

Coface Country Risk Newsletter: Spring 2009

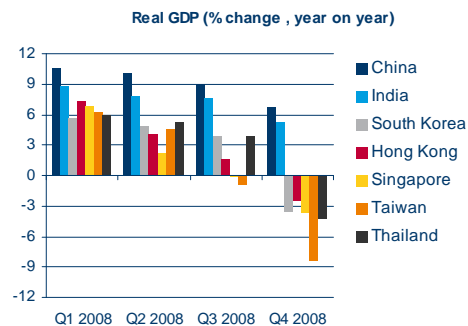
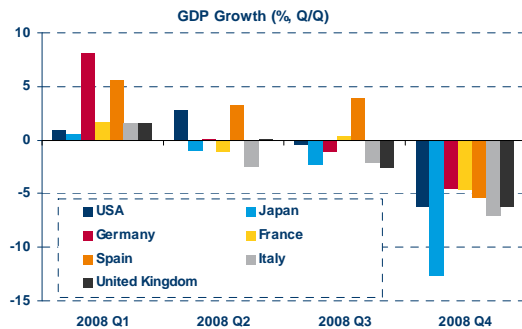
2009/2010 scenarios – A worsening crisis in the real economy

After a record economic downturn marked the fourth quarter last year, forecasters had to reconsider the severity of the recession expected in 2009. Here is our new scenario for growth this year and first estimate for 2010:

A spectacular growth downturn late 2008 ...

Severe declines in growth marked the fourth quarter last year with GDP in the major industrialized countries falling five percent year-on-year on average. For industrial production alone in the 2008 Q4 the contractions were even more pronounced, down nearly 10 percent in Spain, 7.5 percent in Italy, 7.0 percent in Germany, 6.0 percent in France, and 4.0 percent in the United Kingdom. And all demand components weakened. Consumption and foreign trade declined. But productive investment suffered the sharpest fall. It is now clear that companies played a pivotal role in last year's Q4 adjustment, reducing their order books virtually in concert and thereby triggering a generalised shock affecting both domestic and international demand.

And globalization has in some ways exacerbated the shocks. A catalyst of world growth in the expansion phase of the cycle — to a remarkable degree in emerging countries — but symmetrically it has tended to exacerbate the shocks in the current cyclical downturn. The systemic nature of the Lehman Brothers bankruptcy, attributable to the interconnectedness of banks, epitomises the phenomenon: the bankruptcy of a major player, counterparty to the vast majority of financial institutions, put money markets into gridlock throughout the industrialized world. Globalization also contributed to the severity of the adjustment in the real economy late 2008: companies reacted more quickly and virtually in lockstep with their decisions affecting companies worldwide via cross-border economic and financial flows. Fuelled by a severe contraction of industry and a drop in investment, the shock late last year had an impact on the payment incidents recorded by Coface, itself directly exposed — by the very nature of its business — to a sharp drop in B2B transactions.



... prompting a revision of the overall 2009 scenario

Last year's fourth quarter shock has thus led us to present a new scenario for 2009: **According to the new forecast world growth will sink to a negative 1.6 percent this year.**

COFACE	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	-1.6	1.8
Industrialized countries	1.1	1.3	1.8	3.1	2.4	2.9	2.4	0.7	-3.1	0.4
United States	0.8	1.6	2.7	4.2	3.2	2.9	2.0	1.1	-2.9	0.5
Japan	0.2	0.1	1.4	2.7	1.9	2.2	2.1	-0.7	-5.7	-0.1
European Union	1.8	1.1	0.8	1.7	1.5	3.0	2.6	0.8	-2.7	0.3
Germany	1.1	0.0	-0.2	0.6	1.1	3.0	2.5	1.3	-3.0	0.7
United Kingdom	2.3	2.1	2.7	3.3	1.9	2.8	3.0	0.7	-3.0	0.3
France	2.1	1.1	1.1	2.0	1.2	2.0	2.1	0.7	-2.0	0.3
Italy	1.7	0.3	0.1	1.2	0.1	1.9	1.4	-0.6	-3.0	0.5
Emerging countries	3.0	4.4	5.7	7.2	6.6	7.3	7.6	5.5	1.8	4.5
Emerging Asia	4.8	6.5	7.1	7.9	8.0	8.7	9.5	6.6	3.9	6.4
Latin America	0.2	0.5	2.0	5.9	4.5	5.6	5.6	4.3	-0.3	2.3
Central Europe	0.5	4.0	4.6	6.9	6.0	6.6	5.6	3.3	-0.9	1.9
CIS	6.1	5.3	7.8	7.9	6.7	8.2	8.5	5.5	-1.9	2.1
Middle East	2.3	2.6	6.6	6.3	5.6	5.4	4.7	5.7	2.6	4.6
Africa	3.4	6.3	6.4	6.2	5.9	6.5	6.7	5.4	2.2	3.8
World trade	0.1	3.4	5.4	10.3	7.0	7.4	7.2	4.1	-2.8	nd

◆ **Industrialized countries** will be marked by a synchronised recession in the three major regions — United States, Japan, and Europe — with the **recession totalling 3.1 percent overall**.

