. In the UK, the high leverage of the financial and household sectors still weighs on the economy.

Consumption continues to benefit from tax measures, particularly car purchase incentives, and the decline in consumer prices. While inventory reductions have eased considerably, current inventory levels are expected to prove insufficient to satisfy demand. Inventory increases are likely to make a positive contribution to the recovery, as will exports which have experienced a moderate rebound. Corporate investment has continued to fall, affected by the collapse of capacity utilization rates while residential investment is still in the doldrums, although a few encouraging signs are appearing in the United Kingdom and France.

The overall economic upturn has produced a slight growth recovery in industry and services but not in construction, particularly non-residential, which has been struggling to find financing. The renewed economic confidence in conjunction with the improvement in order books, particularly for exports, suggests continuation of the overall positive trend.

But appearances can be deceptive. The rebound remains moderate after starting from very low levels of economic activity and could fade quickly in the face of the obstacles in its path.

Consumption could still be affected as unemployment continues to rise and wages are under increasing pressure by companies intent on restoring their profitability. Retail prices will undoubtedly rise at a faster pace due to the waning impact of the decline in raw material prices. The prospect of increased fiscal pressure in conjunction with the negative wealth effect and the uncertainties surrounding the incipient recovery will prompt households to reduce their debt burdens, save more and remain prudent on spending.

Corporate investment will continue to fall, with the capacity utilization rate down to only about 70% from the pre-crisis level of 80%. Exports will be unlikely to gain speed as a result of recoveries in emerging regions weak on imports and in view of the appreciation of the euro and related currencies. The continued weakening of the pound sterling could, however, bolster the United Kingdom's sales abroad.

In this context, payment incidents have remained commonplace in the region despite the efforts by companies to adjust their costs to the decline in business activity or, in some cases, to increase their margins where market conditions allow. The disparities in the fortunes of regional countries have remained substantial due to differences in their initial profitability levels and the severity of the downturns caused by the crisis. While British and German companies, for example, have in general already restored their productivity levels through cost-cutting, that is not yet the case for their sister companies in Southern Europe.

In Germany (rated A2 since March 2009), the timid recovery that emerged in the second quarter is expected to gain strength from the export stimulus. Economic activity will remain far below the pre-crisis level. With the exception of large payment defaults resulting from the Arcandor and Wadan Yards bankruptcies, corporate payment failures have been rising slowly. As the recovery develops, the greater selectivity exercised by banks in granting loans could particularly affect smaller companies. **Austria (A2 since June 2009)**, where payment incidents have also been rising slowly, will likely benefit from the upturn in Germany and initiate an economic recovery.

In France (A2 since March 2009), after a period of inventory reductions, a moderate production recovery is expected. Amid growing unemployment, a likely upsurge of inflation and increased unemployment, household consumption will likely remain flat in coming months. Although the financial position of large companies has improved significantly, smaller companies have remained weak while the volume of cash advances continued to shrink. Corporate bankruptcies increased 23% in the twelve-month period ending in August with resulting cost to suppliers up 75% for the period.

In the **United Kingdom (A3 since March 2009)**, hope for a very modest recovery this quarter was dashed. However, despite the severity of the economic decline, the deterioration of payment behavior has been successfully kept under control except in sectors like non-food retail, construction, property, plastics, business services, wood and paper processing and transport. Some companies, especially large ones, acted quickly to adjust to the new level of activity and improved their profitability through drastic cost-cutting.

In Italy (A3 since March 2009), the crisis seems to have peaked with a weak recovery expected to emerge this quarter. But the economy nonetheless remains saddled with major structural problems that existed before the crisis. The payment default rate remains very high.

In Spain (A3 since March 2009), there is no recovery in sight at this time. Consumption has suffered greatly from the continued shrinking of the property bubble and will continue to do so in a context of tighter fiscal policy. Exports remain hobbled by a lack of competitiveness. Payment incidents have remained at very high levels with banks exercising increasing prudence.

In **Ireland (A3 since March 2009)**, although the economy stabilized somewhat in the second quarter, the extent of the downturn is impressive. Domestic demand, especially residential investment, has continued to slump. Supported by gains in competitiveness, exports could make a positive contribution to the economy. Payment behavior remains poor.

In **Greece (A3 since March 2009) and Portugal (A3↘ since June 2009)**, the contraction of imports in the wake of falling domestic demand has paved the way for reducing the huge current account deficit burdening each country. The two economies will continue to suffer from an unfavorable environment with the deteriorated condition of public sector finances depriving the respective governments of room to act on measures of economic support.

In Scandinavia, the economic situation has varied widely, from **Norway (A2 since March 2009)** where the recession was brief and mild due in part to the country's oil resources, to **Finland (A2 since June 2009)** affected by the problems in nearby Russia and the Baltic States and by the drop in its exports of paper products and telecom equipment. **Sweden (A1↘ since March 2009)**, and the **Netherlands (A2 since June 2009)**, were buffeted by the decline in world trade, while **Denmark (A2 since March 2009)** is contending with a slump in domestic demand.

Payment behavior has deteriorated across the region in many sectors: retail (home furnishings, clothing), business services (information technology, temporary work, property, in particular), transport, trading, and automotive repair, catering, paper, printing and publishing. The growth expected in these countries this quarter will likely lead to a reduction in payment incidents.

In **Belgium (A2 since March 2009)**, high labor costs and the persistence of tight credit conditions have undermined corporate competitiveness and investment. High public sector debt — over 100% of GDP — has kept the government from taking measures to stimulate domestic consumption. Despite the recession, corporate payment behavior has been satisfactory.

