Country Risk Overview

April 2011

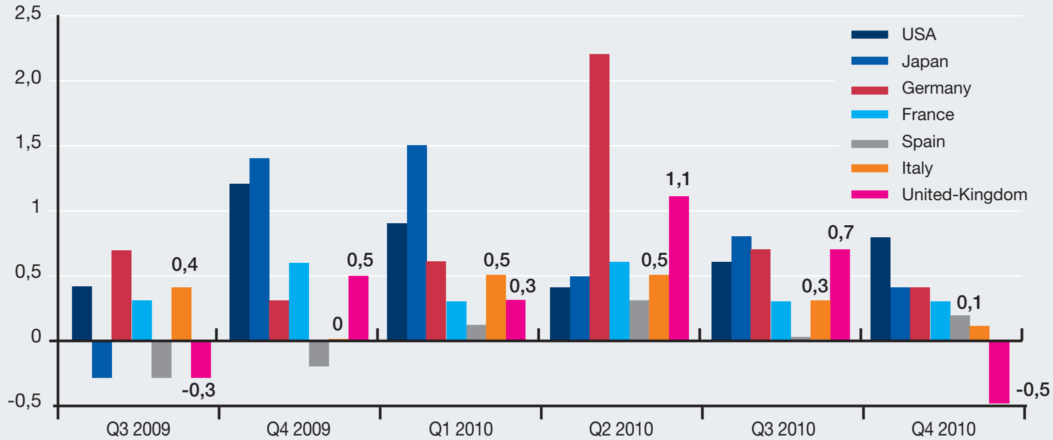
coface

2011 growth scenario

2011 growth scenario and risk outlook

Various events that marked the first quarter 2011 prompted us to revise our world growth forecast for the year, down from 3.4% to 3.2%. And based on virtually finalized data for the fourth quarter 2010, world growth for 2010 comes to 4.2%.

GDP Growth (% Q/Q-1)



As this data clearly shows, the slowdown in the global economy between 2010 and 2011 has reached substantial proportions, representing 1 point of GDP.

Coface	2007	2008	2009	2010	2011p	Coface
World production	**4,2**	**2,0**	**-1,6**	**4,2**	**3,2**	**World production**
Industrialised contries	**2,4**	**0,1**	**-3,5**	**2,5**	**1,7**	**Industrialised contries**
United States	1,9	0	-2,6	**2,8**	**2,5**	United States
Japan	2,4	-1,2	-5,2	**4**	**0,3**	Japan
Euro zone	**2,8**	**0,4**	**-4,0**	**1,8**	**1,3**	**Euro zone**
Germany	2,7	1	-4,7	**3,7**	**2,3**	Germany
United Kingdom	2,7	0,1	-4,9	**1,3**	**1**	United Kingdom
France	2,4	0,2	-2,5	**1,5**	**1,6**	France
Italy	1,4	-1,3	-5,2	**1,3**	**1**	Italy
Spain	3,6	0,9	-3,7	**-0,1**	**0,5**	Spain
Emerging countries	**7,9**	**5,6**	**1,8**	**6,9**	**5,6**	**Emerging countries**
Emerging Asia	10,1	6,9	6,0	**9,0**	**7,2**	Emerging Asia
Latin America	5,6	4,2	-1,7	**6,2**	**4,2**	Latin America
Emerging Europe	5,7	3,0	-4,0	**4,0**	**3,7**	Emerging Europe
CIS	8,6	5,5	6,6	**4,4**	**4,7**	CIS
Middle East	5,5	5,8	1,6	**3,9**	**3,8**	Middle East
Africa	6,9	5,7	1,6	**4,6**	**4,8**	Africa
China	14,2	9,6	9,1	**10,3**	**8,8**	China
India	9,2	6,7	7,4	**8,8**	**8,0**	India
Brazil	5,7	5,2	-0,6	**7,5**	**4,0**	Brazil
Russia	8,1	5,6	-7,9	**4,0**	**4,5**	Russia
World trade	**7,3**	**2,8**	**-10,7**	**14,5**	**6,5**	**World trade**

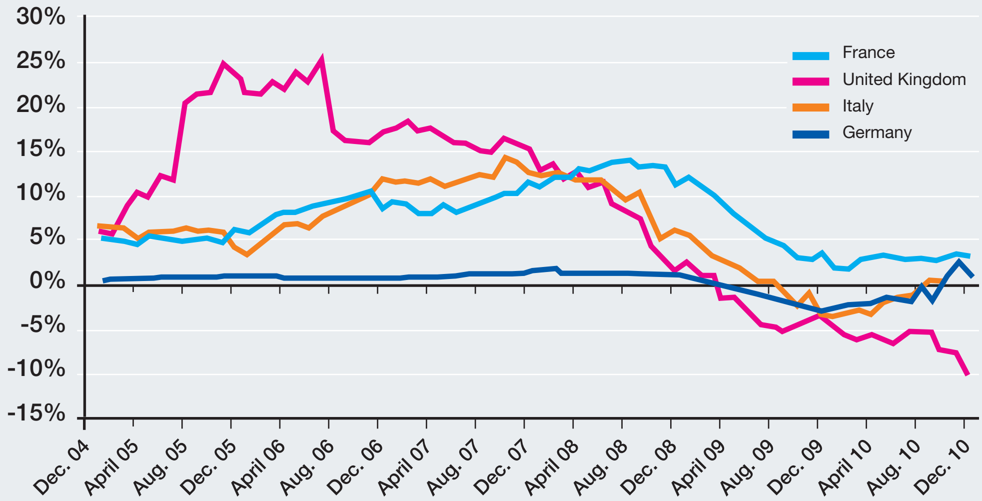
The economic slowdown is attributable to a combination of negative factors that affect the global economy. Two of those factors were already taken into account in our previous forecast.

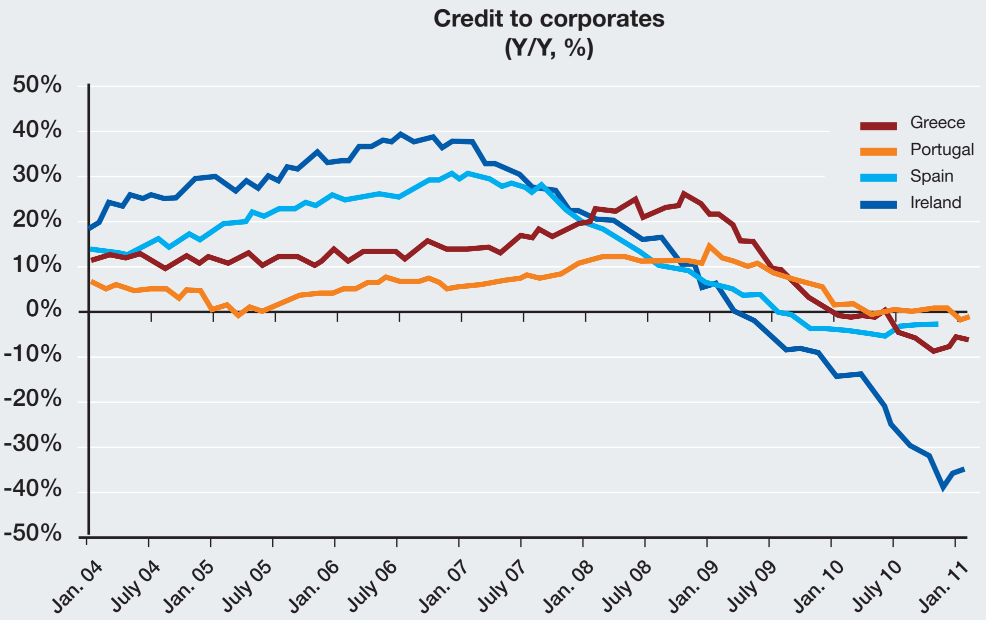
The sovereign crisis in the euro zone has persisted with Portugal having sought a financial bailout from the EU. The country has been mired in a political crisis triggered by the fiscal austerity plan and the scale of the recession has been revised down to a negative1.3%. We are also revising our growth forecast for Italy (notably affected by the Libyan crisis) down to 1%. Germany's performance is expected to remain satisfactory, albeit slightly below recent expectations, at 2.3%, due to the rise of input prices. Overall, the euro zone will achieve 1.3% growth in 2011, just one-tenth of a point of GDP below our previous forecast. A still less than bright result marked by the continuation of restrictive fiscal and in many economies with spreads remaining high for countries deemed financially weak.