↳ **All demand components will contract in 2009.**

The fall of new orders recorded late 2008 will cause unemployment to rise in all industrialized countries. Choked by job losses, household consumption will slump everywhere. Easing inflation (0.7 percent in 2009 for the euro zone), even falling prices (down 0.7 percent in the United States and down 0.8 percent in Japan) will, however, contribute to limiting the decline in household spending.

At the world level, the volume of foreign trade will shrink 2.8 percent according to IMF forecasts. External demand will have a relatively uneven impact on growth in industrialized countries: In the euro zone and the United States the current account deficit will likely decline slightly (which translates to a positive contribution to foreign trade). Imports are expected to fall more sharply than exports. In the case of Japan and Germany, foreign trade will have a very negative effect on the overall economy: their current account surpluses could contract respectively 40 percent and 25 percent.

But productive investment will again be among the most recessive factors with all forecasters expecting it to undergo a severe decline in industrialized countries. In the United States, Spain and the United Kingdom, double digit declines are expected, fuelled by difficult access to credit and a loss of confidence associated with uncertainties over global demand. Closely correlated with world trade, domestic investment in Japan and Germany is thus expected to fall substantially, especially in Japan.

Consensus Forecast March 2009	Personal Consumption (% change)		Business Investment (% change)	
	2008	2009p	2008	2009p
United States	0.2%	-1.5%	1.7%	-15,0%
Germany	-0.1%	-0.1%	5.9%	-9,0%
Japan	0.5%	-0.8%	-3.9%	-15,0%
United Kingdom	1.6%	-2,0%	-4.3%	-10.3%
France	1.3%	0.2%	1.5%	-5.9%
Italy	-0.9%	-1.1%	-2.9%	-6.9%
Spain	0.1%	-3,0%	-3,0%	-10.9%

↳ **Although a recovery appears likely early 2010, it will be soft amid ongoing debt reduction by private economic agents.**

We expect the recession to stabilise late this year and a recovery to emerge early next year. The considerable efforts made by governments overall on both fiscal and monetary policy are expected to begin to take effect during the year. The fiscal deficit as a percentage of GDP will, meanwhile, increase sharply from 2008 to 2009, more than doubling on average in the euro zone from a negative 1.8 percent to a negative 4.2 percent and more than tripling in the United States from a negative 3.2 percent to a negative 10.8 percent.