◆ Emerging Europe

Economic activity continued to slump in the second quarter except in Poland. Although a slight improvement is expected in the second half of the year, the drop in regional GDP will likely come to about 4% for the full year. The three **Baltic States (Estonia and Lithuania: A4↘ since June 2009, Latvia: B↘ since June 2009)** have been hit hardest with their economies shrinking on average 19% year-on-year in the second quarter. For the same period, the declines ranged from 7% to 9% in **Romania (B since March 2009)**, **Hungary (A4 since March 2009)**, and **Turkey (B↘ since March 2009)**. The **Czech Republic (A2↘ since March 2009)**, **Slovakia (A3↘ since June 2009)** and **Bulgaria (B since March 2009)**, meanwhile, suffered relatively mild contractions of their GDP of about 5%. It now appears almost certain, however, that **Poland (A3↘ since March 2009)** will avoid a recession entirely this year thanks to its large domestic market and the improved economic conditions in Germany. Poland was the only European country to achieve positive growth in both the first and second quarters, up respectively 0.8% and 1.1%.

Despite the first signs that economic activity may be improving in the euro zone, only very measured optimism remains in order for 2010 in emerging Europe. Many factors will limit the extent of the recovery in the region including the slow pace of the household and corporate debt reduction process, the measured expansion of credit, the limited growth or freezing of wages, and rising unemployment, all compounded by the lack of fiscal options due to the deterioration of public sector finances. Regional growth will depend heavily on the strength of economic conditions prevailing in Western Europe. Regional GDP growth will thus not be very likely to exceed 1.5% next year.

The tensions in financial markets have begun to subside since March of this year reflecting the easing of foreign investor aversion to risk and the massive aid granted by the IMF to regional countries in difficulty.

The easing process has continued in the second half spurred by the good news from the euro zone and the reduction in the uncertainties surrounding the strength of China's growth.

Regional banks have in general weathered the financial crisis relatively well due to satisfactory solvency ratios and the limited degree of disinvestment by their parent companies, although further recapitalizations will prove necessary. The main source of concern at this juncture is the quality of bank portfolios, which deteriorated markedly amid the decline in economic activity and, in countries with floating exchange rate regimes, currency depreciations.

The recession, the deterioration of public finances, and the increased volatility of exchange rates have considerably reduced the likelihood of the European Union's new member countries adopting the single currency any time soon, a prospect now postponed until 2014-2015 at the earliest.

CIS and Russia: The persistent difficulties experienced by companies and banks have resulted in major defaults in the region.

The financial situation and growth prospects of CIS countries have continued to deteriorate. Despite aid granted by international institutions, the succession of recapitalizations of banks in difficulty, and the many stimulus measures taken by governments, economic activity continued to decline, a trend substantially borne out by indicators of economic activity in the first two quarters this year. Regional GDP is expected to decline about 6.6% for the full current year before rebounding to 2.1% in 2010 as a result of the gradual recovery of oil prices and the upturn of world demand.

Russia (C since March 2009) and **Ukraine (D since March 2009)** have been affected most, suffering recessions in the second quarter of the year down respectively 10.9% and 18% year on year. The impact of the foreign demand decline, credit crunch, investment downturn, and consumption slump on the Russian economy has been greater than expected this year. The fiscal stimulus measures, the injection of over \$80 billion into the economy and the interest rate cuts made by the authorities since April 2009 have not been enough to stem the contraction of either the credit supply or the economy. The recovery of crude prices will take some of the pressure off foreign accounts and public sector finances but will impede any adjustment in the rouble and improvement in Russian competitiveness.

Ukraine has been in even weaker condition and its currency, the *hryvnia*, has been under severe pressure evidenced by the episodes of depreciation this summer. Exchange rate risk seems likely to persist in the near term and remain highly dependent on capital outflows associated with repayment of foreign debt, developments relative to payment of the fourth tranche of the loan granted by the IMF, distrust of the banking system, and political uncertainties in the run-up to the presidential election scheduled in January 2010. All the more so with the government obliged to alleviate the financial difficulties experienced by the state-run gas company, Naftogaz, which recently announced its payment default on \$500 billion in Eurobonds that have reached maturity.

Kazakhstan (rated B), meanwhile, seems to be faring better, affected by a relatively mild 2.3% recession in the first half of the year. Kazakhstan nonetheless continues to grapple with major difficulties associated with its crisis-ridden banking sector and the shaky global economic environment. Despite aid granted by the government, the financial system has remained in very poor shape with economic growth expected to contract by one percent for the full current year. The proportion of non-performing loans continues to rise with Kazakhstan's two largest banks, BTA and Alliance, going into default last spring. The restructuring of their debt is now imperative. The government, however, with little outstanding debt, was able to avert systemic risk by intervening promptly with the aid of the stabilization fund to recapitalize or even nationalize the weakest banks. But the government underscored the selectivity of its support,

eliminating in consequence banks not in compliance with the new capital adequacy ratios or principles of good governance.

North America:

- ◆ **United States: Expected to emerge from recession in the third quarter of the year, but with household debt reduction impeding a strong recovery**
- ◆ **Canada: Also expected to emerge from recession in the third quarter with a sustained recovery depending on economic conditions in the United States**

◆ United States (A2 ↘ since March 2009)

The United States economy stopped deteriorating in the second quarter, driven mainly by public spending and net exports. Consumption, investment and inventories have continued to undermine growth. The signs of improvement this summer suggest that the economy may be levelling off. The question remains, however, whether these signs can evolve into a sustainable trend capable of generating strong growth in 2010. Our scenario is prudent, calling for a soft recovery in 2010 (up 1.3%) for the following reasons:

- Household consumption has benefited from temporary government measures (tax credits, social transfer payments, incentives for car purchase and first-time home buyers, for example) and low inflation. There are still risks that could prompt households to spend less, continue paying off debt (down 3% since 2008), and replenish emergency savings (4.2% in July). The risks include the still high level of household debt (128% of disposable income), an entrenched deterioration of the job market with the unemployment rate currently 10.2%, the contraction of disposable income associated with resurgent inflation, an ongoing public deficit.
- Housing prices, some recent timid growth notwithstanding, are still very low, down 16% year-on-year in June 2009 and exceeded by household mortgage repayments with payment defaults and repossessions thus expected to continue and the stock of available homes to remain high (8.5 months).
- The recovery of manufacturing production, very dependent on the automotive sector, the cash-for-clunkers program and on consumer goods sectors, could prove to be just a technical recovery. The inventory reduction phase proved to be of a shorter duration than expected and companies have remained prudent, gearing their stocks and production as closely as possible to current demand.
- Deterioration of the commercial construction sector could ultimately affect bank balance sheets.
- Exports (10% of GDP) have not benefited from the stronger economic activity in Asia, particularly China, with that region only providing a market for 19% of sales abroad including 6% for China.

Due to drastic cost-cutting starting in the fourth quarter last year large companies were able to limit the decline in profits and significantly improve their cash flow-to-capital expenditures ratio (87.4% in 2009 for the rate and 111.6% for the ratio according to Natixis estimates). They are thus in a position to resume investing and create jobs but have not begun to do so as of yet.

The large-company situation has tended to obscure the difficulties encountered by smaller companies in gaining access to bank credit. According to the Federal Deposit Insurance Corporation, over 400 of the regional banks that are very close to smaller companies are rated high risks. In this context, corporate bankruptcies will likely continue (up 40% in May 2009 compared to May last year) notwithstanding the emergence from recession expected in the third quarter. The sectors hit hardest include automotives (dealers and parts-makers), residential and commercial construction, and consumer staples (clothing, furniture, leisure, and so on). Others, like mechanicals and public works, are expected to begin benefiting by year-end from the vast infrastructure remediation program initiated by the Obama administration and by local communities.

The fiscal deficit and the federal debt will deteriorate in consequence, increasing respectively to 12.7% and 84.4% of GDP.

◆ **Canada (A2 since March 2009)**

Recovery is expected this quarter. Despite the very negative economic fallout from the neighboring US economy, the deterioration of payment behavior has been both limited in relative terms and concentrated in Ontario and sectors like export-dependent automotives and in property-related services and the catering industry. With low levels of public and private debt, a speculative property bubble limited to the western provinces, and a perfectly healthy banking system, Canada came into the crisis particularly well-positioned to cope with its effects. The incipient economic upturn across its southern border coupled with the upswing of raw material prices will moreover support the recovery process. An excessive appreciation of the Canadian dollar could, however, hamper the recovery of sales abroad.

Latin America: Central America has fared less well than regional countries to the south

Several Latin American countries have been affected by the global financial and economic crisis, sinking into recession as a result with regional GDP down just over 2% this year. Unlike their performance in the recent past, most regional countries have shown a certain capacity to cope and do not appear seriously threatened by either monetary or financial crises. Some signs of recovery have appeared since mid-year, particularly in Brazil (which has technically already emerged from recession), where an economic recovery of about 3% is predicted by 2010 provided the external environment has become more favorable by then.

The disparity in economic fortunes across the region reflects the underlying dichotomy in the foreign trade arena. To the north, Mexico (with a quarter of regional GDP), Central American, and the Caribbean area are heavily dependent on North American demand and have thus been severely affected by the recession gripping the United States. Mexico, for example, with its economy likely to contract an estimated 7% this year, is expected to suffer its worst recession in over a quarter century. The southern portion of the region, meanwhile, with its natural wealth making it particularly attractive to Asian countries, notably China, has developed more geographically diversified foreign trade enabling it to cushion the impact of the global crisis.

As a result of the deterioration of public and external accounts, Latin America has large financing needs while the crisis has made liquidity and credit scarcer and access to more volatile international capital markets more difficult. This situation seems manageable, however, for most large economies — **Brazil (A4 since January 2009)**, **Chile (A2 since January 2009)**, **Colombia** and **Mexico (both A4 since March 2009)**, and **Peru (B)** — thanks to their relatively healthy economic and financial fundamentals. Mexico and Colombia have moreover strengthened their external positions by concluding agreements with the IMF last April/May for “modular credit lines” intended for countries with strong performance but feeling the crisis effects. And since early this year Brazil and Colombia have successfully floated sovereign bond issues on international financial markets despite competition from massive issues by developed countries. The prevailing conditions for external financing have remained troublesome for **Argentina (C)** — yet to normalize its relations with its public and private creditors since the restructuring of its debt in 2005 and thus deprived of access to international financial markets — and **Venezuela (C↘ since June 2009)** — successful in raising funds abroad but on costly terms.

Thanks to the improvement in public sector finances nonetheless achieved in recent years by several Latin American countries, their governments have enjoyed some room to maneuver in implementing fiscal stimulus policies. The stimulus measures have come, however, at a cost that will ultimately increase even further an average public debt ratio for Latin America, which already exceeds the overall emerging-country average. With the region once again facing a full electoral calendar, the possibility of overly-generous tax breaks raises the possibility of a decline in public sector finances.

Presidential elections are notably scheduled this year in **Uruguay (B)** in October and Chile (December) and next year in Colombia (May) and Brazil (October).

In Argentina and Mexico, gains made by the opposition marked the legislative by-elections held late June and early July this year and the consequent diminished authority of their respective presidents will not be conducive to the exercise of greater fiscal discipline.

Many private companies in the region have been grappling with cashflow difficulties attributable to a range of factors: the reluctance of local banks to grant loans, an increase in the proportion of outstanding debt reaching maturity, the depreciation of some local currencies with the pressure on companies carrying foreign currency debt increasing in consequence. That could lead in turn to an increase in corporate bankruptcies as has been the case in developed countries.