At this juncture moreover, the restructuring of the sovereign debt of a member country is not out of the question: Rumours to that effect swirled around Greece as the year began. EU aid mechanisms — currently being finalized — include the possibility of "participation by the private sector" via, for example, partial abandonment of debt claims (at the worst), **but only from mid-2013 on**. Greece has already renegotiated the terms of the aid granted by the EU in May 2010. Notably to obtain rate reductions and longer maturities, and the support capacity of European mechanisms is expected to be increased "to buy time" for the four countries deemed weak (Greece, Portugal, Ireland, and Spain). Taking its cue from Greece, the new Irish government has attempted to renegotiate the terms of multilateral aid. But its efforts have yet to meet with success due to the current stalemate over the country's corporate tax rate. European institutions will go to great lengths to avoid reducing the value of the outstanding debt, which would have a substantial effect on European banks highly exposed to sovereign risk in the euro zone.

The rise of sovereign risk in the euro zone will come at a cost (more difficult access to credit) to investors and households whose confidence is still shaky. And bank credit is a channel of transmission of sovereign-crisis effects to companies and it remains sluggish in Europe whereas it had been expected to drive the revival of investment as the economic recovery progressed. Banks, meanwhile, hampered by their high exposure to sovereign risk, will be reluctant to finance economic growth. In cases like Portugal and Ireland, **the credit supply has been contracting**, a trend that could intensify in coming months and trigger additional corporate bankruptcies.

Credit to corporates
(Y/Y, %)



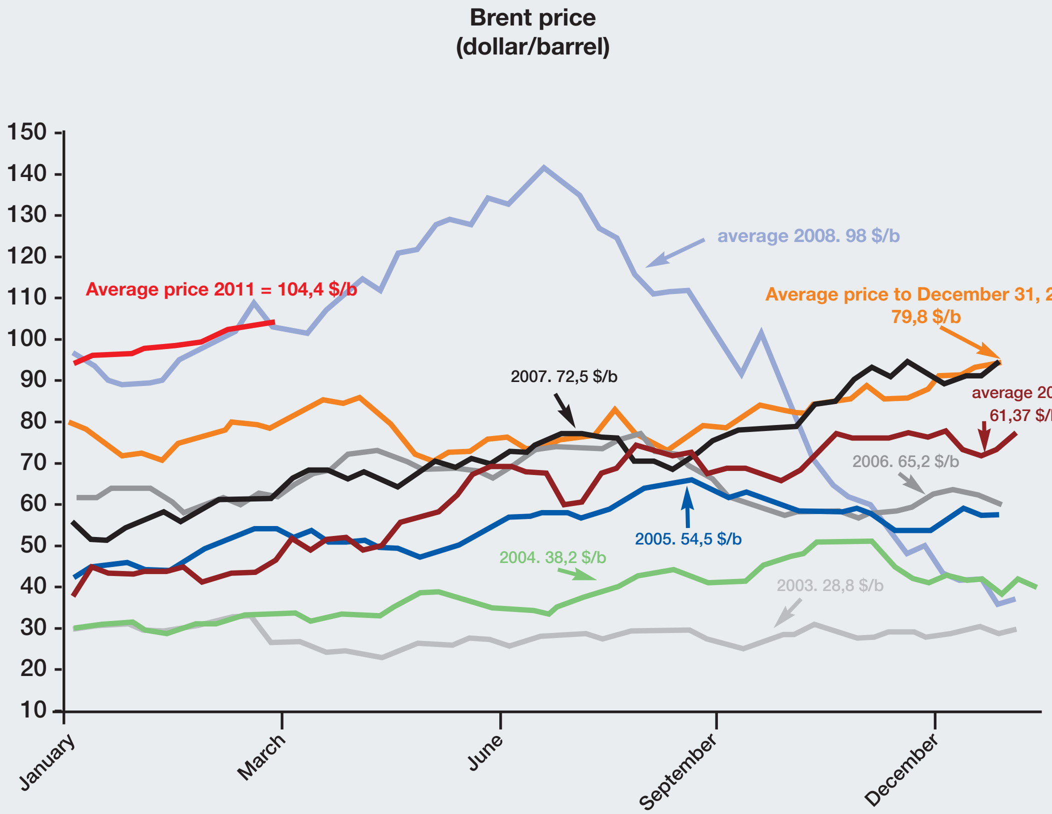


Outside the euro zone, the growth forecast for the United Kingdom has also been revised down: with the economy already gripped by recession in the fourth quarter 2010.

World trade has slowed after the extraordinary rebound in 2010. According to the WTO, world trade growth will ease to a still-very-strong 6.5% rate compared to the booming 14.5% posted in 2010 and the negative 10,7% growth suffered in 2009.

But new elements have clouded the global economic outlook for 2011

The rise of energy prices will affect economic activity. The average price forecast per barrel of Brent in 2011 is about $100, up about 25% from 2010. The actual average barrel price came to $79.80 in 2010 and $104.45 from January to end March this year.

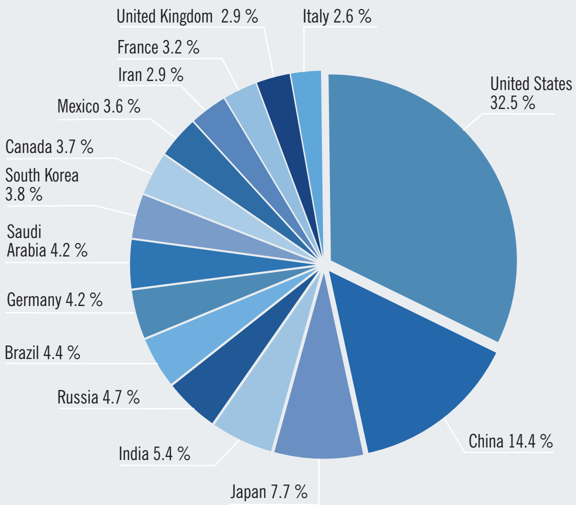


In our estimation, the recent developments in the Middle East — particularly the turmoil in Bahrain where Saudi Arabia has gotten involved, the military intervention in Libya, and the possible spread of the wave of revolutions to other regional countries — are expected to keep oil prices high. The natural catastrophe that battered Japan in March 2011, followed by the nuclear crisis it triggered, is expected to have, in the first instance, a depressive effect on the prices due to the likely decline in economic growth in a country that ranks as the world's third largest oil importer. Beyond that initial phase, however, the need to rebuild and find sources of energy to replace the missing nuclear capacity — with Japan having few energy resources of its own — is expected to drive up world prices not only for oil but also for gas and coal. In this context, we have revised our expectations for crude prices up 25% from our previous forecast. In broad terms, the higher crude prices will shave between 0.1 and 0.2 points of GDP off economic growth in the large importer countries, especially the United States with adjusted growth of 2.5%, Germany with 2.3%, South Korea 3.5%, and India 8%.).

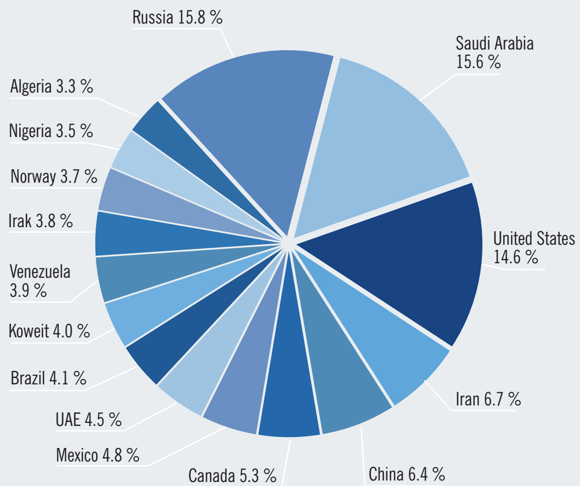
In geopolitical and economic terms, Saudi Arabia will be a pivotal economy in shaping the long-term trend on oil prices. Representing 16% of world production Saudi Arabia is the world leading oil producer (albeit surpassed by Russia some years).