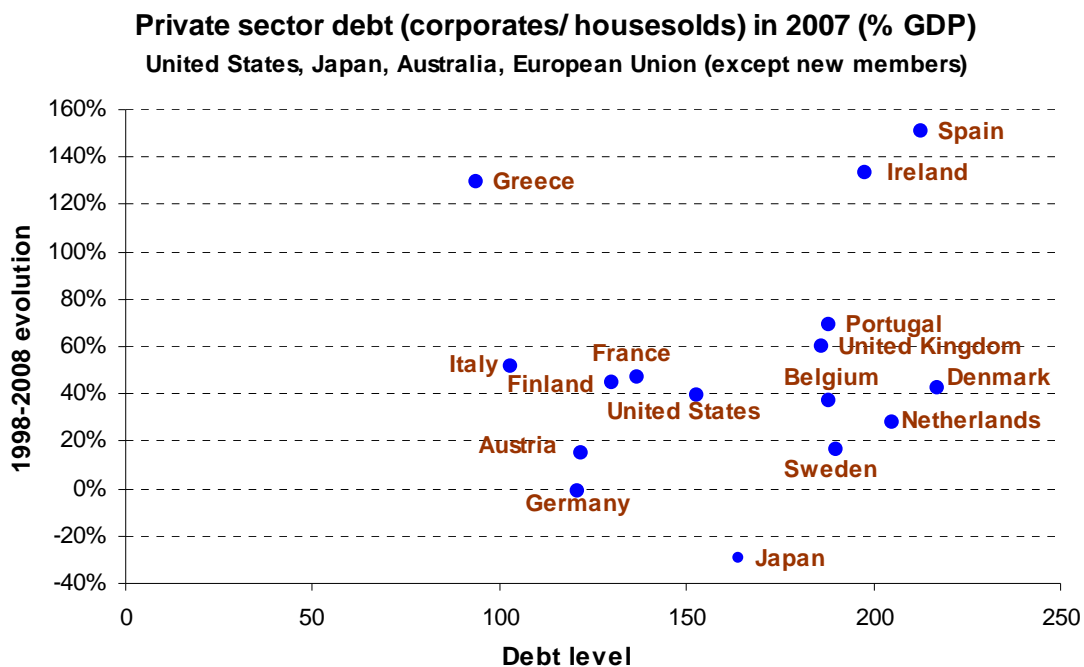
→ **A relatively moderate weakening of the dollar is expected in 2009.** The dollar appreciated from January through early March 2009 from 1.43 dollars to the euro to 1.25 before sinking back its current level of 1.36. And according to Natixis, it will likely continue to weaken, falling to about 1.45 dollars to the euro by year-end. Natixis expects a year-end interest rate differential of 0.75 bps, still favourable to the euro albeit in decline with the Fed stabilising its key rate at 0.25 percent and the ECB cutting its key rate from 1.5 to 1.0 percent in spring 2009. Differentials in growth and the current account balance trend — based on available projections — provide little visibility on prospective exchange rate trends: little difference is expected in the severity of the recessions in the respective regions with both US and EU current account deficits likely to narrow moderately. The more substantial growth of the US public sector deficit could exacerbate risk aversion on dollar-denominated sovereign assets. Pressure on long rates and a decline of the dollar thus appear likely consequences. But the role played by China will have a mitigating effect with the change in monetary policy by China's Central Bank and the yuan's resulting stability against the dollar since the 2008 fourth quarter tending to limit the downward pressure on the dollar. And China's continuing current account surplus fuel's the Bank of China's appetite for US treasury bills. *As a result a moderate depreciation of the dollar against the euro is the most likely scenario.*

→ **A 45-dollar average price for oil is our hypothesis for 2009.** The economic downturn and the drop in demand caused oil prices to fall in the 2008 second half with the price per barrel of North Sea Brent spiralling down from a peak of \$143 on 15 July to \$36 on 29 December. To avert a total collapse of prices the countries in the OPEC cartel — representing 41 percent of world supply on 31/12/08 — decided to reduce the supply they bring to the market by 4.2 million barrels a day starting 1 January 2009, an 11.6-percent reduction from the level of production in the third quarter last year. Relatively good compliance (about 80 percent) with that decision made it possible to stem the fall of barrel prices, which have remained between \$40 and \$45 with the average price per barrel of Brent reaching \$43 on 13 March. And to avoid putting additional pressure on the world economy, the cartel decided on 15 March not to make further cutbacks in production. In this context barrel prices could average about \$45 for the full current year. With a demand recovery expected to emerge late 2009 barrel prices could rise to about \$55 but with the upward trend moderated by uncertainties surrounding the recovery of the American economy.

As a result neither a marked strengthening of the dollar nor a sharp decline in raw material prices is expected. **Private demand in industrialized countries will play the pivotal role in world growth in 2009 and 2010**

- **The level of household and corporate debt must come down in 2009 and 2010.** The 2001 crisis can be considered to mark the end of a cycle of excessive build-up of debt by US companies. But while they reduced their debt from late 2000 until 2004, American households went deeper into debt during that period. Then, from 2004 to 2008, both categories of economic actors were in a phase of growing debt. The euro zone and UK economies have overall been following a comparable cycle albeit not as marked in the euro zone. With all economic agents thus on the high side of the debt cycle in 2008, companies will be unable to pick up the slack for households in 2009.