@rating change:

◀The C rating for Honduras has been negative watchlisted. The worsening of the economic and financial situation is attributable to the political crisis resulting from the military coup in late June this year.

The political situation has remained gridlocked since the removal of President Manuel Zelaya (Liberal Party) from office by the army in late June this year, and subsequent nomination on an interim basis of the President of Congress, Roberto Micheletti. This changeover has drawn condemnation from the international community including the Organization of American States and the United Nations. After the failure of the mediation led by the Costa Rican president, Oscar Arias, Mr. Zelaya's return to the country in late September has only made the overall situation more entangled.

Even before that political crisis, the economic outlook in Honduras was very unfavorable due to the recession in the United States, the country's main trading partner and source of expatriate remittances. With its depressing effect on household consumption and public and private investment, the political turmoil has caused an even more pronounced economic contraction.

The political crisis has also had a profound effect on public finances already in poor shape, on the main exports — coffee and bananas — and on tourism. The higher cost of oil since Venezuela repudiated the preferential *Petrocaribe agreement* has made imports more expensive. Furthermore, although most of the very large current account deficit can only be financed by bilateral or multilateral aid, the political crisis has led to the suspension of that aid from its three sources: the World Bank, the American Development Bank, and — subject to negotiations on renewal of the confirmation agreement that expired last April — the IMF. The country's political, economic and social stability would become unsustainable if the inflows of aid and the international relations on which they depend are not restored very soon. The current gridlocked situation calls imperatively for a renewal of negotiations to pave the way for breaking out of the crisis.

Asia-Pacific

- ◆ **Emerging Asia: Stimulus measures at the core of the recovery**
- ◆ **Japan: Deflationary spiral once again in 2009 and modest recovery in 2010**
- ◆ **Australia: Recession averted**
- ◆ **New Zealand: Five quarters in recession**

◆ Emerging Asia

After the Lehman Brothers bankruptcy, Emerging Asia was significantly affected by the resulting drop in exports and domestic demand. Foreign demand for medium and high technology manufactured products (automotives, electronics, capital goods) particularly sensitive to global investment cycles contracted as

evidenced by the precipitous fall of exports, down 70% in the fourth quarter last year and first quarter this year, which was twice the decline suffered in 2001.

Domestic demand was affected by the loss of confidence, rise of unemployment, the credit crunch, and the increase in emergency savings. Indicators for the first half this year attest to a gradual recovery, driven by China's rebounding growth, up 7.1% for the period due to dynamic domestic demand. The recovery is attributable to three main factors: (1) strong expansionary monetary and fiscal policies in certain countries, (2) resumption of capital inflows and proper functioning of financial markets, thereby paving the way to easing the financial difficulties of small exporting companies and restoring household and corporate confidence, and an (3) industrial rebound fuelled by the stock replenishment process.

- (1) **Support provided by monetary and fiscal policies** was instrumental in easing the tight credit conditions and the decline of domestic demand. Central banks proceeded with interest rate cuts in India, Indonesia, Korea, Malaysia, the Philippines, Taiwan, Thailand and Singapore, thus providing adequate liquidity to the interbank market. In China, the removal of loan ceilings in conjunction with low interest rates spurred a strong credit expansion, up 24% in the first half of the year. Because of the generally sound fiscal situation prevailing in Asia, the fiscal stimulus measures taken there were stronger than in other regions. China has implemented the most ambitious stimulus program, which could represent as much as 5% of GDP in 2009-2010. South Korea is a close second with a stimulus program reaching 4.7% of GDP, followed by Singapore (3.4%) and Malaysia (3%). Most of the programs give priority to spurring consumption, especially in South Korea, and improving infrastructure, as in China.
- (2) **A new influx of capital to Asia** has also been responsible for the economic recovery. Over the first eight months of the year, stock markets were up 65% in ASEAN countries (Indonesia, Malaysia, Philippines, and Thailand), 62% in India, 52% in the four very open economies (Hong Kong, Korea, Singapore, Taiwan) and 47% in China. In this favorable context, spreads on corporate debt in Emerging Asia have narrowed by over 250 basis points since January 2009, easing the financial difficulties of companies and households. The credit expansion has resumed in the very open economies and India due to the restoration of adequate liquidity and the sound capitalization ratios of banks.
- (3) **The stock replenishment process has also fuelled the recovery.** In reaction to the decline of demand in 2008, companies cut back on production and reduced stocks. Since early this year, however, amid a gradual recovery of domestic demand and exports, a stock replenishment process began, particularly in Korea and Taiwan.

The trend toward recovery will likely continue in the second half of the year. The slowdown under way this year (with 5.2% growth expected for Emerging Asia down from 6.5% in 2008) will be moderate with growth then expected to accelerate in 2010 (up 7.7%) fuelled by the gradual revival of foreign demand.

- **China (A3** since January 2009) and **India (A3 since January 2005)** will be the two economic engines with respective growth rates of 8.5% and 6.0% expected in 2009 and 10% and 8% in 2010. This robustness is largely attributable to expansionary economic policies expected to foster rapid growth of domestic demand. In India's case, the country's capacity to cope with difficulties derives from its relatively closed economy and the level of domestic demand. The Congress Party's comfortable victory in the last elections is expected to enable it to initiate the reform process necessary to eliminate economic choke points, particularly in terms of infrastructure. In China, the stimulus implemented via the banking sector, especially the lifting of loan quotas, have been mainly responsible for the economic rebound.

- In **South Korea (A2** since March 2009), after bottoming out in the fourth quarter of 2008, the economy achieved positive quarter-on-quarter growth in the first two quarters this year, up 0.1% and 2.5%, respectively. The recession is expected to be limited to -0.1% for the full current year and the economy could resume rapid growth in 2010 with +4% expected.