The dominant OPEC member, Saudi Arabia is capable of influencing prices by adjusting its production volume: it recently announced an increase in production of between 500,000 and 900,000 barrels a day to stabilize prices and compensate for the loss of Libyan production.

Major oil consumer countries (2009 data - Source BP - US EIA)



Major oil producer countries (2009 data - Source BP - US EIA)



The series of catastrophes that battered Japan (earthquake, tsunami, and nuclear crisis) will take its toll on global economic growth. We have accordingly revised GDP growth for Japan — a country that represents as much as 9% of global GDP (or 6% at purchasing power parity) — down to a barely positive 0.3%. The ultimate impact of these dramatic events on the global economy is difficult to measure: it will essentially depend on how the nuclear accidents evolve. Even if it proves to be of short duration, however, the impact will be tangible.

The earthquake and tsunami in Japan could prove to be the most costly catastrophe in history

Date	Catastrophe	Estimated economic cost USD	% of GDP
1995	Kobe earthquake (Japan)	$100 billion	1.9%
2004	Tsunami (Indonesia, Thailand, Sri Lanka)	$10 billion (wherein $4.5bn for Indonesia and $1bn for Thailand)	Indonesia 1.8% Thailand 0.6%
2005	Katrina hurricane (United States)	$125bn (source: Insurance Information Institute) -$140bn (source: Carnegie)	Between 1% and 1.1%
2008	Sichuan earthquake (China)	$85bn	1.9%
2011	Earthquake and tsunami (Japan)	$235bn (source: World Bank) $309bn (source: Japanese government)	Between 4.3% et 5.7%

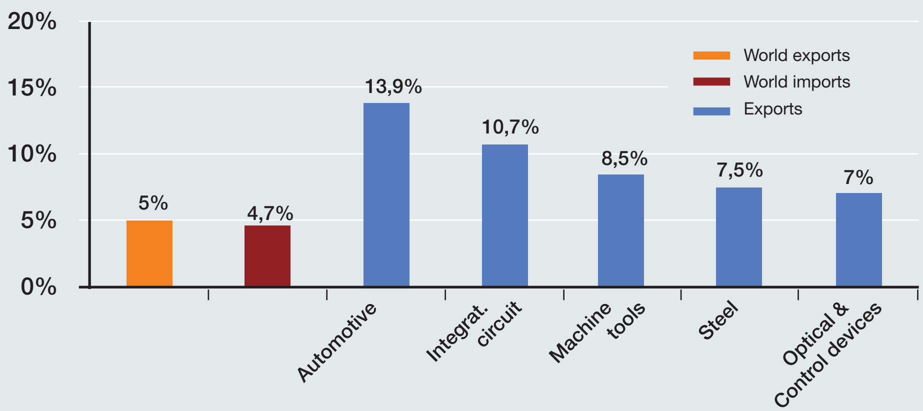
Japan plays a pivotal role in the now highly integrated global production chain. Production processes are divided into phases across international borders. **On the supply side there will thus be, in the first instance, shortages of supplies,** and not only in Japan. The global automotives sector will be directly affected: Japan represents 14% of global vehicle exports and Toyota has announced shortages of stocks in the American market. Japan is also a major supplier of spare parts to the sector. Peugeot, which thus foresees disruptions in its production of diesel motors in Europe and the Volvo production facility in China has warned that its stocks of components originating in Japan would only suffice until early April and that its production could be seriously affected in the near-term. And Japan remains a crucial exporter of intermediate industrial products: it exports 10.7% of integrated circuits, 8.5% of machine tools, 7.5% steel shipments, and 7% of optical instruments. The country is moreover the leading supplier of lithium batteries. **Japan's highly developed specialization in high-end products, particularly in the electronic components, complicates matters in diversifying sources of supply.**

The impact of the Japanese crisis on the rest of the world could thus spread via the supply channel, which seems a priori preponderant in relation to demand with Japan representing about 5% of global imports of goods. Structurally feeble before this crisis, domestic demand will clearly suffer now. Japanese tourists will be less commonplace in Europe and Asia. And global demand could be affected via the channel of psychological repercussions should the nuclear crisis take a turn for the worse.

Impact on emerging Asia

Although South Korea, Taiwan, and Thailand are not very dependent on Japan as a market for their exports (with Japan representing only 8% of Chinese exports, 6% of Korean exports, and 12% of Thai exports), these countries are, however, dependent on imports from Japan, particularly intermediate goods used in the assembly chain mainly in the electronics sector: 15% of South Korean imports, 21% of Taiwanese imports, 20% of Thai imports, and 13% of Chinese imports come from Japan. These countries could thus be affected by a possible shortage of electronic components. The negative impact on Asian manufacturers could be mitigated, however, via adjustments in the sources of supply. And the adjustment process would be facilitated by the existence of excess capacity in factories operating in advanced countries. But as mentioned above, Japan's highly developed specialisation in high-end products, particularly in electronic components, complicates the task of diversifying supply sources, especially since there are several subcontractor classes. And the region's tourism sector, particularly in Taiwan, will likely suffer considerably.

Japan share in world exports and imports (%)



Conversely, there will be little impact on either the relatively closed Indian economy or the Vietnamese economy, which mainly exports farm and low value-added products (fish, textiles). And Japan is moreover a crucial supplier of chemical products, paper, steel, parts for public works equipment.

Impact on capital flows to foreign destinations

Japan is the world's third largest exporter of capital, generating 11.5% of total capital exports behind Germany (13.3%) and China (24.2%). It is the second largest buyer of US treasury bills ($880 billion) behind China ($1,160 billion). A possible sale of assets in that category in conjunction with a reduction in purchases, could drive up interest rates and cause the dollar to appreciate. This phenomenon could coincide with the end of the Fed's quantitative easing (QE2) policy scheduled for end of June, which could prompt the Fed to implement QE3 policy or take other unconventional measures. Bond issues by European governments could also suffer from such moves. Conversely, the impact on foreign direct investment in Thailand and Vietnam and on transfers by Philippine emigrant workers employed in Japan is expected to be marginal in these three countries.

Impact on the yen

The catastrophe drove the yen down briefly on 12 March. Its subsequent strong rebound is attributable to anticipation by the markets of not only asset repatriation by insurers and companies but also settlement of carry trade positions by private Japanese individuals. The yen is thus expected to appreciate in the short-term. But the longer term trend is difficult to assess beyond technical effects. Especially with the major central banks agreeing to coordinate their efforts to limit the appreciation of the Japanese currency in the markets and support Japanese exports. In this context, Japan's current account surplus could shrink substantially. It had been near 5% of GDP before the crisis and 3.6% in 2010.

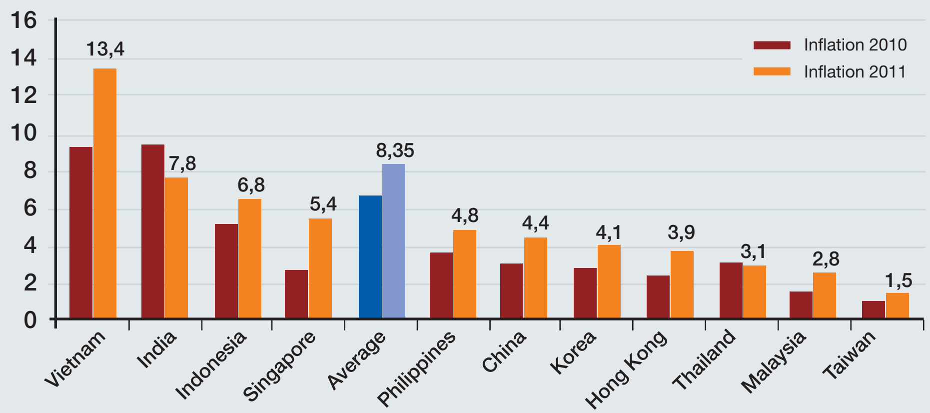
Management of economic overheating in emerging countries entails adjusting their growth rates to 5.6% in 2011, down from 6.9% in 2010