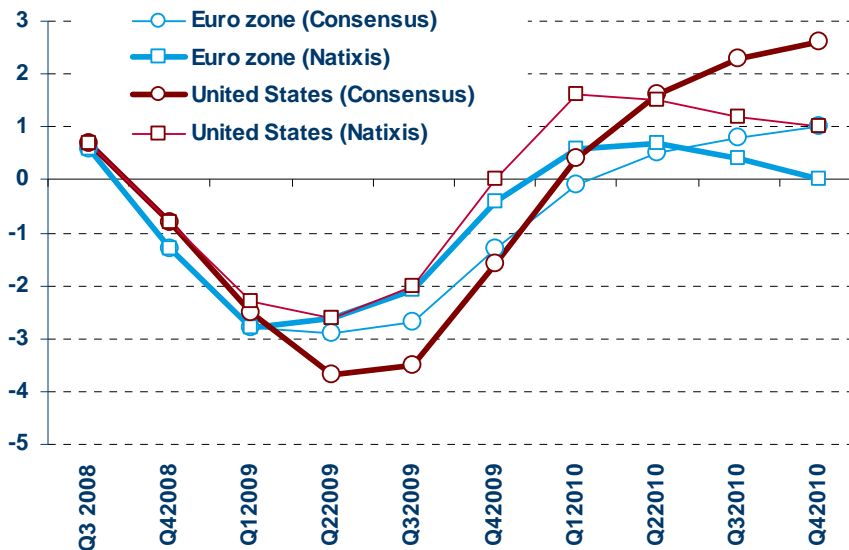
- **And a high proportion of the dynamic growth recorded from 2001 until 2008 in the United States, Spain, and the United Kingdom is attributable to growth of private debt.** Once the cycle begins to flag, the part of dynamic growth underpinned by the growing debt of private agents will disappear giving way to a cycle of debt reduction that could last several years. The resulting situation is naturally not the same for all countries as shown in the chart below, which relates the growth of private debt (households and companies) between 1998 and 2008 and the ratio of private debt to GDP in 2007:



The “growth dynamic/debt level” combination is particularly nettlesome in Spain, Ireland, Portugal, and the United Kingdom. Although the United States seems to be in an intermediate situation, the moderate debt burden of companies (50 percent of GDP reflecting the four-year cycle of debt reduction between 2001 and 2004) contrasts with the very high level of household debt (110 percent of GDP). The same applies to Denmark. In Portugal, both households and companies have very high debt, representing 100 percent of GDP for each actor category.

This chart suggests that many countries will prove unable to achieve respectable growth rates without first purging the debt burdens. But such purges often take years to accomplish. Japan and Germany are a case in point, countries where the total debt burden did not undergo anything like the expansion experienced by many industrialized countries these past years. On the contrary, it declined for both German and Japanese households and even contracted sharply in the case of Japanese companies. Even if the stock of outstanding debt has remained high in Japan (160 percent of GDP), it was the dynamic of the debt that affected economic growth and contributed to its sluggish performance: **debt reduction translated to sluggish domestic demand over the past ten years**. For each of these two major economies it appears likely that the recovery will depend less on a debt reduction process than on the dynamic operating in the rest of the world economy. The slow emergence from the debt reduction process in countries like the United States, Spain, and the United Kingdom will weigh on the export dependency of countries like Germany and Japan neither of which possesses the domestic resources capable of driving an economic rebound.

On balance in 2010 world growth will likely reach 1.8 percent with a very soft recovery in industrialized countries (0.5 percent) and a more marked recovery in emerging economies (4.5 percent). The views of forecasters on the shape of the recovery in 2010 are relatively divergent at this juncture. The IMF’s expectations for 2010 seem zeroed in on a year characterised by soft economic activity in industrialized countries. But the Consensus economists appear very optimistic as to the United States’ capacity to rebound. Some economists, conversely, expect economic activity to slacken late 2010. And we are sticking with our main scenario of recovery, albeit soft, in 2010.



2010 forecasts	United States	Euro zone	Japan
IMF	0.2	0.1	-0.2
Consensus	1.7	0.5	0.7
Natixis	1.3	0.5	0.8
Coface	0.5	0.3	-0.1

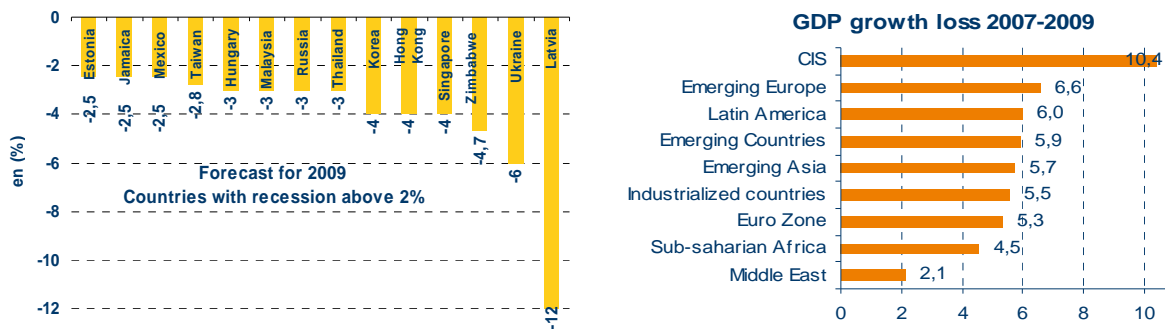
◆ **With the crisis no longer sparing emerging countries from harsh treatment, various shocks will affect companies in those countries this year.**

The growth of emerging economies will likely fall to 1.7 percent in 2009 with the recovery shaping up for 2010 likely to be sharper — 4.5 percent — than that expected in mature economies. But emerging countries overall will be unable to resume economic growth at the rates achieved from 2004 through 2006: seven percent on average.

