

Country Risk Overview

October 2011



Growth Forecasts

World growth
revised downward
in 2011

2011 world growth is trending down in the wake of a slowdown in advanced countries

Disappointing growth figures for the second quarter of 2011, political tensions in the United States this summer around the question of the debt ceiling and the loss of its triple-A rating, the never-ending sovereign debt crisis in the eurozone, the persistent lack of confidence on the financial markets, tensions on the money market and the vertiginous fall of bank share prices: So many negative signals that are likely to affect the global recovery observed since mid-2009. Global growth in 2011 will settle at 3.2%, representing a slowdown of 1.1 point of GDP compared to 2010.

Downswing in the advanced economies

Against the background of the continued move towards clearing of debts by households in some large economies (the United States, the United Kingdom and Spain) and the high unemployment rate (9.9% and 9.7% in the eurozone in 2011 and 2012, 9.1% and 9.2% in the United States), consumption is encumbered and cannot constitute a solid driver for growth. Public sector expenditure is likely to contribute negatively to activity in almost all the developed countries, with the particular exception of Japan.

Confidence amongst industrials has been low since summer 2011, in the context of the stock market crisis: surveys suggest a slowdown in manufacturing activity in the 2nd quarter but not a recession at this stage. In Germany, the IFO and the ZEW have been heading downwards since the summer. The synthetic index for the manufacturing sector for the entire eurozone was published at 49.7 vs. 50.4. This index has not dipped below the 50 mark since September 2009. In the United States, we also witnessed a decline in confidence amongst investors.

The figure is still above 50 (the floor that is considered to be a precursor to recession), standing at 50.6, but there was a clear drop in the 2nd quarter of 2011. Surveys continue to show a reduction in new orders, which would indicate that the buoyancy of industrial investment is fragile.

Eurozone growth is expected to drop 1.6% in 2011

More of a rise cannot reasonably be expected due to the banking crisis that has been raging since the summer in Europe. It is possible that banking credit will contract in the eurozone. In the first quarter of 2011, credit growth slowed down in Germany (it is close to zero). It remains positive in France and Italy but is down in Greece, Spain, Portugal and Ireland. The other drivers for growth are struggling: public and private sector consumption will contribute very little. Furthermore, it could be assumed that the synchronisation of budget cuts in the eurozone will have a cumulative negative effect on the activity of each of its member states. We expect a zero contribution from foreign trade.

In the United States, our growth forecast is +1.7% in 2011

US growth for the 2nd quarter has been revised downwards. In June, carry-over growth was only 1.3% and the bad indicators published in September point to a pronounced slowdown in all drivers of activity over the second part of the year.

In the United Kingdom, all the signals are red

Growth skidded to a halt in the 2nd quarter (+0.2% q/q), the FTSE 100 index fell over the summer (-13% between the beginning of August and September) and bad indicators were published, auguring for weak growth in the coming quarters. Growth has therefore been revised downwards to 1.1% for 2011, in line with the continued contraction in household consumption, clear cuts in public sector expenditure and the weak growth in exports despite the depreciation of the pound, which has lost, since September 2008, more than 11% against the dollar and 8% against the euro.

In Japan, downward revision of its gross domestic product in the 2nd quarter (-0.5%)

Japan has posted a contraction for three quarters in a row. The consequences of the earthquake in March 2011 continue to encumber household consumption and exports, which were already penalised by the appreciation of the yen which has gained 28% against the dollar and 30% against the euro over the last three years. Only public sector investment, sustained by the beginning of the reconstruction effort in Tohoku, contributed positively. Electricity shortages are still affecting a number of businesses over the entire territory (shutdown of Fukushima and other reactors) and radioactive contamination hampers reconstruction projects. Activity for the whole of 2011 is expected to be posted at -0.3%.

The emerging countries likely to cope with potential storms

In a context of a slowdown in international trade, activity in the emerging countries is expected to mark time in 2011 (+5.8%) and 2012 (+5.6%) against +7.1% in 2010 and +7% in 2003-2007. However, it will continue to pull global growth along, thanks to the dynamism of domestic demand.

The decline in growth in the emerging markets was widely expected at the beginning of the year,

due to the tightening of monetary policies that began after the end of 2010 in countries that were threatening to overheat, such as Brazil, India and South Africa, or threatened by bubbles created by the influx of volatile capital, such as China and Hong Kong. These measures made it possible to contain the rise in inflation, which is expected to settle at 6.2% in 2011 against 5.2% in 2010, and to readjust the foreign trade imbalance. This was with the exception of Turkey, where inflation is still in excess of 7% and the current account deficit reached 9% and India, where the current account deficit is likely to continue to rise to 3.2% in 2011. **The extent of the slowdown is, however, more pronounced than anticipated, due to the unexpectedly significant contraction in international trade.** The growth rate for global trade, which advanced by 13% last year, is expected to settle at 5% in 2011 against the 7% forecast at the beginning of the year. This cool down in international trade will have a direct impact on Asia, particularly the open economies (Singapore, Hong Kong, Taiwan). There will also be consequences for China, with the United States and Europe each accounting for 18% of Chinese exports. However, the impact on activity will be mitigated by domestic demand that will remain strong (reevaluation of salaries, sustained investment). In Latin America, apart from the countries which will suffer directly from the downturn in the US, exports are expected to slow down moderately thanks to the diversification of export destinations (China now represents the largest or second-largest destination for exports from Latin American countries). However, the possibility of a more pronounced decline in exports from Latin America cannot be excluded, if commodities prices see a more significant downward revision.