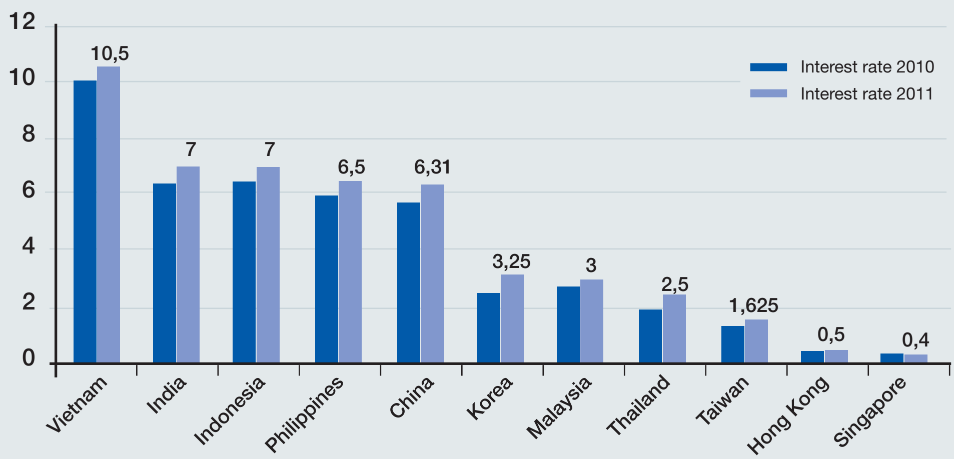
The outlook is much the same for Latin American where a soft landing has been shaping up, especially in Brazil (4%) but also in Argentina (5.5%) with growth in 2010 having far exceeded the potential. The continent would thus ease from 6.2% growth in 2010 to 4.2% in 2011. The CIS and Africa could, however, benefit from the rise of energy and mineral raw material prices to post growth of 4.7% and 4.8% respectively in 2011. The Middle East, endowed with a high proportion of global oil reserves but hobbled by political upheavals, would derive relatively little benefit from the rise of oil prices. Overall, the Middle East-North Africa region is expected to grow 3.8% in 2011 compared to 3.9% in 2010 — a large increase in hydrocarbon prices notwithstanding. .

Among emerging regions, emerging Asian countries recorded the most pronounced slowdown (down to a nonetheless very dynamic 7.2% from 9% in 2010) with adjustments in the growth forecast for China (8 .8% compared to 10.3% in 2010) and India (8% compared to 8.8% in 2010) as a result of the rise of energy prices and the action of monetary policy measures (interest rate hikes, exchange-rate appreciation, and, in China's case, quantitative credit control) intended to check economic overheating. That was also the case in South Korea, Thailand, and Indonesia.

As shown in the following charts, inflation has reached troublesome levels especially in Vietnam and India. On average for the 11 main Asian economies, annual inflation is expected to rise from 6.7% in 2010 to 8.4% this year, which would constitute a substantial rise in prices. Forecasts by Natixis are based on a relative effectiveness of the interest-rate-hike policy in India (with inflation easing from 9.5% in 2010 to 7.8% in 2011) with the rise of prices continuing to accelerate in Vietnam and reaching 13.5% on average in 2011. Still according to Natixis, interest rates in Asia would rise on average by only 0.4 basis points. But with respect to inflation, the situation varies widely from country to country. In Malaysia, Taiwan, or Hong Kong, even if inflation rises in 2011, it will not reach troublesome levels.

The inflation observed in most emerging countries does not seem to derive from a structural problem involving a possible disconnection between supply and demand. Instead it often appears to involve inflation imported via food and energy goods purchases. In China, for example, the core inflation rate — exclu-





ding food and energy prices —remained below 3% at most in 2010 and in the first quarter this year. That is why a fundamental indicator like the consumer price index can constitute an unreliable basis for assessing social risk associated with rising prices. In Asian countries, authorities are well aware that prices tend to rise in a context of growth that, albeit strong, is often inegalitarian and can thus be a powerful vector of risks of social unrest: The most underprivileged population segments are relatively more sensitive to foodstuff prices. In India, however, there is a perceptible correlation between the core inflation rate and the CPI with prices for food goods causing an increase in costs that shows up in end prices. Also according to the IMF, the core inflation rate in India has been increasing: it was negative end 2008 and increased to 10% by early 2010.

Whether interest-rate hikes can be an effective tool in stemming the rise of prices when such inflation derives largely from increases in staple commodity prices constitutes a crucial question. In practice, to combat speculative bubbles, monetary authorities tend to focus on limiting liquidity. Monetary policy based on interest rate hikes can thus have a stimulus effect on deposits and thus foster savings to the detriment of consumption thereby keeping demand from overheating and intensifying the inflation observed in prices for food goods. In a second phase, moreover, a slowdown in domestic demand is made necessary in some cases by the growth of current account deficits in a context of ebbing capital flows. Such imbalances are of little concern in Asia with the notable exception of India and Vietnam (who situation is becoming disquieting). In Brazil, Turkey, and South Africa, the current account deficit has been widening. In any case, the slowdown of the Chinese economy (to some degree desired by the authorities) is far from certain since the instruments intended to cool off the economy have yet to prove their effectiveness. With an 8.8% rate still constituting strong growth, it remains possible that China's economic growth will, as it has in past years, ultimately prove to be even higher.

Europe

Austerity measures have affected domestic demand in Portugal and in the United Kingdom, whereas in Cyprus, the burst of the housing bubble have hurt households and generated difficulties in the banking sector.

Portugal and Cyprus ratings have been downgraded from A3 to A4 and the positive watch on the United Kingdom A3 has been withdrawn.

Rating Modification

Portugal

Downgrade from A3↘ (rating held since June 2009) to A4

Hampered by inadequate cash flow, companies have become dependent on bank credit, which has been sluggish. Out of the necessity to reduce a large public sector deficit, the government has imposed a harsh austerity regime on the country likely to result in a sharp decline in domestic demand and sink Portugal back into recession this year. Despite the support mechanisms put in place within the euro zone, interest rates on Portuguese government bonds have soared to record levels. Deeply in debt and confronted with a poor growth outlook, Portugal has been compelled to seek aid from Europe. The current political crisis might have actually speeded up the process.

An economy apt to sink back into recession in 2011 as a result of a tightening austerity regime

Tax hikes, reductions in social transfer payments and civil service wages as well as tighter credit conditions had a negative effect on domestic demand in the second half of last year that resulted in a decline in economic activity in the last quarter. Exports alone maintained a role as an engine of growth. And the tightening of fiscal austerity measures could cause the country to sink back into recession in 2011 in a context already marked by high household debt, substantial unemployment, sluggish credit, and low corporate profitability and cash flow. Consumption is expected to contract again with investment declining for the third straight year. Although demand from abroad will likely weaken somewhat, the contribution of foreign trade is expected to remain slightly positive.

Accumulation of macroeconomic imbalances

The initial measures of economic support and the effects of the recession resulted in a widening of the fiscal deficit and a sharp increase in public-sector debt to over 80% of GDP. Compared to Greece, Portugal was quicker to take action to consolidate its public finances and, unlike Ireland, its banking sector suffered no losses associated with the explosion of a property bubble. But pressures on the Portuguese debt market have strongly increased, with interest rates reaching record levels. And the contraction of GDP will moreover complicate matters in reaching the government's fiscal objectives. With Greece and Ireland, already bailed out by Europe and the IMF in 2010, Portugal now has the dubious distinction of being the weakest country in the euro zone, and actually it also had to resort to external aid. Despite progress in some areas, the economy remains handicapped by low productivity, a lack of competitiveness, and a high level of debt overall. The low productivity is attributable to a rigid labour market, cumbersome regulations, insufficient competition, and a lack of skilled manpower. Compounded by a sharp increase in wages, the low productivity has resulted in a loss of competitiveness. Portugal has lost market share and has been running current account deficits among the highest in the euro zone. And the size not only of its foreign debt but also of debts carried by households and companies has grown sharply. Portuguese banks have become dependent on financing granted by the ECB and have considerably increased their holdings of public debt securities. The deterioration of the economic and financial situation has moreover been compounded by a political crisis with the opposition's refusal to back a new austerity plan prompting the prime minister to resign. And that has paved the way for early elections and has actually speeded up the decision to call for international aid.