The main financial risk facing emerging countries meanwhile is associated with private debt service. According to JP Morgan, in 2009, emerging companies will have to repay a total of USD 200 billion on their foreign debt including syndicated loans, commercial loans, and eurobonds. This debt service tends to undermine the financial health of many countries that have just financed their current account deficits by increasing private debt that they must now repay and that they will have difficulty refinancing given the conditions currently prevailing in the market. For short-term company-to-company transactions, the situation has thus been tense in emerging economies.

Companies in emerging countries will suffer from the repercussions of three major shocks:

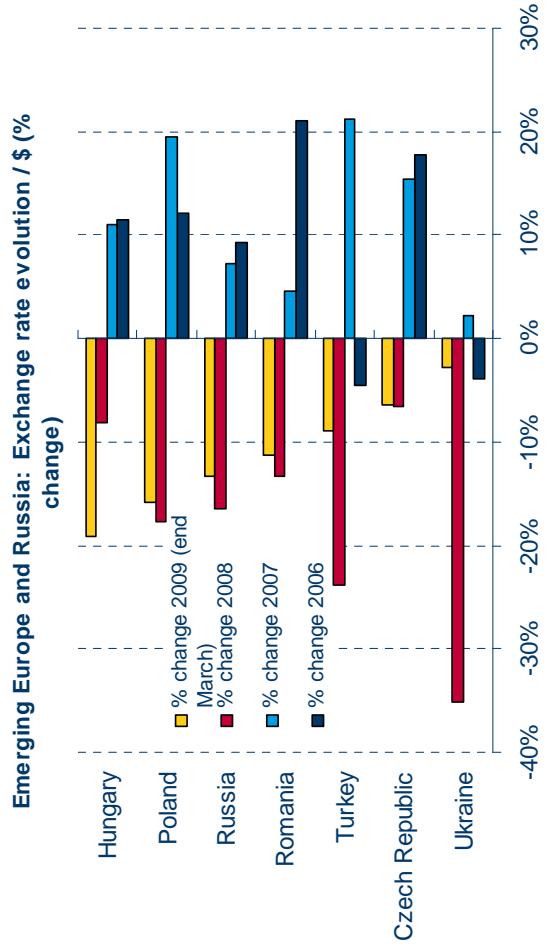
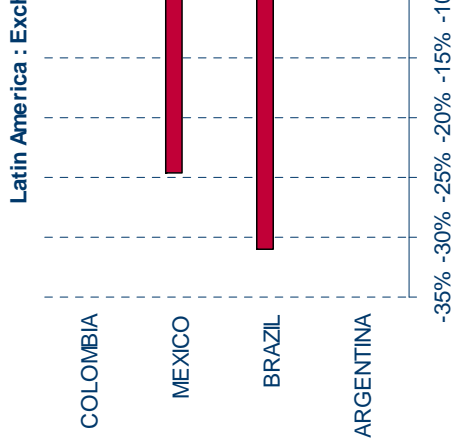
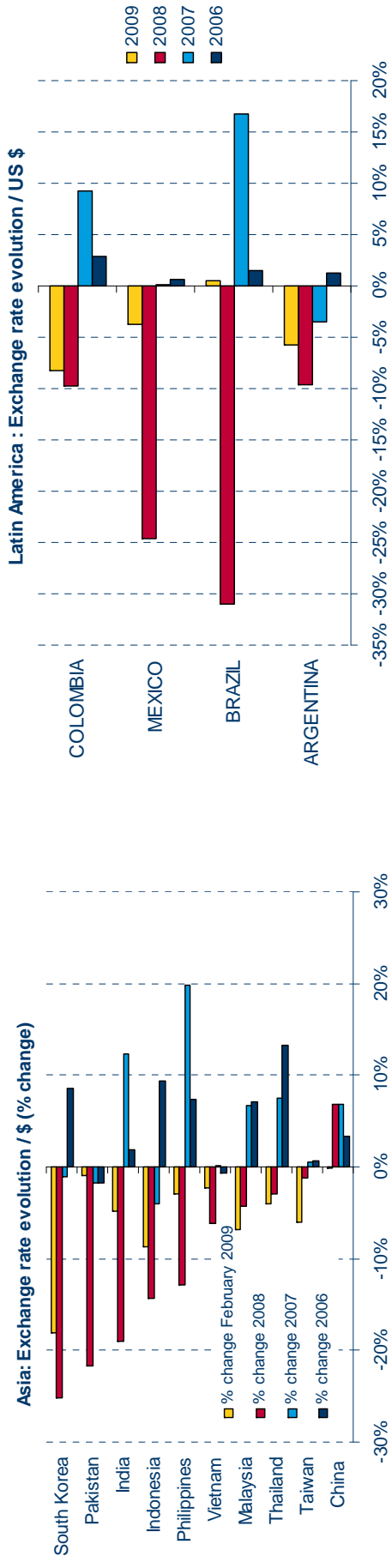
➔ **Substantial loss of growth and in some cases recession**