In this context, we are seeing a gradual re-orientation of macro-economic policies in the emerging countries, or at least the stoppage of anti-overheating measures. In Asia, after a cycle of tightening interest rates and increases in compulsory reserve requirements, we are witnessing a status quo that has been maintained since the spring of 2011, except in India, Thailand and Vietnam, where interest rates continue to rise. In Latin America, the Brazilian Central Bank dropped its rate by 50bp to 12% in August 2011.

We believe that in the event of a double dip, the emerging countries will still have significant room for manoeuvre to face up to a more larger than expected decline in international trade, except in Central Europe where the private sector, which has issued debt in hard currencies, is continuing with the

process of balance sheet adjustment. Unlike the developed countries, which have not yet recovered their pre-crisis activity levels, the emerging countries have largely exceeded them since 2010. Furthermore, despite the counter-cyclical policies followed in 2008-2010, the margins for manoeuvre to sustain domestic activity are still substantial. The foreign exchange reserves accumulated by the emerging markets now represent two-thirds of global foreign exchange reserves. Furthermore, at 34% the national debt of these countries is well below that of the developed countries, which is higher than 80%. The policies being undertaken in China to promote domestic demand as the main growth engine, or even in Brazil to encourage the rapid growth of a dynamic middle class, should make it possible for these countries to absorb the disruption to external demand.

Coface	2002	2003	2004	2005	2006	2007	2008	2009 e	2010 f	2011 f	Coface
World production	2.1	2.7	4.0	3.7	4.3	4.2	1.9	-1.8	4.3	3.2	World production
Advanced countries	1.4	1.8	2.9	2.4	2.8	2.4	0.0	-3.8	2.6	1.4	Advanced countries
United States	1.8	2.5	3.5	3.1	2.7	1.9	-0.3	-3.5	3	1.7	United States
Japan	0.3	1.4	2.7	1.9	2.0	2.4	-1.2	-5.2	4	-0.3	Japan
Euro zone	1.2	0.8	2.1	1.7	3.3	2.8	0.3	-4.0	1.7	1.6	Euro zone
Germany	0	-0.2	1.2	0.8	3.4	2.7	1	-4.7	3.5	3.0	Germany
United Kingdom	2.1	2.8	3	2.2	2.8	2.7	0.1	-4.9	1.3	1.1	United Kingdom
France	1.0	1.1	2.5	1.9	2.2	2.4	0.2	-2.6	1.4	1.7	France
Italy	0.5	0	1.5	0.7	2.1	1.4	-1.3	-5.2	1.2	0.6	Italy
Spain			3.3	3.6	4.0	3.6	0.9	-3.7	-0.1	0.8	Spain
Emerging countries	4.4	5.7	7.2	6.8	7.6	7.9	5.6	1.9	7.1	5.8	Emerging countries
Emerging Asia	6.5	7.1	7.9	8.3	9.2	10.1	6.9	6.2	9.3	7.5	Emerging Asia
Latin America	0.5	1.9	5.9	4.5	5.6	5.6	4.2	-1.7	6.2	4.5	Latin America
Emerging Europe	4.0	4.6	6.9	6.0	6.6	5.7	3.0	-4.1	4.4	3.9	Emerging Europe
CIS	5.3	7.8	8.1	6.8	8.2	8.6	5.5	-6.6	4.5	4.4	CIS
Middle east	2.5	6.3	6.9	6.2	5.8	5.4	5.7	1.3	4.0	4.1	Middle east
Africa	6.3	6.4	6.0	6.0	6.9	7.0	5.7	1.6	4.6	4.9	Africa
China	9.1	10.0	10.1	11.3	12.7	14.2	9.6	9.2	10.7	9.0	China
India	3.8	8.5	7.5	9.5	9.6	9.3	6.8	8.0	8.6	7.8	India
Brazil	2.7	1.2	5.7	3.0	4.0	5.7	5.2	-0.6	7.5	4.0	Brazil
Russia	4.7	7.3	7.2	6.4	7.4	8.1	5.6	-7.9	4.0	4.5	Russia
World trade	3.4	5.4	10.3	7.0	7.4	7.3	2.8	-10.7	14.5	5.0	World trade

Euro zone

Country risk assessment
is downgraded in a
context of defiance and
deleveraging

Country risk assessment changes

Germany

A2 country risk assessment removed from positive watch list (since December 2009)

The recent trend towards improvement in corporate financial health could stall with a marked growth slowdown expected in coming months. Despite the good economic environment prevailing in the country, resilient domestic demand will not suffice to fully offset the downturn in demand from abroad.

The economy has slowed considerably and will be unlikely to even begin to recover before spring next year at the earliest

In the second quarter this year, the economy expanded 0.1% compared to the previous quarter. That slow growth was attributable to a decline in household consumption, doubtless affected by the rise of prices, and to a negative contribution from foreign trade with imports growing at a faster pace than exports as a result of both restocking by companies and energy purchases in the wake of the shutdown of nuclear power plants.

Although the economy will likely make some progress in the third quarter, it could contract slightly this winter. This outlook is borne out by the results of the September 2011 IFO and MARKIT/PMI surveys of companies in industry, services, and construction, which showed that while current conditions were still good, the out-

look was deteriorating: Although no longer growing, the economic base nonetheless remains strong. But expectations for the coming six months in all economic sectors, except retail, have, however, been deteriorating implacably since early in the year, duly reflecting the slump in new orders.

The IFO business climate index fell from 115.4 in February 2011 to 107.5 in September. And the MARKIT/PMI index was down to 50, its lowest level in two years, reflecting a balance between positive and negative opinions. In the ZEW survey of financial market actors, meanwhile, 95% of respondents consider the present conditions good or normal and 52% rate the outlook as poor. Despite the recent deterioration, the results of these surveys nonetheless remain higher than they were when the 2008/2009 crisis was going full blast.