Although the three wide open economies — **Hong Kong (A2** since March 2009), **Taiwan (A2** since March 2009) and **Singapore (A2 since March 2009)** — achieved positive quarter-on-quarter growth in the second quarter this year, they remain very export dependent and will be in recession for the

full current year, down respectively 2%, 4% and 3%; which explains why they remain negative watchlisted. A gradual recovery is expected in 2010, with the three likely to achieve positive growth once again.

- For **ASEAN** economies the outlooks are divergent. While the open economies, **Malaysia (A2↓ since March 2009)** and **Thailand (A3↓ since March 2009)** will be in recession in 2009 (-3.5% expected), the **Philippines (B since March 2005)**, **Indonesia (B since March 2004)** and to a lesser degree **Vietnam (B↓ since June 2008)** are expected to achieve strong performance. In 2010, however, all ASEAN countries will achieve positive growth of 4% expected overall for the period.

The recovery will not be risk-free. The rapid credit expansion in several countries, notably China, could lead to over-investment and overcapacity. The risk of engendering a speculative bubble has grown and the deterioration in the quality of banking-system assets is already noticeable. The government loan-guarantee systems implemented in several countries, like South Korea, could foster excessive risk-taking.

Even with the recovery expected in 2010, Emerging Asian growth will not reach pre-crisis levels (9.5% in 2007, for example). The timid recovery expected in the United States and Europe will dim the outlook for the region's exports. An adjustment in the growth scheme seems to be under way. Gradual implementation of social security systems, planned as part of several stimulus programs, could ultimately strengthen the role of domestic demand as an economic engine by paving the way for reductions in emergency savings by households. Reducing the reliance on foreign debt, which will require developing the role of domestic financing, remains a major challenge, particularly in countries like South Korea and India with high debt abroad.

@rating changes

☛ **South Korea's A2 rating removed from negative watchlist reflecting the investment-driven growth recovery spurred by expansionary monetary and fiscal policies.**

☛ **China's A3 rating removed from negative watchlist status reflecting the economic recovery driven by a credit boom.**

☛ **South Korea**

The South Korean economy, very open and integrated into international capital markets, suffered from the global economic and financial crisis in 2008 but recovery is already in progress.

The economy bottomed out in the fourth quarter of 2008. In the first two quarters this year, the country achieved positive quarter-on-quarter growth respectively 0.1% and 2.3% due to the won depreciation's favorable impact on exports and to expansionary monetary and fiscal policies. The Central Bank made several reductions in interest rates and legal reserves and the government implemented a stimulus program — involving income tax reductions, public sector investment and support for smaller companies and needy households — representing nearly 4% of GDP. Authorities also withdrew \$55 billion from foreign exchange reserves to support the banking system and strengthened the loan guarantees extended to smaller companies.

The trend toward recovery is expected to stay on track in the second half of the year and the recession for the full current year could be limited to -1%. The fiscal and monetary stimulus measures will likely foster a gradual investment recovery. Private consumption will remain sluggish amid rising unemployment and tightening credit conditions. Exports will begin to show some activity.

In 2010, under the assumption of a gradual global recovery, the economy could rebound with 4% growth expected. South Korea's economic growth rests on solid fundamentals including a diversified industrial base competitive in new technologies, an effective education system and high R&D spending. Exports could begin to grow again, particularly to China, South Korea's main trading partner. Domestic demand

is expected to strengthen gradually in a context of easing aversion to risk and an expected credit recovery.

Persistent weaknesses exist. Household and corporate debt remains too high. Companies are faced with doubts as to the sustainability of their debt. If a credit crunch develops they would have to make adjustments by improving their profitability and cash flow-to-capital expenditures ratio or else cut back on investments. Companies also remain exposed to exchange rate risk. For households, their growing debt burden increases the sensitivity of their net worth to interest rate variations and income shocks.

South Korea remains nonetheless in good financial health. Public sector debt is expected to remain sustainable. In deficit in 2008, the current account is expected to show a surplus this year. Foreign debt — with over 80% borne by the private sector — will likely remain stable. Despite the proportion of short-term debt and the high volatility of portfolio investments, the risk of a foreign currency liquidity crisis has been kept under control thanks to large foreign exchange reserves representing nine or ten months of imports.

Although the global crisis severely affected the banking sector systemic risk is expected to remain limited. After the Lehman Brothers bankruptcy, Korean banks, with substantial short-term foreign debt, suffered from the reduction of credit lines and they were only able to renew 40% of their short-term debt. To avoid widespread default, the government withdrew \$55 billion from foreign exchange reserves to provide banks with swap and credit lines while the Fed granted \$30 billion in swap lines to the Central Bank. The government also injected capital into several state-run banks. These strenuous measures averted a systemic crisis. In 2009-2010 systemic risk will remain limited assuming a gradual clean-up of bank balance sheets and continued government support for the banking sector.

☛ China

In 2008, the economy slowed due essentially to internal imbalances (overcapacity in the steel, automotive, and construction industries) and restrictive economic policies that remained in force for too long. Exports only began to slump in November 2008. Bankruptcies in industries saddled with overcapacity and among low value-added export companies increased, particularly in the Guangdong region. Over 10,000 factories representing two-thirds of the textile industry closed. Three thousand-six hundred toy manufacturers failed in the first half last year, representing 53% of all toy producers in China. The economy then bottomed out in the fourth quarter of 2008. In this environment, the government adopted an expansionary policy. The Central Bank reduced interest rates and legal reserves while loan quotas were discontinued. Due to the low level of public sector debt (18% of GDP) and a high savings rate, the government was in a position to adopt a \$586 billion stimulus program focused on large infrastructure projects (investments in transport and electricity, reconstruction of area devastated by the earthquake) and on social programs (education, subsidies to rural populations, housing aid). In late 2008, officials made adjustments in foreign exchange policy intended to make the yuan more stable to support difficult export sectors.