As these charts show, the loss of growth will be very substantial in emerging regions. In the case of the CIS and emerging Europe, some of the growth achieved these past years is attributable to the creation of an indebtedness and credit bubble, which burst and contributed to the crisis. The region will thus be particularly slow to emerge from the crisis with its growth limited, according to our forecasts, to 1.9 percent in 2010 (after a 0.9 percent recession in 2009), undermined by the impact of debt reduction by companies and households on domestic demand. In Asia, countries with very open economies have particularly suffered from the world economic downturn. China and India will achieve relatively strong growth this year, respectively 6.5 and 5.0 percent. Without those two giants, Asia would, however, suffer a one percent recession compared to positive 3.7 percent growth with China and India included (66 percent of emerging Asian GDP). With a relatively closed economy India has not suffered in a pronounced manner from the contraction of world trade. As for China, speedy implementation of highly expansionary economic policy — both monetary and fiscal — will likely facilitate efforts to limit the slowdown. But even for the very open Asian economies, it is generally believed that a growth rebound will come sooner than later, provided external demand strengthens. A recovery is thus expected in 2010: 6.4 percent for emerging Asia and 3.8 percent excluding India and China.

➔ **Emerging currencies exposed to depreciation risk.**

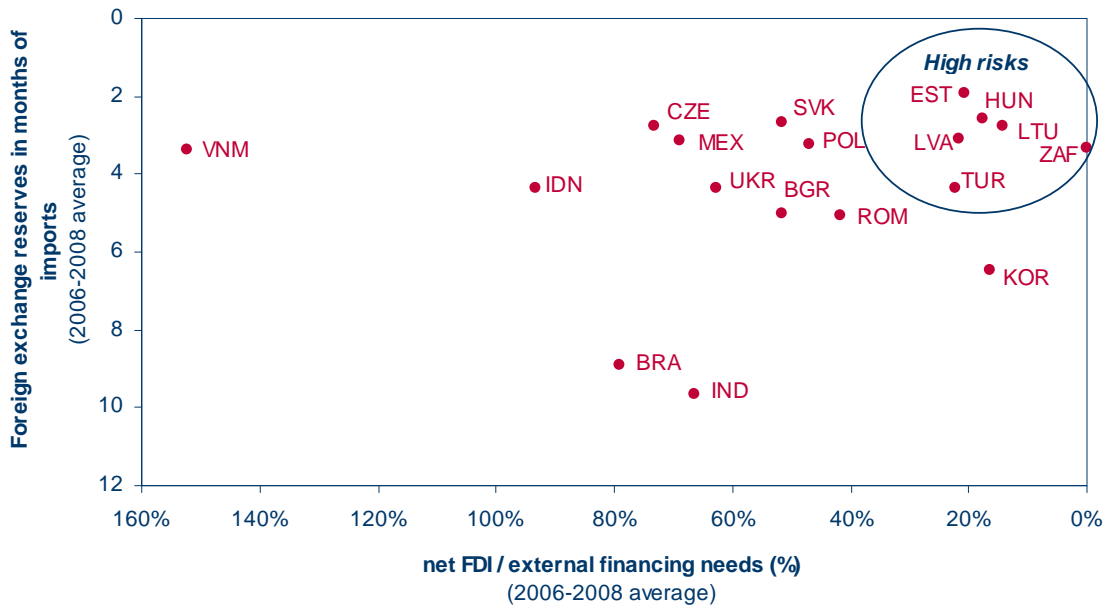
In the wake of the Lehman Brothers bankruptcy in September 2008 the flight of capital and rush to dollar liquidity triggered a spectacular weakening of emerging-currency exchange rates: down 15 percent on average for the 28 largest emerging countries for all of 2008. Other mechanisms went into action in the wake of capital flight early 2009: rapid deterioration of current account balances thus also played a role with exports undermined by the contraction of demand from industrialized countries.