The foreign trade contribution could become slightly negative

For exports, which generate 50% of GDP, the road ahead will not be as smooth as it has been. Demand from the euro zone has already declined with exports to that market representing 21% of GDP. Demand from emerging countries, however, which absorbs 37% of Germany's exports including 6% by China alone is only expected to weaken slightly, which will provide a cushion particularly for capital goods manufacturers. Concurrently, imports will slow but to a lesser degree thanks to the continued strength of investment and consumption. The overall foreign-trade contribution to economic growth could become slightly negative.

In a context of relatively accommodating fiscal policy enabled by the success in bringing the deficit down to about 1%, domestic demand will likely hold up better than foreign demand

The completion of the restocking process and the decline in public spending will be offset by the strength of private investment and consumption. Corporate investment will derive support from the high level of capacity utilization rates and the large influx of new orders recorded in past months that now have to be filled. Residential construction will likely continue the moderate recovery it initiated in 2010. The deceleration of prices, further wage increases, and a continuing bright job picture will tend to limit any loss of confidence by households whose consumption spending will continue at a steady pace in consequence. The GfK consumer survey in September 2011 brought out

the still high level of expectations on incomes and future spending as reflected by the composite confidence index (5.2 from 4.4 a year ago), albeit down slightly from previous month. The Markit survey of retailers bears out the favourable trend.

The improvement trend in corporate profitability will doubtless come to a halt and do so without recovering to the levels prevailing in Germany before the crisis

Neither the number of bankruptcy proceedings nor the amount of the claims filed in consequence is expected to surge, however, with German companies in better financial shape than they were before the crisis and the economy unlikely to undergo a downturn comparable to the one suffered in 2008-2009. Access to bank financing is described as restrictive by only 22% of the companies surveyed by IFO in September. But the downturn that appears to be getting underway in manufacturing may augur a credit crunch.



Country risk assessment changes

Austria

A2 country risk assessment removed from positive watch list (since December 2009)

The recent trend towards improvement in corporate financial health could stall with a marked growth slowdown expected in coming months. Despite its resilience in a somewhat restrictive fiscal context, strong domestic demand alone will not suffice to fully offset the downturn in demand from abroad.

After an excellent first half the outlook for the rest of the year appears dimmer

Quarter-on-quarter, the economy grew 1% in the second quarter, up from 0.8% in the first quarter. And compared to the same quarter last year, the economy grew a solid 3.7% in the second quarter 2011 down slightly from 4.2% the previous quarter.

With the external environment becoming less buoyant in the second half, however, the economy will suffer a marked slowdown that domestic demand will be unable to offset. According to the latest surveys of corporate and household sentiment, confidence has been trending down. But this decline can nonetheless not be compared with the abyssal downturn of 2008/2009.

Exporters will suffer in an environment lacking buoyancy

Austria enjoys close trade and industrial ties to Germany and its exports to this large neighbour represent 10% of GDP. Via the integration of Austrian products into German exports, Austria has benefited from the dynamism of demand from emerging countries. As a result of the slowdown in foreign demand, sales abroad will be less dynamic. With the slowdown expected to affect less imports than exports, the net foreign-trade contribution to economic growth will decline. The widening trade deficit will not, however, prevent the current account balance from remaining substantially in surplus.

The pace of corporate investment will slow

The sluggishness of exports, the stagnation of industrial production, and the loss of confidence will prompt

companies to drop some investment projects. They will also be likely to reduce their now largely replenished stocks. Spending in the construction industry will remain steady.

Household consumption will continue to trend up very moderately

Real income per capita declined this year amid a surge of inflation. The domestic price inflation reflects the increases in prices for raw material and energy as well as in indirect taxes and rent. Wage increases, meanwhile, have been moderate. The decline in unemployment and the creation of jobs could slow.

The fiscal context has remained relatively restrictive

In the wake of statistical adjustments intended to integrate investment in railroad infrastructure, operating costs of regional hospitals and costs associated with the KA Finanz defeasance structure, the public debt and deficit increased, albeit remaining at sustainable levels. In this context, a modest fiscal adjustment plan underpinned by an agreement between the Federation, federal states, and local communities was adopted late last year. It essentially calls for the institution of a levy on banks and higher taxes on cigarettes, fuel, and airplane tickets. Despite these light measures, the deficit is expected to ease to 3% by next year.

Further reduction in the bankruptcy rate will likely be impeded by a tighter access to credit amid deteriorating economic conditions. A return to the level of bankruptcies prevailing before the crisis will thus be unlikely this year.

Country risk assessment changes

Belgium

A2 country risk assessment removed from positive watch list (since December 2009)

The recent trend towards improvement in corporate financial health could stall with a marked growth slowdown expected in coming months. Resilient domestic demand will not suffice to fully offset the deterioration in foreign trade. The final resolution of the federal political crisis constitutes a source of uncertainty particularly as regards fiscal policy.

The strong domestic demand will nonetheless be likely to compensate to some extent for the slowdown in sales abroad

After excellent economic performance in the first half of this year, a marked slowdown has developed in the second and the economy is expected to operate at a slow pace until mid-2012. The disappearance of a positive contribution to growth by foreign trade will only be partly offset by the strength of domestic demand. The drop in CEO confidence in Q2 and Q3 this year lends credibility to that trend analysis.

In the 2011 first half, exports continued to benefit from the boom in Germany, Belgium's main trading partner. But they will slow considerably in the second half, dragged down by the souring economic conditions prevailing in Europe. Imports will also decelerate but at a slower pace thanks to the strong domestic demand: the foreign trade contribution to economic growth will thus likely become slightly negative in consequence. The current account will continue to show a surplus albeit smaller than in the past.