In the first half of this year, strong growth resumed (up 7.1% year-on-year) driven by the recovery of domestic demand. Urban investment soared 31% in the first quarter and then 43% in the second. Consumption was very dynamic as evidenced by a surge in retail sales, up 16% in the first quarter and then up 43% in the next quarter. Auto sales benefited from a reduction in taxes on purchases of small cars. The property market rebounded with home sales surging 50% in the second quarter.

That trend is expected to stay on track in the second half and in 2010. Economic growth could be as high as 8.5% for the full current year and 10% in 2010. Domestic demand is expected to drive the economy whereas the growth contribution of net exports will likely be close to zero (increases in VAT reimbursements on exported products notwithstanding).

There are, however, persistent weaknesses:

- The strong credit expansion — +27% from January to August this year compared to +16% for all of 2008 — is not devoid of risk. Possible deterioration of bank assets constitutes a source of concern even if

systemic risk will likely remain under control with the government able to cope with any difficulties that may arise. But the risk of engendering a speculative bubble will bear watching. In the near term, however, an alarmist assessment of conditions in the property and stock markets would be premature. The strength of demand in the property market quite logically puts pressure on prices to the extent that the tight policy pursued by the government in 2007-2008 resulted in the delay, even freezing, of many projects and thus slowed normal development of the supply of property for sale. Demographics, urbanization and middle class-family aspirations for better housing will underpin China's property market. Likewise, despite the strong stock market recovery since early this year (up 47%), the composite Shanghai index is still below its October 2007 peak. The fact that stock market capitalization in relation to GDP is just 32% in China — far below the 67% ratio for Japan and 87% for the United States — would tend to mitigate the macroeconomic consequences of a crisis.

- The allocation of the high volume of new bank loans in the first half (\$1,097 billion, or a quarter of GDP) will hardly contribute to establishing a better balance in the Chinese economy with 25% of the total amount of the new loans used to finance property transactions and another 20% to finance stock market trading. The balance of the new loans went essentially to financing infrastructure and the expansion of industrial production capacity. The emphasis thus given to investment will accordingly delay development of the household consumption contribution to GDP (35% in 2008). This sustains industrial overcapacity in an environment of contracting demand from all the main export markets.
- The default risk associated with some companies will bear watching this year. Despite the fiscal stimulus, payment default risk is still high in particular sectors. The vast stimulus program has resulted in major structural changes with the country initiating a move upmarket for industry. Sectors where the number of companies is consequently expected to fall — particularly those dealing in low value-added products (textiles, shoes, toys) and those suffering from overcapacity (automotive, construction, steel),— will be the focal points for default risk in China.

◆ **Japan (A2 since March 2009)**

Japan emerged from recession in the second quarter this year with economic growth (up 0.6% quarter-on-quarter) driven by household consumption. The benefit to Japanese consumers of measures taken by the Aso administration last April to spur sales of autos and energy-saving consumer electronics contributed to the improvement in the economy. Exports, meanwhile, achieved modest growth due mainly to orders from China for transport equipment, electric appliances and chemical products. Corporate investment and stocks continued, however, to severely undermine growth. The growth pattern will be largely the same in the third quarter except that the focus of export business will shift from China to the United States, underpinned by the cash-for-clunkers program through end-August.

Economic growth is thus expected to remain negative for the full current year, down 6%, and then strengthen considerably in 2010 to a positive 1.1%. Exports will not return to pre-crisis levels as long as households in OECD countries (30% of Japanese sales abroad) continue to focus on reducing their debt and as long as domestic demand in emerging countries, particularly China (16% of exports) continues to be satisfied by local production with little foreign content. The yen's appreciation against the currencies of the main trading partners, if it lasts, will contribute to both undermining the competitiveness of Japanese exports and reducing the prices of imported products. As a result, the rates of profit and cash flow-to-capital expenditures ratios of Japanese companies will likely continue to deteriorate. With the capacity utilization-rate in the manufacturing sector an estimated 57 percent, investment will continue to contract.

The labor market is expected to continue to deteriorate with wages trending down. Consumption could gain support from the measures announced by the new Hatoyama government administration (reduction or discontinuation of provisional tax on petrol, bonus for children from June 2010, etc.) and the renewal of measures taken by the previous administration. But any resulting improvement in consumption would be limited by the continued deflationary spiral (down 2.4% in August this year compared to August 2008) in progress this year and by the process of replenishing emergency savings which have dropped from 6.8% in 2008 to 3.7% by 2010.

The infrastructure-related spending called into question by the new administration will affect the profits of companies in several sectors including construction, construction-related materials and metallurgy. Measures directed at households will particularly benefit the retail, food, and people-services sectors.

The ongoing fiscal stimulus program and the sharp contraction of revenues will widen the public sector deficit (from a -9% of GDP estimated for 2009 to a -10% expected for 2010), and the already colossal government debt will grow even more (over 191% of GDP this year and 198% next year).

◆ **Australia (A2 since January 2009)**

The economy is expected to grow 0.5% in 2009 and 1.1% in 2010. Australia has thus far avoided slipping into recession during the global crisis due to a range of government measures directed at companies and households (tax rebates, aid to first-time home buyers via the First Home Owner Grant program). Other factors have contributed to the country's staying power: exports of iron ore and coal (34% of sales abroad) with China a major market and cuts in the Central Bank's key rates since September 2008 (down 425 basis points to reach 3% in April), which benefited consumption by easing household debt service. Unemployment increased moderately with companies giving preference to reductions in working time over layoffs. Household debt has nonetheless remained high at 156% of disposable income, which will likely prompt households to exercise a degree of prudence in making purchases and to replenish emergency savings, especially with the interest rate hikes initiated by the Royal Bank of Australia in early October likely to hamper repayment of their property loans.