Weakened companies

The increase in bankruptcies continued at a high rate in 2010. Hardest hit sectors include ready-to-wear clothing, textiles, leather, construction and furniture. Construction activity has continued to decline and turnover in the retail trade is still falling except in food distribution. Textile production has been trending down and the sector will have to continue to invest in new technologies and production methods to be able to meet competition from India and China. The food industry, Portugal's main industrial sector, has proven relatively resilient to the crisis, thanks particularly to major modernization and innovation efforts. This sector has the capacity to prospect for new markets and to make adjustments. But, it remains very fragmented, dependent on raw materials and subject to pressure from mass distribution. And, in the automotive sector (subsidiaries of foreign groups), the outlook for sales abroad (97% of production) appear relatively bright, with domestic sales likely to suffer from the recession in 2011.

Rating Modification

United Kingdom

Withdrawal of the positive watch on the A3 rating

The British economy has experienced a recession in the last quarter of 2010, and households' confidence has significantly deteriorated. Austerity measures implemented by the coalition government will affect British consumers' spending, which should contract this year. Moreover, exports are expected to slow-down, in the wink of a less dynamic demand from main commercial partners of the UK, and notably from the European Union countries.

Despite a well orientated growth trend in 2010, household confidence sagged in the 4th quarter

After the deep recession in 2009, economic activity recovered last year (+1.3%), driven mainly by the good performance of domestic demand associated with the restocking process. Exports benefited from the pound sterling depreciation, but the growth was not as strong as expected, especially in the services sector. The prospect of tightening fiscal policy seriously affected consumer confidence late last year. The 2010 fourth-quarter GDP contracted by 0.5%, and this decline was heavily snow-realted.

GDP growth will be modest in 2011

Economic activity will slow this year (+1%), undermined by the severe economic measures implemented by the government coalition. Many headwinds will compell households to reduce their consumption: The deep cuts made in public spending, the 2.5% VAT increase in January 2011, high food and energy prices pushing inflation up above 4%, wages remaining quasi flat, unemployment due to stay at a high level (8%). With debt burdens exceeding 150% of their disposable income, households will initiate a debt repayment process. As a result of these negative trends, households will be likely to draw on their savings again this year (5.4% of disposable income in the first quarter of 2011). Property wealth remained more or less on an even keel in 2010. The sluggishness of property transactions this year is expected to drive prices down about 10% from their peak in 2010. Public-sector investment will suffer a marked decline while corporate investment will improve only moderately. The current account deficit will narrow thanks to a marked slow-down in imports in phase with less dynamic domestic demand. Despite the likely persistence of favourable exchange rates, the strength of goods and services exports will be partly cancelled out by the the expected slowdown in demand from the United Kingdom's main client markets, the euro zone notably accounting for 50% of shipments abroad. Thanks to the reduction in spending, the fiscal deficit will contract. Public-sector debt will, however, continue to grow, reaching over 80% of GDP compared to 52% before the crisis. Monetary policy will nonetheless be likely to remain expansionary with a 0.5 per cent interest rate. Nonetheless, there are uncertainties about Bank of England'reaction to a possible rate hike by the ECB. In case of a more severe deterioration in economic activity, it could extend the use of unconventional measures, like the quantitative easing it had implemented in 2010.

Bank credit has been slow to recover and bankruptcies have continued at a high rate

The financial consolidation of the banks and the new Basle III regulation will limit the expansion of credit again this year. That will particularly affect smaller companies with tight cash positions, which could increase the risk of breakdowns in restocking and deliveries. In contending with prudent buying by households, retailers could decide to adopt more aggressive commercial policy, which would squeeze their margins.

Manufacturers and retailers of consumer durables, restaurants, travel agencies, distribution of leisure products will be hit hardest by the slowdown in private spending. Residential and commercial construction will suffer from much weaker demand and will thus bear watching in 2011. Bankruptcies eased above 12% in 2010, which is consistent with the trend reflected in Coface payment monitoring records. The bankruptcy rate will nonetheless remain high.

Rating Modification

Cyprus

Downgrade from A2↘ (rating held since December 2010) to A3

The recovery is sluggish due to the durably deflating housing bubble affecting households and Cypriot banks. The latter are also exposed to the increased risk of default by the Greek State, corporations and households, which capture a large share of loans in Cyprus.

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

In 2011 GDP growth will stay sluggish. 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.

Tourism revenues will likely continue to suffer from the sluggishness of the European market and the deterioration of tourist infrastructure. Similarly, the pharmaceuticals and chemicals sectors will continue to suffer from erosion of their competitiveness. Investment will remain weak due to the difficult recovery in the property and construction market. And public spending will be squeezed by the low level of fiscal revenues and the impact of measures taken since 2010 to reduce the public sector deficit. Pension contributions were raised in 2009, and the 15% VAT could be increased by 1% in 2011. But the government will be highly unlikely to take action on increasing the corporate tax rates (10%) since such a move could jeopardize the country's position as a regional business services hub. And unless an adjustment is made in the current growth regime founded on a low tax rate, the fiscal deficit will continue to grow and the public-sector debt could exceed the 60%-of-GDP threshold this year.

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.

A very slow negotiation process on reunification

Little progress has been made in the negotiations on the Island's reunification, which resumed in September 2008. And the northern part of the island remains occupied by 25,000 Turkish soldiers. Despite the efforts made thus far by the Greek and Turkish presidents, much work remains to be done to smooth the divergences (power-sharing, settlement of the despoiled property question). Moreover, since the victory in the Turkish Cypriot presidential election in April 2010 of Dervish Eroglu, leader of the Nationalist Party, there is little likelihood of the reunification process coming to a successful conclusion in the near

Asia

In Japan, the earthquake and the tsunami, along with the nuclear crisis, will have an impact on the global supply chain and on the Japanese growth which has been revised down to 0.3%.
Its A1 rating, the best risk level, has been put under negative watch.

In Vietnam, the economy could experience a hard landing, due to the strong deterioration of the financial situation of the country.
The country rating has been downgraded to C.

Rating Modification

Japan

Negative watch on the A1 rating

The rating of Japan has been downgraded to A2 in March 2009 and has recovered its A1 pre-crisis level in September 2010, thanks to the rebound of exports underpinned by the regional dynamism and to the deceleration in bankruptcies.

It is difficult, as it stands, to precisely determine what will be the impact of the three shocks on the Japanese economy. However, it can be taken for granted that businesses – notably SMEs operating as sub-contractors of large groups –, located in the directly-hit areas but also in regions depending upon the nuclear plant of Fukushima regarding their electricity supply, will be under strain. They are actually facing headwinds such as infrastructure destruction, production chain stoppages, and electricity and water erratic supply. In this context, exports, traditional growth engine, should significantly decelerate, whereas households' consumption should contract. Therefore, 2011 growth has been revised down to 0.3%.

Strong growth in 2010 driven by a spectacular rebound in exports

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

The effects of the earthquake and the tsunami will persist for several months

In the fourth-quarter 2010, economic growth stalled, affected by the contraction in both exports, hobbled by the appreciation of the yen, and household consumption, affected by expectations that the disposable income might begin to stagnate, or even decline, again. It was in that context of economic weakness that Japan was hit by the earthquake and tsunami in March 2011. Compounded by nuclear fears, the two cataclysms subjected the country to a shock of unprecedented violence. Breakdowns in the supply of electricity and water, in conjunction with the destruction of road, port, and rail infrastructure will affect production not only by factories operating in the stricken regions (the four counties affected represent 6.2% of GDP) but also in administrative subdivisions supplied with energy by nuclear power plants located in north-eastern Japan and which are more industrialized (Kanagawa and Shizuoka). The sectors that have suffered most include automotives, electronics, steel, pharmaceuticals, and food. So exports, where a slowdown was already expected before these dramatic events, might even decelerate for months to come. This will particularly concern sales to China, South Korea, and Taiwan of electronic components and other intermediate products essential in the assembly of finished products notably intended for Japan, the United States, and Europe. The existence of excess production capacity in Japan could nonetheless mitigate that negative effect. The price competitiveness of Japanese products will moreover continue to suffer from the strength of the yen. And the exchange rate is expected to remain high as a result of repatriation of assets held abroad and settlement of carry trade transactions by insurance companies, businesses in general, and households. This trend will be mitigated, however, by the monetary policy pursued by the Bank of Japan, which has very large foreign exchange reserves at its disposal for use in stabilizing the Japanese currency and thereby supporting exports. Households will suffer from this new and unprecedented crisis, which could have a lasting effect on their confidence even if national solidarity and cohesiveness will ensure that support will be provided to those that suffered most. Their spending is thus also expected to decrease especially with household savings having declined considerably in past years to a level in 2010 representing about 2.5% of disposable income. However, the negative effects could fade, at the best, by summertime, and give way to an economic rebound driven by reconstruction. Nonetheless, the intensity of the recovery will depend on Tepco's ability (Tokyo Electric Power) to limit the radioactivity contamination on the environment and to restore electricity supply. The ultimate cost is yet to be determined, but its financing is unlikely to be a source of concern with Japan possessing the financial means to cope with the situation. Although public-sector debt is currently very high (225% of GDP), 95% of the amount outstanding is owed to residents. And the archipelago holds considerable assets abroad (60% of GDP). The government could also draw on the substantial reserves accumulated at all levels of the national economy (25% of GDP) mainly by companies. In this context, the 2011 outlook for economic growth has been revised downward (0.3%).