The pace of investments will be moderately slower. For companies, it will be buoyed by the return of the capa-

city utilization rate to its historic average level and by the improvement in profitability. As for the public sector, investment will benefit from the prospect of local elections in 2012. The moderate recovery of spending on housing will continue.

Household consumption will grow at a slower pace. Indexed wages will somewhat offset a contracting credit and a likely tightening of fiscal policy necessitated by a public sector debt representing 95% of GDP. The trend towards an improving job picture will stall temporarily.

A process of public sector financial consolidation initiated this year

The rescue of several banks, the effect of automatic stabilizers, and the stimulus plan, all came at a high cost to public finances. The fiscal deficit soared in 2010 while the debt – after being reduced to a level representing just 90% of GDP against 138% in 1993 – verged on 100% of GDP.

Despite a caretaker government since April 2010, the medium-term consolidation programme has started with the 2011 budget.

The consolidation will depend on resolution of the political crisis

Tough measures will have to be taken to reach the objective of wiping out the deficit by 2015. All the more with the rescue of Dexia which is going to cost the Belgian state 4 billion Euros, under the nationalization of the Belgian retail banking activity. Belgium will also provide a guarantee for 60% of risky assets (estimated at 90 billion Euros) to be placed in a “bad bank”.

Even though federal political problems have little impact on the economy, and a substantial portion of economic policy falls under the responsibility of federated entities, this implies the resolution of the federal crisis. The debt is essentially federal as is the case for taxes and social security.

The draft agreement signed in early October 2011 between the Flemish and Walloon political parties, prior to the formation of a coalition government, focuses on the devolution of further powers to the federal entities, especially in social matters, transfer to the regions of a quarter of taxes, the split of

Brussels-Halle-Vilvoorde constituency complemented by an agreement on the participation of suburbs to the financing of Brussels. The adoption of this agreement by Parliament should finally allow the formation of an elected government and facilitate the adoption of 2012 budget directed at fiscal consolidation.

The trend towards improvement in corporate financial health will run out of steam

Belgian companies suffered in the crisis. Despite the stabilizing of social contributions, their operating income declined on average a cumulative 30% from its level in 2008-2009, which admittedly had increased twofold in the preceding five-year period. This weakening of corporate earnings performance has resulted in an annual increase in bankruptcies of about 10% in both 2008 and 2009. The improvement recorded in average operating income recorded last year resulted in a slight slowdown in the number of companies filing for bankruptcy in 2010. The current economic slowdown may now cut that improvement trend short.



Country risk assessment changes

France

A2 country risk assessment removed from positive watch list (since December 2009)

After strong growth in the first quarter this year, up 0.9%, GDP was steady in the second quarter. Investment weakened slightly, up 0.9%, but household consumption, which represents 58% of GDP, began to slump, down 0.7%. Imports declined 0.9% while exports were flat.

Household and corporate confidence plummeted in September. Household morale was down five points from its level in July reaching its lowest point since February 2009. During the same period, the business climate fell eight points to an index reading of 97 below its long-term average of 100. The economic downturn indicator, trending down slightly since April, now clearly reflects a gloomy outlook across all sectors.

The sagging confidence against a background of crisis in the euro-zone, tightening fiscal policy, and slumping world trade augurs sluggish growth through year end with growth up at best about 0.2% a quarter. Investment, which has shown some resilience until now, could suffer from the wait-and-see stance of companies in coming months.

In such conditions, we expect full-year growth of 1.7% for 2011. Household consumption will gain about 0.7%. Public consumption (25% of GDP) will slow further (up 0.8%). And goods & services exports will follow a similar pattern (up 4.4%). Based on our hypothesis, investment will likely gain 3%.

According to Coface monitoring records, meanwhile, payment delays have been rising again, especially in the construction sector.

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.

After surging in the first quarter of 2011, growth will slow through year-end

Annual growth is expected to be slightly higher on average in 2011 with investment benefiting from a re-stabilization. GDP surged in the first quarter. Consumption was stronger compared to the previous quarter. Corporate and public investment spending increased. Stock variations also made a substantial contribution to economic growth. Conversely, the trade balance deteriorated as a result of the rebound in imports. The recovery peaked, however, early in the year. And GDP was flat in the second quarter. This disappointing performance was largely due to the expiration of the scrapping incentive (whose lingering effects were perceptible in the first quarter) and the lack of stock variations. Household consumption declined and investment decelerated slightly. Meanwhile, imports contracted and exports were flat. The decline in household and corporate confidence as summer ended against the background of the euro-zone crisis, fiscal policy tightening, and world trade slowdown augurs anaemic growth for the rest of the year. Investment, which has proven resilient thus far, could suffer from the wait-and-see stance taken by companies.

Still weak financial position and erosion of market share

Corporate financial health, particularly cash flow, has yet to return to the levels prevailing before the fall 2008 crisis. With companies remaining weak, credit conditions could tighten once again. From a structural viewpoint, French companies in general are not very innovative and do not export enough apparently as a result of the lack of ambition rather than for reasons of competitiveness. With only a limited presence in

emerging countries, they fail to benefit sufficiently from the economic dynamism of those markets. Despite tighter profit margins, French industry has thus been losing market share.

A continuing decline in bankruptcies but worsening payment behaviour and a drop in creation of new companies

Although payment incidents recorded by Coface began to decline in summer 2009 and fell to low levels by end 2010, late payments have been rising since early this year, particularly in the construction sector. Although the bankruptcy rate has moreover remained high compared to pre-crisis years, it has nonetheless been easing since September 2010: The number of bankruptcies declined 3.4% in 2010 and 3.5% in the first half of 2011. The cost of the bankruptcies to suppliers, trending down since fall 2009, declined even more, down 11% % in the first six months of 2011 after falling 22% in 2010. But bankruptcies have not declined in five sectors notably including means of transport, food, and distribution. Conversely, in pharmaceuticals, energy, and agriculture/fishing, which had suffered most a year ago, the failure rate has declined sharply. Meanwhile, the decline in new company creation recorded since the 2010 second half (down 5% a year) accelerated in the first half this year (down 20%).