Despite unfavorable exchange rates since last March with the AUD gaining 22% against the currencies of the country's main trading partners, mining sector companies will continue to benefit from the flow of orders from China. The proportion of export sales now absorbed by China (up from 15% to 20% in just two years) constitutes a risk of increasing dependence on its great neighbor. Measures taken by the government in support of infrastructure and construction will continue at the same pace as in 2009. The public sector deficit (a negative 3.8% of GDP) could stabilize with the debt increasing only slightly (22.7% of GDP). The bankruptcy rate eased considerably from May to July (up 5.6%).

◆ **New Zealand (A1↘)**

Five quarters of recession have fuelled a surge in corporate bankruptcies. The recovery that emerged in the second quarter of the year brought welcome relief. Dairy industry exports have benefited from a favorable regional context (Asia, Australia). Consumption has been moderate with the positive contribution from immigration offset by a still tight employment market, stagnation of incomes and the growth of savings. The recent moderation has been a timely development, contributing to the trade surplus and the reduction of a current account deficit whose size was a major weakness even before the onset of the global crisis.

Near & Middle East and North Africa: Speedier recovery in oil countries

Countries in this region have been affected by the global crisis, particularly oil economies contending with a contraction of oil demand and a decline in barrel prices. The Near & Middle East (excluding Turkey) and North Africa will lose an estimated three points of growth this year compared to 2008 down from 5.4% to 2.4%. The global economy's improvement is likely to benefit the region via a demand recovery and higher hydrocarbon prices in 2010. The region could regain slightly more than two points of growth as a result.

The decline in both foreign demand and barrel prices has affected the region's oil producing countries. In the six Gulf Cooperation Council countries (Saudi Arabia, United Arab Emirates, Kuwait, Qatar, Oman and Bahrain), the global crisis also led to declines in the securities and property markets. The credit crunch

and increased financing costs prompted the cancellation or postponement, in value terms, of 23% of the investment projects planned. But despite the drop in oil revenues most oil exporting countries were still able to pursue expansionary policies and support the non-oil sector due to the reserves built up in past years. With oil production down between 8% and 10%, **Saudi Arabia (A4)**, the **United Arab Emirates (A2)**, and **Kuwait (A2)** will be in recession in 2009, with their economies shrinking between 1.0 and 1.5%. In the United Arab Emirates federation, the Dubai emirate, which boasts the region's most open economy, suffered most from the global financial crisis.

Spreads for credit-default swaps on Dubai's sovereign debt reached 900 basis points (bps) last March but eased to 400 bps in August reflecting the financial support provided by the federation. During the same period, spreads on Saudi Arabia, Abu Dhabi, and Qatar dropped from 400 to 200 basis points. The narrowing of these spreads can be interpreted as a sign of emergence from the crisis, reflecting the strengthening of oil prices so far this year.

With an average barrel price of \$60 expected for North Sea Brent most oil countries will avoid running twin deficits for the current year. **Algeria (A4)** and **Iran (D)** will probably run a public sector deficit.

A relatively soft growth recovery is expected next year in step with foreign demand. Barrel prices will be moderately higher, around \$70 under our preferred hypothesis, a level that will generally make it possible to run larger trade and fiscal surpluses than those recorded in 2009, but still below the levels reached in 2008.

The other regional countries also suffered as a result of the global crisis but none of them have been in recession this year. Although they achieved growth of around 4%, their economies were affected by the contraction of foreign demand, emigrant worker remittances and foreign direct investment. **Egypt (B)** suffered a sharp decline in Suez Canal traffic, albeit partly attributable to the piracy risk in the Gulf of Aden. While tourism slumped in Egypt and **Jordan (B)**, it trended up in **Lebanon (C)** and **Syria (C)**. Lebanon has shown that it has the capacity to cope effectively with the global crisis thanks particularly to a stronger climate of security. But saddled with high debt (particularly Lebanon), large fiscal imbalances (Lebanon, Jordan, and Egypt), and great dependence on foreign capital (particularly Jordan), these countries can do little to support their economies. Next year may thus still be too soon for the hoped-for economic recovery to materialize.

Israel (A4), meanwhile, although directly affected via the trade channel, has shown signs of recovery with the rate of recession revised to a -0.3% reflecting the trend toward positive growth. As in industrialized companies, the recovery expected in 2010 will be moderate (1.6%).

In **Pakistan (D since March 2009)**, the political situation continues to give cause for concern and cloud the economic outlook despite mobilization of massive international aid.

Sub-Saharan Africa: Affected by a second wave of the global crisis but still afloat

After achieving near 6% growth these past five years, sub-Saharan Africa will undoubtedly suffer more than expected this year from the repercussions of the global economic contraction. Between 2008 and 2009, the continent could lose nearly four points of growth with forecasts for 2009 revised downward to under 2% (compared to 5% in October last year). Growth is expected to rebound next year (up 4.0%) but will remain below pre-crisis levels.

Oil countries have been among those suffering most with their growth, while remaining positive, plummeting 5.5% from 6.9% in 2008 to just 1.4% a year later. Most will be unable to offset the decline in prices by increasing production, whether for technical reasons, as in the case of **Nigeria (D)** contending with the Niger Delta insurrection, or because of OPEC-imposed constraints.

In **Angola (C)**, economic growth is expected to be zero, down steeply from the near 20% growth maintained these past five years. In 2010, oil countries are, however, expected to benefit from the price rebound and achieve 5.5% growth on average.

Although the great majority of African countries benefited from the decline of oil and foodstuff prices in the first half of the year, they all suffered from the drop in their exports in both volume and value terms and from the decline in flows of financing, particularly foreign direct investment and private transfers. With little diversification, African economies suffered directly from the decline in prices and global demand for their main export products, like diamonds for both **Botswana (downgraded to A4 in June 2009)** and **Namibia (A3)** or coltan for the **Democratic Republic of Congo (D)**.