Over the full current year, it remains uncertain whether the overall impact of current account balances on exchange rates will spur depreciations: recessions have led to reductions in current account deficits in many countries, particularly those with the most severe economic imbalances like Ukraine, the Baltic states, Romania, or Bulgaria. But the foreign currency-denominated debt service paid by companies (and households) has, however, undermined demand not only in Eastern Europe but also in South Korea and Brazil. In emerging Europe, the foreign debt service burden is, moreover, compounded by that of domestic debt service due to the high proportion of euro-denominated loans. But, in the pervading atmosphere of recession, the main risk is the possibility that a flight of non-resident capital associated with the growing aversion to risk will be succeeded by **a crisis of confidence among residents** with expectations of an impending fall of exchange rates thus becoming self-fulfilling. That is notably the case in Russia where pressure is exerted on the rouble not only by demand for foreign currency from companies and banks with very large repayments coming due but also by re-dollarization of resident savings.

A mapping of the liquidity risk — relating the level of foreign currency reserves (in proportion to imports) to the stock of stable capital (direct investment) — associated with a country's foreign currency financing needs shows emerging Europe at peak risk levels.

External financing channel
(vulnerability to a foreign capital shortage)

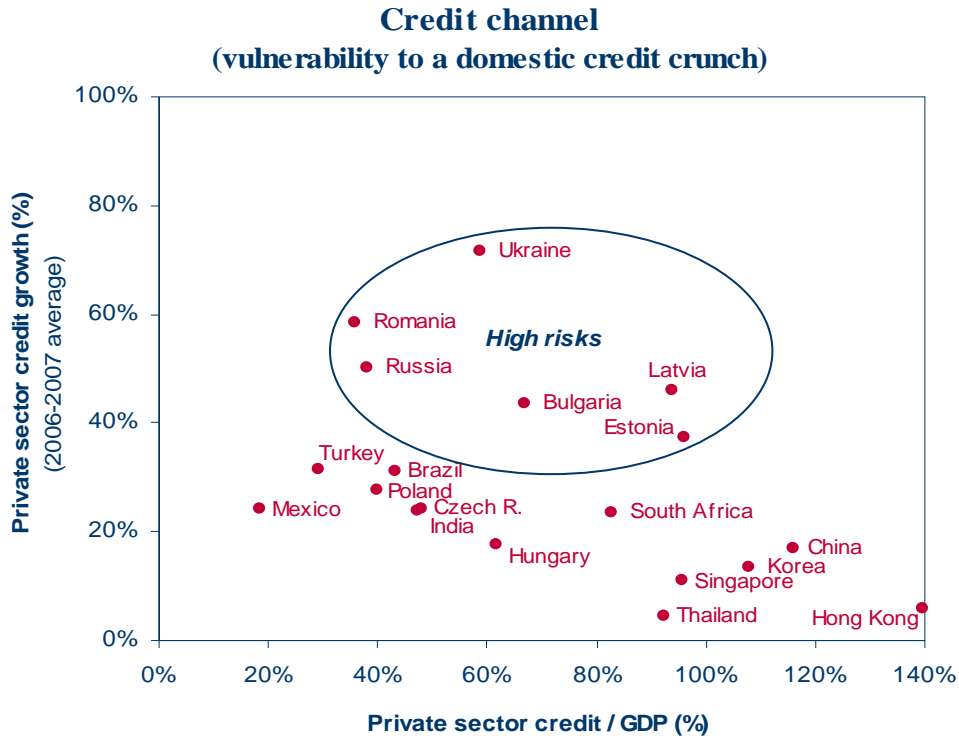


Countries appearing on the upper right of the chart have limited reserves and limited stable capital to finance their economic imbalances. Their exchange rates are thus very shaky. **This is true for South Africa, Hungary, the Baltic states, and Turkey.** It is noteworthy that for the Baltic states that the severe pressure apparent on the chart will be exerted on a very rigid exchange rate regimes. It seems highly likely that with the benefit of multilateral financial aid the Baltic countries will succeed in maintaining their exchange rate peg (which will ultimately serve them as an instrument of transition to the euro). But on the flipside that means the economy will have to absorb the full impact of the adjustment made necessary by the capital flight. **The recessions expected in the three countries will be all the more severe and durable (with a 12 percent recession expected en Latvia and 2.5 percent in Estonia).**