Country risk assessment changes

The Netherlands

A2 country risk assessment removed from positive watch list (since December 2009)

Following good first-quarter 2011 performance, the economy slowed considerably in the second quarter. Investment stalled and consumption declined for the second straight quarter. Growth is expected to remain weak for the rest of the year amid sagging consumer and corporate confidence, negative wealth effects resulting from the fall of property and stock market prices, fiscal austerity and declining foreign demand. The foreign trade contribution to growth is likely to remain slightly positive due to the slowdown of imports. Expected growth for this year is 1.7%.

Marked slowdown in growth in Q2 2011

The economy improved in 2010 thanks to restocking, a rebound in exports, and a slight strengthening of investment. The recovery in household consumption nonetheless remained hampered by the decline in disposable income, in part linked to issues of solvency encountered by the pension funds, which have had to increase contributions while cutting benefits. Thanks to good first-quarter performance, including a strengthening of investment, growth is expected to remain positive in 2011. The economy slowed considerably in the second quarter; however, with investment stalled and consumption in decline for the second consecutive quarter. Growth is likely to remain weak for the rest of the year amid the erosion of consumer and corporate confidence, negative wealth effects resulting from the fall of property and stock market prices, fiscal austerity, and declining foreign demand. The foreign trade contribution to growth is nonetheless likely to remain slightly positive for the full year due to the slowdown in imports, and the country is expected to continue

to run a large current account surplus (about 7% of GDP). Under these conditions, its level of competitiveness still seems very acceptable.

A convalescent private sector and public finances on their way to recovery

With its large banking sector and open trade and financial policies, the Netherlands proved vulnerable to the international crisis. Highly exposed to American sub-primes in particular, Dutch banks suffered heavy losses that necessitated massive government intervention via injections of capital, nationalizations and the granting of government guarantees. Although Dutch companies came into the crisis in relatively good shape, that did not prevent them from suffering from the economic downturn and from their heavy dependence on bank credit, which was growing increasingly scarce. The explosion of bankruptcies in 2009 (up 74%) attests to the difficulty of the situation, although company failures declined in 2010 (down 10%) and in the first half of 2011 (down 8% in a year).

Moreover, due to the measures taken to bolster the economy and the drop in fiscal revenues, public sector finances are again in the red. The deficit remained high in 2010 due to the continued economic stimulus policy and higher unemployment, which (at less than 5% of the economically active population) still compares favourably with levels elsewhere in Europe. Government measures taken to consolidate public

finances starting this year are mainly focused on reducing spending (tougher eligibility rules for benefit entitlement, civil service staff cuts). The government also expects a slight increase in revenue from natural gas exports. The public debt burden grew slightly (63% of GDP in 2010) but remains below the European average.



Country risk assessment changes

Italy

Negative watch on the A3 country risk assessment (since March 2009)

The recovery began to give signs of running out of steam in the second half last year and the trend continued in the first quarter this year (up 0.1%). Although economic growth accelerated somewhat in the second quarter (up 0.3%), spurred by a rebound in industrial production, the economy will likely be flat in the second half. On average, GDP is expected to grow only 0.6% this year, down from 1.2% in 2010. As a result of the austerity policies implemented in the euro zone, demand from abroad will likely weaken with exports declining in consequence. Household income will suffer from the gloomy job picture and the rise of prices. The recent tension in financial markets will increase financing costs for companies. And the fiscal austerity measures taken last summer will of course affect private consumption and investment. Additional measures cannot moreover be excluded in case of new attacks by the markets on Italian debt. Expectations in that regard are reflected in recent confidence survey results. The Istat business climate index in September fell to its lowest level in 20 months.

According to Coface monitoring records, meanwhile, late payments have been trending up.

GDP growth undermined by the apathy in evidence throughout the economy

Already low in 2010, economic growth will slow even more this year. Apart from the upturn recorded in the second quarter of 2011 (up 0.3% from the previous quarter), the recovery has been waning since the 2010 second half. And performance in the 2011 second half and 2012 first half will likely bear out the lack of dynamism. The crisis appears to have durably undermined the country's economic potential. Exports and investment, crucial drivers of economic growth until now, will undergo a bout of weakness. Despite some gains in competitiveness attributable to the slow rise of payroll costs, the economic slow-downs suffered by the main trading partners will weigh on exports. Imports will also decelerate parti-

cularly in case of a decline in the cost of imported energy. The recently negative net contribution of foreign trade to growth will become neutral. External deficits will persist.

The already limited dynamism of corporate investment will throttle down even more. Already affected by overcapacity and the fact that corporate financial health is still not back to normal, it will be undermined by the tightening of credit and the increasingly sombre outlook. Investment in housing will likely fare relatively well thanks to the limited level of household debt and the extent of the needs. But public investment spending will likely be flat due to budgetary constraints.

Household consumption will remain sluggish. Unemployment will again exceed 8% with companies

focusing on restoring working time back to normal before taking on new hires. Real disposable income will not grow much amid persistent inflation, gradual ineligibility of wage-earners for the special insurance coverage set up for partial unemployment (Cassa Integrazione Guadagni), and frozen civil service wages. Income from informal jobs will not be easy to build up again.