But there are a few noteworthy exceptions like the rise of prices for cocoa benefiting **Ghana (C)** and the higher prices for cotton (associated with drop in production) benefiting **Mali (C)** and **Burkina Faso (C)**, and the firm prices for gold (Ghana, South Africa, Mali). **The decline of foreign direct investment** in a context of a global liquidity shortage and increased aversion to risk has primarily affected mineral prospecting and production in **Zambia, Uganda (both rated C), and the DRC** where these activities have become less profitable. Infrastructure, energy, and transport projects have also been subject to many delays. Foreign direct investment is, however, expected to remain dynamic in the telecommunications sector, particularly in **Niger, Ethiopia (both rated C)**, and in agriculture notably in **Mozambique (B)** and Mali. Even if estimates of the decline are only rough approximations (down 20%), **the drop in private transfers** has doubtless affected household consumption in Africa, particularly **Senegal (B)** and **Togo (C)**, with the transfers representing as much as 30% of goods and services exports. Covering financing needs has consequently become even more difficult. This is especially true in view of the uncertainties over the capacity of developed countries to meet their bilateral commitments on public development aid despite the measures taken by the IMF to help African countries cope with the global crisis effects notably via a twofold increase in donations and increases in concessional loans. In 2010, a moderate 3.4% recovery is expected to benefit non-oil countries due to a rebound of exports, FDI, and, underpinned by private transfers, household consumption.

The return of political risk to the African scene was borne out by events in 2009 after several years of growing stability marked by the end of major conflicts involving Angola, the RDC, **Sierra Leone (D)**, **Liberia (D)**, and **Rwanda (D)** and by the progress made, notably by Ghana and **Namibia (D)**, on improving governance. The coups carried out in **Madagascar (C)** in January 2009, **Guinea (D)** December 2008, and **Mauritania (C)** August 2008) underscored the weakness of democratic processes in Africa. Elections continue to be critical milestones capable of derailing a country's socio-political equilibrium as evidenced by the tensions that marred the election in **Gabon (B)** in September 2009 and the threat of a resurgence of civil war in **Sudan (D)** in the run-up to elections scheduled next year.

Negative watchlist status has been maintained for the A3 rating of South Africa, which represents 33% of sub-Saharan Africa's GDP. Sluggish household consumption continues to undermine the South African economy despite the 550-basis point reduction made by the Central Bank in its key rate since December 2008. Platinum and mechanical exports have suffered from the slowdown of global demand. Many public investment projects in infrastructure, energy, and transport have been postponed due to the tightening of conditions for obtaining financing with the sovereign rating downgraded by rating agencies. South Africa thus slipped into a technical recession in the first half of the year after two consecutive quarters of negative growth. The economy is expected to contract, down 1.5% for the full current year, with a recovery getting started in the second half, borne out by the rebound of the rand and stock market indices. However, because of the severe household consumption slump exacerbated by a high level of structural unemployment (24%), the recovery next year is expected to remain below the 5% average growth maintained from 2004 through 2007.

Economic Growth Rates

	2001	2002	2003	2004	2005	2006	2007	2008	2009 f	2010 f
World production	1.6	2.0	2.8	4.1	3.6	4.3	4.1	2.3	-1.9	2.4
Industrialized countries	1.1	1.3	1.8	3.1	2.4	2.9	2.4	0.7	-3.6	1.0
United States	0.8	1.6	2.7	4.2	3.2	2.9	2.0	1.1	-2.6	1.3
Japan	0.2	0.1	1.4	2.7	1.9	2.2	2.1	-0.7	-6.5	1.0
Euro Zone	1.8	1.1	0.8	1.7	1.5	3.0	2.6	0.7	-4.0	0.4
Germany	1.1	0.0	-0.2	0.6	1.1	3.0	2.5	1.3	-4.8	1.2
United Kingdom	2.3	2.1	2.7	3.3	1.9	2.8	3.0	0.7	-3.7	0.7
France	2.1	1.1	1.1	2.0	1.2	2.0	2.1	0.3	-2.3	0.9
Italy	1.7	0.3	0.1	1.2	0.1	1.9	1.4	-1.0	-4.7	0.5
Spain	0.0	0.0	0.0	3.3	3.6	3.9	3.7	1.2	-3.7	-0.7
Emerging countries	3.0	4.4	5.6	7.2	6.6	7.3	7.6	5.4	1.3	5.3
Emerging Asia	4.8	6.5	7.1	7.9	7.9	8.7	9.5	6.5	5.2	7.7
Latin America	0.2	0.5	1.9	5.9	4.5	5.5	5.6	4.2	-2.2	3.1
Emerging Europe	0.5	4.0	4.6	6.9	6.0	6.6	5.7	3.1	-4.3	2.1
CIS	6.1	5.3	7.8	8.1	6.8	8.2	8.5	5.5	-6.6	2.5
Middle East	2.1	2.5	6.4	6.0	5.7	5.0	4.8	5.9	2.4	4.7
Africa	3.4	6.4	6.4	6.2	5.9	6.6	6.7	5.4	2.0	4.1
China	8.3	9.1	10.0	10.1	10.4	11.6	13.0	9.0	8.5	10.0
India	5.8	3.8	8.5	7.5	9.5	9.7	9.0	6.7	6.0	8.0
Brazil	1.3	2.7	1.2	5.7	2.9	4.0	5.7	5.2	0.1	4.4
Russia	5.1	4.8	7.3	7.2	6.4	7.4	8.1	5.6	-7.5	2.0
World trade	0.1	3.4	5.4	10.3	7.0	7.4	7.3	3.0	-11.9	2.5