The Polish zloty, Brazilian real, and Turkish lira fell sharply in 2008, down respectively 18 percent, 31 percent, and 25 percent. But exchange rates tend to be all the more volatile the more flexible the regime that governs them — that is, when the central banks are reluctant to intervene to defend them — which is the case for these three important currencies. For Turkey the prospect of an IMF agreement (currently under negotiation) has improved the outlook for the lira but will in no way guarantee the absence of volatility in 2009. Any rumour of delays in payment of IMF tranches could rattle investors and trigger a new wave of capital flight. And with Romania just signing a \$20 billion agreement on 25 March almost every country in the upper part of the chart currently benefits from IMF aid.

➔ Risk of a domestic credit crunch compounded by an international credit crunch

Many emerging countries experienced strong growth of domestic credit often financed by non-resident loans (by foreign banks) to local banks — often subsidiaries of those foreign banks — or to companies. Examination of data on domestic credit alone (loans extended by resident banks) **reveals the presence of speculative credit bubbles in many emerging European economies**. The following chart shows the relationship between the credit dynamic (annual growth of lending to the private sector) and the level of financial intermediation (lending to the private sector in proportion to GDP).

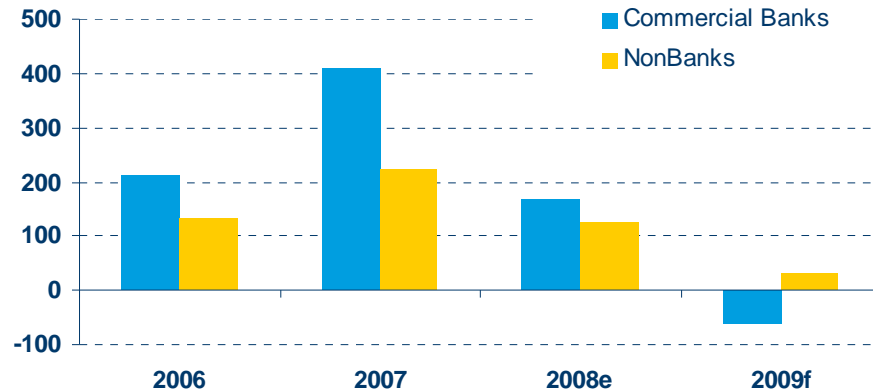


In highly vulnerable regions, the high-risk countries again include not only the Baltic states, Romania, and Bulgaria but also Russia and Ukraine. Credit expansion rates on the order of 50 to 70 percent are ordinarily a source of concern. But growth of the aggregate credit-to-GDP ratio is, however, not an anomaly in emerging economies: the development of financial intermediation is part of a catch-up process, up to the levels around 100 percent prevalent in Western Europe. That process nonetheless needs to be kept under control.

This chart also shows emerging Asian countries have been in a more comfortable position: the intermediation level may be very high — around 100 percent of GDP — but with the underlying dynamic less explosive than it was in emerging Europe. The Asian crisis in the late 1990s — characterised precisely by excessive growth of private sector debt — clearly prompted profound banking reforms that put controls on the credit supply. In Brazil, India, and Turkey, the domestic credit expansion was also less explosive and intermediation less developed. **But that nonetheless does not mean that Brazilian, Indian, or Turkish companies have little exposure to the risk of a credit crunch developing in any of the three countries:** Financing their operations at least partly via foreign debt, those companies have been suffering this year from the shortage of international credit.

But the limited data available at this juncture complicates matters in spotting the emergence of such international credit crunches. There is nonetheless little doubt that European and American banks have reduced their exposure to emerging companies since the 2008 fourth quarter. According to the latest data available from the Bank for International Settlements, banks from BIS member countries reduced their lending to emerging countries between March and June 2008. Credit rationing thus began as early as spring last year. And the forecast published by the Institute for International Finance show clearly that a credit crunch in cross-border financing toward emerging countries will develop this year:

Capital Flows to Emerging Economies, Private Creditors, net, Billions US \$



Complete risk assessments for 155 countries are available on www.coface-usa.com.

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Coface is a global provider of credit insurance and credit management solutions, serving 120,000 companies in over 90 countries. Our products and services include commercial credit insurance, worldwide business information and ratings, accounts receivable finance and factoring, and commercial debt collection and accounts receivable management. For more information, please contact us.

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