Persistent concerns over public finances, fiscal constraints notwithstanding

Well aware of the already high level of debt (119% of GDP in 2010), the authorities pursued prudent stimulus policy: The deficit was held below 5% of GDP and is expected to ease to less than 4% in 2011 and to 3% by 2012 with a 2% primary surplus. Under pressure from the markets and the European Central Bank, however, two successive savings plans were adopted this summer with the objective of balancing the books by 2013. In addition to the freeze on civil-service wages, the plans call for a one per cent VAT hike, a withholding tax on incomes exceeding 300,000 euros, a tax increase on financial incomes, tobacco and gambling, in conjunction with a reduction in retirement pensions and a higher minimum retirement age for women. A reduction in transfer payments to regions and municipalities, savings on health spending and civil service operating budgets are also planned. The campaign against fraud will be intensified. Despite these measures and the limited size of the deficits, the Standard & Poor's rating agency lowered Italy's sovereign rating a notch to A while maintaining its negative watchlist status. Besides the enormous debt, the agency is concerned about the Italian economy's limited long-term growth potential, which will notably slow the deleveraging process. It moreover has doubts about Italy's capacity to implement all

necessary structural reforms. The political setbacks suffered by Silvio Berlusconi and his coalition in May and in summer this year with the loss of his Milan stronghold, the crushing majority of the electorate that voted no to the referendum on water, nuclear power, and the legal system, not to mention the legal difficulties besetting the prime minister and other public figures, could effectively slow the pace of reforms and give rise to early elections (otherwise scheduled in 2013).

Corporate financial health still fragile

Indices of payment incident frequency for Italy have traditionally been above average while corporate financial health, albeit improving, has in general remained fragile. After rising 25.5% in 2009 and 19.8% in 2010, bankruptcies increased another 10% in the first half this year. Renewing credit lines is both more costly and more difficult as banks strive to improve their profitability with a view to raising their capitalization rates. SMEs, already hit hard by the recession, are in the most delicate position. Some sectors have remained healthy, like food, pharmaceuticals and IT. And sectors like metallurgy, electrical equipment, machinery and textiles, appear to have weathered the serious difficulties caused by the crisis. Others, such as timber, paper, printing, rubber/plastic processing and transport equipment manufacturing, are still convalescent.

Country risk assessment changes

Portugal

Negative watch on the A4 country risk assessment (since March 2011)

The tightening of fiscal austerity suggests a recession of about 2% this year. The country fell back into the morass in 2011, with GDP registering contractions of 0.5% and 0.9% year on year in the first and second quarters. Domestic demand is in free fall. Only the decline of imports together with sustained exports has prevented the economy from contracting even more drastically. Household consumption and investment indicators continued to deteriorate early in the second half. This trend is likely to continue in view of the additional tax pressure, in an environment already marked by high household debt, significant unemployment, and sluggish credit. Coface has recorded a sharp increase in late payments.

An economy plunging back into recession in 2011 as austerity measures start to bite

Rising taxes in conjunction with reductions in social security benefits and civil service wages, as well as tighter credit conditions, had a negative impact on domestic demand in the second half of 2010, leading to a slowing of the economy from the last quarter. The tightening of fiscal austerity measures has plunged the economy back into recession in 2011. GDP fell in the first and second quarter year-on-year. Domestic demand is in free fall. Only the decline of imports together with strong exports has prevented an even more drastic economic contraction. The decline in household consumption has become significant while investment contraction is accelerating. The domestic demand indicators continued to deteriorate in July-August 2011. Only exports and tourism held onto positive territory. These trends are expected to continue over the coming quarters, especially given

the additional fiscal pressure. In an environment already marked by high household debt and significant unemployment (12% of the economically active population), consumption will continue to contract. Flagging demand, sluggish credit, weak profitability and weak company cash flow does not bode well for a pick up in investment. Moreover, foreign demand is expected to decrease slightly. Nevertheless, the contraction in purchases abroad means that the contribution of foreign trade to growth will remain strongly positive. The current account deficit could be reduced to a little less than 7% of GDP in 2011, having averaged over 10% in 2009 and 2010.

Macroeconomic imbalances which forced the country to seek international support

The cost of the initial measures of economic support, compounded by the impact of a severe recession, resulted in 2010 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. However, there has been a sharp rise in tensions in the Portuguese debt market, where interest rates have reached record levels. Following on the heels of Greece and Ireland, already beneficiaries of bailouts by Europe and the IMF in 2010, Portugal had no choice but to seek external support. And the country obtained a three-year loan of €78 billion (52 billion from the European Union and 26 billion from the IMF). Portugal successfully underwent a review of its austerity programme by its international funding partners last August, thus qualifying for the release of a third loan tranche. 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 opposition's refusal to ratify a new fiscal austerity plan prompted the socialist prime minister to resign. The elections in early June 2011 were won by the centre right, who must now pursue the austerity programme and implement reforms, at the risk of disrupting social cohesiveness.

Weakened companies

Coface has recorded a noticeable rise in late payments and bankruptcies are increasing more quickly. The sectors most affected included ready-to-wear clothing, textiles, leather, construction, and furniture. The slowdown 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 from the recession.

Country risk assessment changes

Cyprus

Country risk assessment downgrade from A4 (since June 2011) to B

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, around 0.3%. 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. Industrial production will be constrained in the second part of the year by the explosion in July of the Vassilikos power station that has taken out half of the country's electricity supply. 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. Yet, 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 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 households 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 wink 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. 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

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. 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 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.



Country risk assessment changes

Greece

Country risk assessment downgrade from B (since June 2011) to C

Greece will remain in recession in 2011 for the third consecutive year (down 5%). GDP contracted by more than 7% year on year in Q2 2011, after contracting by over 8% in the two preceding quarters. Consumption and investment are still falling with exports slightly in decline, even if foreign trade has been contributing positively to the economy due to the strong contraction of imports. Domestic demand will continue to be affected in coming quarters by the fall in real household incomes, rising unemployment, higher taxes, and tighter bank lending policy. The EU economic slowdown will continue to affect sales abroad.