Smaller companies seem to be the most vulnerable

Large Japanese and foreign groups have production units in the regions affected by the earthquake and tsunami. But many smaller subcontracting companies and high technology hubs also have production facilities there. The Japanese just-in-time production model, which eliminates the accumulation of stocks, tends to amplify the impact of production stoppages. The lack of essential production inputs can lead to the shutdown of assembly lines while the electric-power rationing put into effect could result in losses, particularly in the manufacturing of products for the electronic component sector were Japan provides 21% of world production and which entails very high precision work. Subcontracting companies may, furthermore, be faced with increases in input costs they will be unlikely to be able to pass on to customers since they are locked in by annual contracts. The pressure on their margins will consequently increase. Even before the onset of the financial crisis, companies in this category had been giving signs of serious weaknesses (low profitability, overdependence on one large customer, difficult access to credit). This situation contrasts with that of large companies, which have largely been able to reconstitute their cash flow (up from about 60% mid-2009 to over 115% late last year). The continuing strength of the yen in conjunction with lessons drawn from this latest catastrophe could serve as a catalyst to the already broad movement to delocalize manufacturing facilities abroad, which would tend to weaken subcontracting companies even more. And even if the risk of nuclear contamination either fails to materialize or remains limited in scale, consumers might nonetheless be likely to remain wary of any product whatsoever "made in Japan". That will particularly be the case for agri-food industries. The impact of the massive catastrophe on the environment (radioactive radiation, petrochemical complexes in flames), besides the public health issues it will generate, will have a long-lasting effect on farming activity.

Rating Modification

Vietnam

Downgrade from B↘ (rating held since June 2008) to C

The Vietnamese financial situation has deteriorated significantly (high current account deficit, uncontrolled credit and public debt, very low foreign exchange reserves, repeated devaluations, highly dollarized banking system) and could lead to a hard landing.

Significant deterioration in the country's financial position: high exchange-rate and liquidity risk

The Vietnamese current account deficit has widened substantially in the past four years, from -0.3% of GDP in 2006 to -9.0% in 2010, due to the opening up of the economy (marked by membership in the WTO), the dynamism of investment, which has necessitated massive imports of capital goods and repatriation of profits by foreign companies operating in Vietnam. And amid the rise of food and energy prices in 2011 the current account deficit could grow even deeper. 80% of the financing need will be covered by foreign direct investment and the rest by bank debt. In that context of insufficient capital inflows and high inflation, the downward pressure on the dong (fixed exchange-rate regime) has been strong, prompting the authorities to devalue the dong six times since June 2008. While the devaluations carried out in 2008-2009 were of marginal proportions, in 2010-2011 they were both more frequent and sharper (8.5% in February 2011). Despite the devaluations, exchange-rate risk has remained high. Anticipating further devaluations residents have been converting their portfolios into gold and dollars. On the grey market, the dong has been trading at a considerable discount. Over the rest of the year, the substantial current account deficit and the strong growth of monetary aggregates (credit expanded by 45% 2009 and 35% in 2010) could cause another sharp decline in the currency.

However, capital outflows could ease thanks to capital controls (restricted dong convertibility) limiting the possibilities for speculative attacks against the dong, the introduction of restrictions on imports of gold - a traditional refuge used by residents to protect against dong depreciations - and to the large rate differential between contracts denominated in dong and those denominated in dollars (underpinning the carry trade).

But foreign-exchange reserves have fallen to precariously low levels (estimated at between six and eight weeks of imports), limiting Vietnam's capacity to cope with a sudden flight of capital.

A weak - undercapitalized and highly dollarized - banking system

Banks remain very vulnerable to exchange rate risk as a result of their high degree of dollarization: 16% of domestic loans are denominated in dollars and 22% of the deposits are denominated in foreign currencies. Moreover, credit has grown significantly (+150% at constant prices since 2005), reaching 120% of GDP in 2010 (vs. 48% in 2003). Moreover, despite recent progress (with the economy opened more decisively to foreign capital and a process initiated to privatize state-controlled banks), the banking system has remained highly exposed to risk due to low capitalization, a high rate of nonperforming loans (10% according to the consensus compared to 2% officially), and a lack of transparency and oversight.

Significant sovereign risk: high public-sector debt and a lack of transparency

The public debt is expected to grow and with half denominated in foreign currencies it will be vulnerable to exchange rate risk. And the practice of classifying some spending as off-budget has made public accounts opaque with default risk increasing in consequence.

Late January 2010, the government nonetheless successfully issued a 10-year $1°billion sovereign bond with 6.95% yield on international markets. This success suggests that the markets remain confident in Vietnam's capacity to meet its commitments. Although the bonds were fully subscribed, the 333 basis-point spread on the Vietnamese issue compared to American treasury bonds was much higher than spreads on recent issues by Indonesia (228 basis points) or the Philippines (184 basis points on a $1.5 billion issue in January 2010).

A growth slowdown is expected

After rebounding in 2010, driven by the recovery of domestic demand and exports, economic growth could weaken somewhat in 2011 (5% growth expected compared to 6.7% in 2010) with domestic demand expected to suffer from the high inflation expected in 2011 (13.4%) and the tightening of monetary policy. Foreign direct investment inflows are nonetheless expected to remain firm with Asian companies continuing to set up production facilities in Vietnam in the framework of a broad delocalization movement. This phenomenon is exemplified by delocalizations from China prompted by the gradual strengthening of the yuan and recent wage growth: the $96 monthly average wage of Vietnamese workers represents about two thirds of the average wage in China. Export sectors (textiles shoes, electronics) are expected to be very dynamic. Similarly, the services sector (tourism, transport, communication, financial services) will outperform. And the growth of the primary sector -which provides 74% of rural employment - is expected to remain dynamic thanks to do the better weather conditions forecasted.

Persistent shortcomings in the business environment

The Communist Party continues to exercise total control over political, economic, and social life in Vietnam. Although the 11th National Congress scheduled in January this year was marked by changes in party leadership, they did not, however, jeopardize economic policy continuity. But governance problems, especially corruption, remain the country's Achilles' heel as attested by the scandal over the bankruptcy of the state-controlled Vinashin naval shipyard group.

North Africa Near and Middle East

Political transition in Tunisia and Egypt, very serious deterioration in Libya and socio-political unrest in Bahrain and Syria, are that many events which will impact negatively on the economic and financial situation of these countries. Consequently ratings are put on negative watch or downgraded.

Rating Modification

Tunisia

Negative watch on the A4 rating

Political uncertainties are to weigh negatively on economic activity and result in further deterioration of public finances and external accounts.

Political uncertainty with many social and economic challenges

After the ouster in mid-January 2011 of the former president Ben Ali, in power since 1987, an interim government of national unity was formed, notably to organize presidential and legislative elections in the coming months. This new situation brings about many uncertainties, as the transition to a stable regime is not assured given the preeminence of the former ruling party, the Rassemblement constitutionnel démocratique, as well as divisions and the weakening of the political opposition.