Late payments recorded by Coface grew substantially in the first half of 2011. Meanwhile, relations have been strained between Greece and its international funding partners, critical of the time taken to implement fiscal measures and privatisations. The release of the sixth tranche of the loan granted to Greece in 2010 by the IMF and the EU has been postponed. Public debt is threatening to spin out of control and there is now a strong fear of a Greek default.

High risk of Greek default

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. However, this plan is not enough as the country is not in a position to return to markets, as envisaged, in 2012. The worsening economic, financial, and social situation has pushed long bond rates to record levels and creditors are increasingly sceptical, while Euro-

pean governments are still struggling to implement the measures agreed at the European summit of 21 July 2011, when a new Greece bailout plan was set at €160 billion, with private sector help involving, at this stage, a 21% haircut on Greek sovereign debt securities. Relations are strained between Greece and its international funding partners, critical of the time taken to implement fiscal measures and privatisations. The release of the sixth tranche of the loan granted to Greece in 2010 by the IMF and the EU has been postponed. In addition, the recession, worse than expected, further increases the budget deficit and public debt is threatening to spin out of control. Against this background, a larger Greek default is expected. Even if it is an orderly default, banks and Greek investors will have little resistance.

Lengthening recession

The decline in economic activity increased further in 2010 under the combined effect of low domestic, foreign and public demand. The recession continues in 2011 with GDP contraction reaching 7.3% year on year in the second quarter, after contracting 8.1% in the first quarter and 8.8% in the fourth quarter of 2010. Private consumption and investment continue to fall. Exports have declined slightly since the start of the year but foreign trade is still contributing positively to the economy due to the sharp drop in imports. Consumption is expected to shrink by approximately 7% in 2011, affected by the fall in real household incomes, higher taxes, and rising unemployment. Meanwhile, the drop in business confidence, higher corporation tax and tighter bank lending policies, themselves faced with a lack of liquidity and a rise in bad debts, will bring about a double-digit investment contraction for the third straight year. The EU economic slowdown (over 60% of sales) will affect exports. 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. Overall, the current account deficit is likely to continue to contract (expected to represent 8% of GDP in 2011) due chiefly to weak imports.

Companies finding it difficult to obtain 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 were significantly higher in the first half of 2011. The construction and retail sectors in particular have been weakened by the deterioration of domestic demand. Sea transport remains an economic strongpoint. Companies are bracing themselves for a shortage of finance. Greek banks are indeed skittish on lending to either households or businesses - all the more so where they had been excessively generous in the euphoric economic period. Annual growth in lending to business peaked at 25% in October 2008. This shrank to 7% in the first half of 2011.

Outside the euro zone

Bankruptcies
are trending up
in the United States,
whereas Iceland
is recovering a
positive growth

Country risk assessment changes

United states

A2 country risk assessment removed from positive watch list (since December 2009)

This move is based on the downward revision of economic growth to 1.7% in 2011. The economy weakened considerably in the second quarter with the macroeconomic data published in September, particularly indices of company and household confidence suggesting that the economy will remain very sluggish in the second half. And the ideological confrontation between Democrats and Republican is expected to prevent a vote by Congress on the entire jobs programme put forward by Barak Obama and consequently to undermine growth in 2012.

Economic growth was disappointing in the first 2011 half

Supported by very reactive fiscal and monetary policies in 2010, economic growth is expected to come to about 2.9%, driven by household consumption, re-stocking, and capital investments. But the deep-rooted trends that persisted throughout 2010 continued in the first half this year. Economic growth slumped in the first and second quarters (up respectively just 0.4% and 0.2% quarter-on-quarter), which prompted a downward revision of annual growth in 2011 from 2.2% in June to 1.7%.

Decline in household and corporate confidence

Growth in the first 2011 half was underpinned by the \$900-billion agreement concluded late in the year between the Republican Party and the Obama administration. This stimulus package, intended for households and companies alike, supplements the Federal Reserve's unconventional monetary easing measures (QE2) came to an end this past 30 June. The combined effect of the macroeconomic data released since September, the face-off by Republicans and Democrats this summer over the need to raise the federal debt ceiling, and the downgrading of the country's

triple-A credit rating by Standard & Poor's have driven household and corporate confidence to their lowest point since 2009. Several factors continue 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 114% in 2011), and maintaining their saving level (around 5% 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 6.6 months in August, 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 by 5%-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 arrear due prudence as long as demand has not really come back to life. Job creation remains low and unemployment high at over 9%. Exports, meanwhile, will still benefit from favourable dollar exchange-rates, even if the currency may appreciate once again due to its role as a safe haven. Sales abroad could also derive support from Asian demand (20% of sales), which would offset expected slowdown in

demand from advanced countries, which constitute a majority of the US export market. Foreign trade will continue meanwhile to make a limited but steady contribution to economic growth.

On 21 September, the Federal Reserve Bank announced \$400-billion in new monetary policy measures effective through June 2012. By selling from short-term holdings treasury bills with residual maturities between three months and three years and buying long-term paper with maturities between six and thirty years the central bank seeks to lower the yield curve and thereby make returns on long-term investments less attractive with the ultimate purpose of inducing households and companies to spend more now.

The announcement also included a series of support measures for the property sector.

The Obama administration meanwhile has proposed a vast, \$447-billion jobs programme for 2012 intended to increase household purchasing power (renewal of the extension of unemployment benefits to 99 weeks, reduction of payroll taxes) and spur job creation (reduction in employer payroll costs, funding of infrastructure projects). With the ideological debate over the reduction of public debt still going full throttle between the two diametrically opposed camps, the chances of Congress adopting the entire jobs programme appear decidedly slim.

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 slowdown 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.