Moreover, the new authorities are facing multiple social and economic challenges. Unemployment, which officially affects about 15% of the population (but as much as twice according to other sources) and especially young graduates, remains a major challenge. It stokes intense feelings of frustration and has provoked protests leading to the fall of the former president. In addition, there is the question of the future of parts of the economy (commercial and automotive distribution, hotels, airlines, banks) which were under the influence of the Ben Ali-Trabelsi clan. Moreover, the fruits of growth have been unequally distributed, not only socially but also geographically, and a planning policy is essential for inland parts of the country which are handicapped in comparison with coastal regions.

Activity dependent on changes in the political situation

The Tunisian economy rebounded in 2010 thanks particularly to a moderate recovery in the European Union (EU), which remains Tunisia's primary trading partner representing over three quarters of exports, tourism earnings, expatriates remittances, and foreign direct investment (FDI).

GDP growth is expected to moderate in 2011, mainly due to political uncertainties, much being dependent on the outcome of the transition period. The activity is also dependent on the likely economic slowdown in the EU and the impact of political events on the tourism sector. A revival of investment could, however, occur. Public investment should benefit from necessary upgrades to infrastructure in the poorest regions. As for private investment, which had been hampered by the former presidential clan's nepotism, it should be spurred.

Besides, Tunisia should continue to seek new sources of growth by diversifying its export markets and by fostering moves upmarket by a various range of sectors, including textiles, by integrating conception and design, but also in electronics, information technologies and services (55% of GDP), with tourism and finance.

Deterioration of twin deficits

The possible revival of public investment, various measures to improve living standards and reduce unemployment, as well as price subsidies for some commodities, will result in a widening public deficit. However, in recent years, the level of public debt has been declining in relation to GDP (43%) and is now near average for comparable emerging countries. In addition, 70% of this debt is contracted with multilateral institutions on concessional terms, and sovereign risk is thereby reduced.

Exports may stagnate in 2011 because of political uncertainties and weak demand from the EU. Exploring new markets, particularly in Africa, is likely to be postponed. However, the robustness of domestic demand, notably investment, could result in a slight increase in imports, and thus maintaining a significant trade deficit. It would only be partially offset by expatriates' remittances and, to a lesser extent, by tourism receipts. The current account deficit should ultimately deteriorate. Moreover, this deficit should be only partially covered by FDI inflows, with Tunisia likely to be a less attractive destination for foreign investors, at least temporarily.

Rating Modification

Bahrain

Downgrade from A3 (rating held since September 2003) to A4

Reflecting the very severe socio-political unrest since mid-February this year, which led to the military intervention by Saudi Arabia and the declaration of a state of emergency on 15 March 2011, with these events expected to have a negative economic and financial impact on the archipelago, particularly its role as regional financial centre.

A very difficult socio-political climate

In the wake of the Tunisian and Egyptian revolutions, the social and political unrest has intensified in Bahrain since mid-February this year with the Shiite majority, which represents about 70% of the population, considering itself economically and politically marginalized by the Sunnis. The demonstrators, mostly Shiites, are demanding political change, especially constitutional reform focused on strengthening the powers of Parliament. In the legislative elections last October, the main Shiite opposition group Al-Wefaq fell short of the majority but received the most votes and came out ahead of the pro-government movement of independents allied with the Sunni parties.

In this very tense climate compounded by geopolitical uncertainties mainly associated with the proximity to Iran, Saudi troops were deployed in Bahrain on March 14 this year at the request of the authorities in Manama and under the aegis of the joint forces of the Gulf Cooperation Council. The next day, the King of Bahrain Hamad Ben Issa Al-Khalifa,- a Sunni, has declared a state of emergency for three months. These measures will tend to further radicalize the opposition and its attacks on the legitimacy of the regime.

This context could moreover negatively influence a business environment considered propitious until now thanks to efforts to stimulate the private sector, attract more foreign investment, and improve the local reservoir of skills, prompted by the need to diversify the economy.

Predictable decline in growth in 2011 due to political tensions

The impact on the economy of the current crisis is expected to limit GDP growth to about 3% in 2011 compared to the 5% rate initially forecast.

The unstable situation has already had negative repercussions on tourism and commerce, which have traditionally benefited from an influx of Saudis. This negative trend is also illustrated by the cancellation of the Formula One Grand Prix (originally scheduled in March this year) and other major commercial events like trade fairs and conventions.

And with Bahrain's reputation for financial stability tarnished by the continuing risk of confrontations, financial institutions have been inclined to transfer their activities to Doha or Dubai, deemed to be less risky locations. But the Bahrain offshore financial sector, the preeminent player at the regional level until now, constitutes the main supply-side component of the economy. Economic activity will thus suffer greatly in 2011 from the decline in financial services.

The hydrocarbon sector will nonetheless be likely to continue to make a decisive contribution to the economy despite the country's limited reserves. Although oil production is not expected to develop significantly, gas production will increase slightly with the industry's efforts focused on higher value added activities like refining. The economy will moreover benefit from an improvement in demand: Since the demonstrations in February/March this year, private consumption has been spurred by the increase in the minimum civil-service wage, the temporary assistance granted each Bahrain family and the continuation of subsidies.

Emergence of a current account deficit and deterioration of the public deficit

Limited reserves notwithstanding, hydrocarbons remain the main source of export earnings, representing about three-quarters of total sales abroad. In conjunction with exports of refined oil products and of aluminium, they will likely suffice to offset the import bill and maintain a stable trade surplus. Conversely, the services balance is expected to deteriorate with regional companies doing less business with the Bahrain financial sector. The income deficit will grow, furthermore, with profit repatriation by foreign companies and outgoing transfers by expatriates exceeding dividend payments received from abroad. On the balance, a current account deficit (estimated at 3% of GDP) will emerge.

Buoyed by high oil prices, fiscal revenues are expected to grow, but public spending will continue to rise due to the cost of the on-going investment and subsidy programme (water, electricity, petrol, food products) benefiting the neediest Bahrainis and of the additional measures taken to keep protests from growing in intensity. This policy mix will spur the deterioration of the public deficit (to about 2.5% of GDP) whose financing via the issuance of securities on international markets will likely be postponed due to the sharp rise in spreads on Bahrain sovereign issues. In this context, and due to the relative illiquidity of the assets in the sovereign fund and their relatively limited amount (about $9 billion), the government submitted a request to the Gulf Cooperation Council in March 2011 for $10 billion in financial aid.

Rating Modification

Egypt

Negative watch on the B rating

A relatively uncertain political transition is to affect adversely economic growth, public finances and external accounts.

Relatively uncertain political transition

The political turmoil, which led to President Mubarak's resignation on February 11, will hit economic activity hard, at least in the first half of 2011.

The Supreme Military Council, chaired by Field Marshal Mohammed Tantawi, should run the country for six months at least. The next steps include the appointment of a Committee to revise the Constitution, the removal of the state of emergency and the implementation of free presidential and parliamentary elections, leading to a civilian government. In this context, there should be an increased participation of the political spectrum, including notably the Muslim Brotherhood, a previously forbidden movement. There is, however, a risk that the dissatisfaction of the population would degenerate and call into question a smooth transition.

Sharp GDP growth deceleration

The magnitude of the disruption to economic activity will depend on how the transition period unfolds. At this stage, the economy should not fall into recession.

Nearly all sectors are likely to be affected in the early months of 2011, particularly wholesale and retail trade, tourism, financial and business services, transport, telecommunications and manufacturing. The oil and gas sector and Suez Canal traffic will probably be less affected. Most sectors should rebound once the situation gets back to normal, although tourism industry (6% of GDP) will likely be slower to recover, as the unrest coincides with the peak season.

In the current uncertain political and economic environment, already high pressures on prices are going to increase, leading to higher inflation, with double-digit rates.

Public finances even more worrying

Current events shall result in higher than expected budget deficits for fiscal years 2010/11 and 2011/12. The government objective was to gradually reduce the budget deficit and the public debt, with a program of tax reform and reduced subsidies, but it had to be constantly postponed.

Sales tax receipts will drop sharply, as customs duties, because of disruptions. Meanwhile, expenditure will be higher than budgeted, reflecting an increase in public sector wages and in social assistance, as well as larger subsidies (25% of total expenditure).

Financing the deficit will be a challenge, as higher perceived risk will increase borrowing costs and the interest burden. There is, however, large liquidity in the financial system. Nevertheless, public debt, which stood at 75% of GDP last year, will probably rise to over 80% of GDP this year.

External accounts under pressure

Exports of goods will slow, although imports will also be weaker, leaving the trade deficit broadly unchanged from the previous year. Important foreign exchange sources, such as Suez Canal receipts or workers' remittances, are not likely to be affected significantly. The main reason for the deterioration will be a sharp drop in tourism in the first half of 2011, resulting in a substantial widening of the current account deficit.

Half of foreign direct investment (FDI) flows - in manufacturing industries, tourism and real estate - should be affected by the events. On the other hand, the remaining part of FDI, which goes to the oil and gas sector, is less likely to be affected.

Moreover, given the uncertainty, substantial capital flight could occur in the near term and non residents are also likely to add to outflows by selling treasury bills.

Egyptian pound under strain

Under these circumstances, and within the current managed float regime, with an informal anchor to the US$, it will be a major challenge to maintain exchange rate stability.

However, the likelihood of significant depreciation of the pound will be mitigated by the interventions of the Central Bank, which has accumulated sufficient foreign exchange reserves ($35 billion) and also has significant foreign currency deposits in the banking system. The authorities will no doubt be brought to tap into these reserves and deposits to support the currency and the official foreign exchange reserves are thus expected to significantly decrease.

Banking sector rather unscathed

The banking sector, dominated by large state-owned banks, has remained poorly capitalized, inefficient and weighed down by a high rate of non performing loans (15%). Since 2004, however, the banking system has been engaged towards reform and it has emerged from the global financial crisis in a fairly satisfactory shape. There is, moreover, sufficient liquidity in the banking system, particularly among state-owned banks.

The Central Bank of Egypt has taken steps to avoid a bank run, by limiting withdrawals of deposits in local and hard currency, and the situation should evolve in a relatively orderly manner.

Rating Modification

Syria

Negative watch on the C rating

In view of the potentially unfavourable repercussions the tense political context may have on economic growth, payment behaviour, public-sector finances, and external accounts

Political protest in a poor business environment

President Bashar al-Assad, who began his second seven-year term in 2007, has been contending with a growing protest movement hostile to his regime since mid-March this year, whereas until then the extensive security system and the predominance of his Baath party had enabled him to maintain tight control over the country.

The announcement late March 2011 of the formation of a new government —notably responsible for promoting the creation of jobs and combating corruption — and the implementation of limited political reforms has proven to be an insufficient response to the expectations of a segment of the population for at least a gradual democratization. And the disappointment was compounded by the failure of President Assad to announce the lifting, albeit expected, of the state of emergency in force since 1963 and by the perception that everything would be done to ensure that the legislative elections, still scheduled in April this year, result in a broad victory for the Baath Party.

Moreover, there continue to be considerable obstacles to change and gradual liberalization of the economy, although authorities have already begun to overhaul the business and banking sectors and have plans for law on public-private partnerships. And the business environment suffers from major weaknesses including limited corporate transparency, bureaucracy, nepotism, corruption, a shortage of skilled labour, and the lack of a consistent framework for foreign direct investment. All these factors, in conjunction with the marked deterioration in the political context, could give rise to an increase in late payments and debt collection difficulties.

Weaker than expected economic growth attributable to the political tensions

GDP growth in 2011 is expected to be underpinned by the social measures announced by the authorities in response to the protest movements and by the investment spending planned by the government. And household consumption will likely benefit from the recovery expected in the farm sector, which will buoy incomes, as will the social measures, and from remittances by emigrant workers. Conversely, the strong political tensions prevailing in the country could have a negative impact on household consumption in the near term.

On the supply side, the hydrocarbon sector, a decline in production notwithstanding, will likely make a positive contribution to growth thanks to the rise of barrel prices and the development of a new facility near Homs for the production of gas intended for fertilizer factories and cement makers. Conversely, services, which now represent 45% of GDP, especially tourism, are expected to suffer from the effects of the deteriorated political situation, whereas the goal adopted for the sector had been to double hotel capacity in the next five years with the construction sector expanding in consequence. The recent political events could moreover delay action on a crucial strategic objective set by the authorities: to strengthen Syria's role as a regional hub, by improving and developing road and rail links with neighbouring countries, improving port infrastructure, and liberalizing air transport.

Persistence of the twin deficits

As regards public finances, the authorities have sought to diversify revenues to compensate for the decline in oil export earnings. But as a result of the political tensions, the gradual implementation, from 2011, of a value added tax could be delayed and food products will likely be exempt. And the authorities moreover were prompted to interrupt, at least temporarily, their efforts to reduce subsidies. As a result of this new unstable context, no reduction in the fiscal deficit will be likely in 2011. The cancellation in 2005 of Syria's bilateral debt with Russia nonetheless made it possible to reduce the public debt-to-GDP ratio to about 20% in 2010.

As regards the external accounts, the rise of barrel prices and a slight increase in grain and cotton production will likely make it possible to limit the trade deficit, even though Syria's imports of oil products are equivalent in value to its exports of crude oil. Meanwhile, the likely slowdown in tourism revenues and the possible stagnation of transfers from expatriates will be unlikely to enable even a slight reduction in the current account deficit-to- GDP ratio.

However, Syria's external financial position presents no major difficulty considering its moderate level of debt and comfortable foreign exchange reserves.

Rating Modification

Libya

Downgrade from C to D

The extreme worsening of the political and military situation is causing dramatic drop in economic activity, degradation of public and external accounts, and a further deterioration in the already very difficult business environment.

A popular uprising degenerating into military conflict

In power for nearly 42 years, Muammar Gaddafi has faced since mid-February 2011 an unprecedented popular uprising, starting in the eastern part of the country, in the aftermath of the Tunisian and Egyptian revolutions. The armed opposition has, however, met with strong resistance and then to a counter-offensive from the forces of power in place. Moreover, the regime of Colonel Gaddafi has been isolated on the international scene: Libya has been ousted from instances of the Arab League and the Security Council of the United Nations adopted on 17 March 2011 a resolution authorizing use of force to protect civilians, including through the establishment of a no-fly zone. Air strikes were since carried out by a coalition mainly US-Franco-British, but the risks of a stalemate, a civil war or partition of the country into east and west are high, owing to determination of the regime of Colonel Gaddafi.

Devastating economic consequences in 2011

Whatever the outcome of military conflict, the economic consequences will be devastating, at least in the short term. The activity must shrink dramatically in 2011, of at least 15% according to estimates, due to total disruption of production and oil exports resulting from the conflict.

Ultimately, the level of activity will depend on the possibility of restarting oil production by foreign oil companies, which manage a very significant proportion of resources. Moreover, the resumption of oil exports will be dependent on securing supply routes and the reopening of the main ports.

Public and external accounts very negatively impacted

The country has recorded fiscal and current account surpluses until 2010, thanks to the exploitation of hydrocarbon resources (90% of budget revenues and 95% of exports).

Public finances will suffer greatly from the near depletion of oil production, representing most of the budget revenue. The implementation of development programs and maintaining public subsidies, especially for food, health and housing, will be postponed. After a budget surplus of 13% of GDP in 2010, the public accounts could show a deficit of about 25% by some estimates, although so far public debt was equal to zero.

The external accounts will also be significantly deteriorated, from a surplus of 20% of GDP in 2010 to a deficit of at least 1% in 2011. The main reason is the fall in oil production and, moreover, increases in import prices of foodstuff and semi-durable goods.

In this context, the very large foreign exchange reserves (representing more than three years of imports in 2010) should melt and heavy pressures on the exchange are expected. In addition, the fate of the sovereign wealth fund, Libyan Investment Authority, equivalent to the amount of GDP, is in question following the intensification of international financial sanctions against the regime of Colonel Gaddafi, resulting in a freeze of assets abroad of this SWF.

Business environment even more catastrophic

The institutional and governance problems have continued to weigh during the oil boom of the 2000s and slowed the diversification of the industrial fabric. Indeed, plans to liberalize the economy and privatize public enterprises have encountered strong opposition within the ruling class.

In addition, the business environment was very difficult, due to uncertain regulation and administrative inefficiency, which greatly slowed the decision process.

In the current context, these problems will escalate dramatically and cause long delays in payment and debt collection problems.

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