Country risk assessment changes

Iceland

Positive watch on the A4 country risk assessment (since March 2009)

This move is justified by Iceland's success in implementing the IMF agreement signed in 2008: economic growth should reach 2.5% this year, underpinned by household consumption and corporate investment. Meanwhile the country has made considerable strides on improving its position on albeit still-high foreign debt. It has moreover consolidated the banking sector and resolved the dispute with its British and Dutch partners.

A major financial and economic crisis

Iceland suffered a major financial crisis punctuated by a growth shock of over ten points between 2007 and 2010: household disposable income fell sharply, their capital and financial assets shrank in value, and unemployment soared from 1% of the working population in 2007 to over 8% in 2010. In 2009 alone, corporate investment was cut back by over 50%. Exports conversely benefited from the sharp Icelandic krona depreciation in 2008 and 2009. To cope with its many major difficulties, Iceland turned to the IMF for support in 2008: The resulting agreement expired this past 31 August.

Economic growth has become positive again

Iceland's ordeal has blossomed into a success story. The objective of consolidating public sector finances has been achieved with the public deficit reduced from 8.6% of GDP to 4% and a public debt representing 100% of GDP scheduled to begin to come down next year. And the country's foreign debt, although inarguably still an inordinately high (251% of GDP), has nonetheless eased from its gargantuan proportions in 2008 when it represented 564% of GDP. Thanks to controls

on capital movements, the krona exchange rate has steadied with the currency now expected to undergo only a mild depreciation as those restrictions are gradually lifted. Although price inflation seemed about to be brought under control early in the year (1.9% compared to 12% in 2008), it surged to 5% in July, in phase with the rise of raw material prices. The central bank consequently tightened monetary policy for the first time since the crisis last August, setting its key rate at 4.5%. The three main banks (Glitnir, Kaupthing and Landsbanki) have been restructured and recapitalized: the first two, renamed Islandsbanki and Arion, are now owned by their creditors while the third is 80% state-owned.

Positive economic growth is expected to resume in 2011 with a 2.5% expansion expected to be driven by household consumption and corporate investment. Although exports will make only modest gains, imports will surge in phase with domestic demand. The current account balance will come back to a healthy position with a surplus representing about 2.2% of GDP after several years with deficits ranging from 10% to 20% of GDP.

Recovery bolstered by resolution of the Icesave dispute

The dispute involving the Icesave digital bank, a Landsbanki subsidiary, has been resolved: the United Kingdom and the Netherlands had demanded that Iceland reimburse British and Dutch depositors for losses suffered in the Icesave bankruptcy. After two settlement agreements were rejected in referendums held in March 2010 and April 2011, the Icesave parent company Landsbanki announced, perhaps in response to pressure exerted by Iceland's partners, that it had set aside the funds necessary for the reimbursements without calling on government financial support.



Emerging Asia

The political context
is stabilizing
in Thailand

Country risk assessment changes

Thailand

A3 country risk assessment removed from negative watch list (since March 2009)

The withdrawal of the negative watch is linked to the stabilization of the political situation after the elections of July 2011 and to the strong resilience of the economy to the global financial turmoil.

Persistent internal divisions after the July 2011 elections

The Puea Thai, led by Yingluck Shinawatra, the sister of former Prime Minister Thaksin Shinawatra who was deposed in a military coup in September 2006, achieved a decisive victory in the general elections held in July 2011. With the support of the rural population (2/3 of the population), the pro-Thaksin party won 265 of the 500 seats in parliament. As Prime Minister, Yingluck will face major challenges in governing a deeply polarised society and her government's economic-policy plans have already proved contentious. Yingluck is expected to implement a number of populist economic policies, which include a higher minimum wage and guaranteed rice prices. These proposals have been criticised as the return of fiscally unsustainable and market distorting. Thus, internal political divisions are expected to remain strong and the political cleavage could intensify in the run-up to the succession of King Rama IX, now over 80 and in poor health. A respected moral authority,

he has embodied political stability and continuity. The uncertainties surrounding the succession could further exacerbate the internal tensions in the country.

Satisfactory growth

After suffering a recession in 2009, the Thai economy achieved a significant rebound in 2010 thanks to the recovery of both foreign demand (especially from Asia) and domestic demand spurred by expansionary policies. Manufacturing (automotives, home appliances, capital goods) and construction (driven by infrastructure projects) performed well while services suffered from the slowdown in tourism (7% of GDP) and the decline in household confidence in the wake of the violent demonstrations in April-May 2010. Agriculture was affected by poor weather and a plague epidemic. Economic growth may weaken in 2011 amid tightening economic policies and the decline in demand from the main trading partners (United States, Japan, European Union). Economic activity will nonetheless remain at satisfactory levels. Private consumption will

benefit from an improved job picture and from the 5% increase in civil service wages scheduled to take effect in April 2011. Investment will moreover be buoyed by road construction and water distribution projects. Economic bottlenecks nonetheless persist: the investment rate is still too low and despite the projects announced, infrastructure development has been limited by postponement of reforms.

Solid financial position

After the improvement in public-sector finances in 2010 due to the exit of the stimulus plan, the fiscal deficit is expected to increase in 2011. However, the public debt will remain at sustainable levels.

Besides, the current account surplus declined in 2010 as a result of the recovery of imports fuelled by a rebound in domestic demand, a trend likely to continue in 2011. Thailand will nonetheless continue to enjoy significant financing capacity. Underpinned by large foreign exchange reserves (expected to represent 10 months of imports in 2011), the country will have the means at its disposal to defend the baht, even in the case of sudden capital flight.

The banking sector's weaknesses have eased as reflected by the decline in non-performing loans, the improvement in oversight, and the adoption of international risk management and transparency standards.





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