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Economic Outlook
May 2014

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Editorial

In our November Economic Outlook we reported that "things were different" – an observation that marked a change in the fortunes of the global economy. A change, indeed, for the better. We finally saw growth in advanced economies picking up, whilst emerging economies were powering on, although at a slowing pace. Large downside risks, such as a Eurozone break-up, showed signs of receding. That picture, at the time still tentative, has now, six months later, strengthened further. Several events in the past couple of months, however, have emphasised that the high growth levels in emerging economies can no longer be taken for granted.

Firstly, as the US Federal Reserve (the Fed) carefully executed its 'forward guidance' policy to communicate gradual retreat, or 'tapering', from expansionary monetary policy, a possible mini-crisis in the global financial markets as in the summer of 2013 was averted. But this did not prevent other, more country-specific events, happening early this year. Argentina, not exactly a textbook case of economic management, was involved. Ukraine and Russia followed suit, as did 'Fragile Five' members Turkey and South Africa. The emerging market turmoil forced interest rate hikes and the spending of foreign currency reserves to prevent uncontrolled currency depreciations. These measures restored calmness, but reinforced the existing pressure on economic growth: it is also clear that risk aversion among investors has risen.

Secondly, the secession of the Crimea and subsequent events in eastern parts of Ukraine put the already muted economic growth prospects for Russia under further pressure. Financial markets sent a gentle reminder of the economic impact of geopolitical tensions: the Moscow stock exchange fell by more than 20%, the rouble depreciated and capital flight ensued as (the threat of) US and EU sanctions mounted. Interest rate hikes and foreign currency reserve spending were used again, but with only limited success. As this Economic Outlook goes to press, we see the growth forecast for Russia still being adjusted downwards. On the assumption that tensions will gradually recede, the impact on Eurozone growth will be limited.

Meanwhile, in the Eurozone optimism reigns. Further progress was made with the European Banking Union, as a final agreement on its configuration was reached. This represents a big leap in terms of integration, strengthening monetary union. Freed from excessive Eurozone gloom, sentiment indicators have continued their rapid ascent, paving the way for economic revival. Even Greece managed to issue a heavily oversubscribed EUR 3 billion sovereign bond in April. Tight credit conditions and high levels of unemployment will, however, continue to weigh on the revival.

Against this background, it comes as no surprise that the dynamics in our forecasts are a little different from previous editions of our Economic Outlook. Emerging economies' growth forecasts for 2014 have been adjusted downwards since November 2013, in particular for Latin America (by 0.9 percentage points). For Asia the adjustment is marginal (0.1 percentage points). The adjustments for the US and Eurozone, on the other hand, are up (by 0.1 and 0.3 percentage points, respectively). The gap in growth between the emerging and advanced economies is shrinking, reversing a long time trend.

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Executive summary

Global economic growth has picked up over the past six months and is expected to continue to accelerate this year and next. This is driven largely by stronger growth in advanced markets, while growth in emerging markets is slowing.

Key points

- The global economy is forecast to expand 2.9% in 2014 and 3.2% in 2015.
- The Eurozone has performed better than expected and is forecast to expand 1.2% in 2014. The United States economy is also accelerating, and growth of 2.7% is expected this year.
- Latin America, Emerging Asia and Eastern Europe are all forecast to see a slight deterioration in economic growth prospects in 2014 compared to last year.
- Risks to the outlook are; 1) that the normalisation of US monetary policy could further unsettle emerging markets; 2) the sustainability of high Chinese economic growth is uncertain; 3) escalating political tensions between Russia and the West could damage the economy; and 4) the Eurozone recovery is still fragile and could derail.
- We forecast that the insolvency environment will improve in the Eurozone and the US, but may deteriorate across emerging markets.

Global economic growth is forecast to reach 2.9% in 2014, up from 2.5% last year. This is still below its pre-crisis historical average, but growth is expected to pick up further to 3.2% in 2015. As a result of the better performance of the global economy, trade is forecast to increase 4.5% in 2014. Last year trade grew only 2.2%. Trade growth is still restricted by protectionist measures and tight conditions for trade finance.

Advanced markets have experienced improving conditions and can expect further improvement this year and next. The Eurozone crisis has moved further into the background, with growth also recovering in the Southern European countries. Portugal and Greece made good process with their programmes and were both able to issue a long-term government bond for the first time in years. The US economy also picked up steam and its performance is set to improve further this year despite a poor first quarter as a result of harsh weather conditions in a large part of the country. The robust recovery has triggered the central bank to start scaling back its expansionary monetary policy.

Many emerging markets have seen their growth forecast cut significantly over the past six months. Latin America in particular has seen a substantial drop in expectations, as financial unrest arose in Argentina and Venezuela over domestic issues at the beginning of this year. Economic growth in Latin America is projected to slow to 2.3% this year. Eastern Europe has in turn been affected by the crisis in Ukraine and tensions with Russia. The region is projected to expand 1.7% in 2014. Emerging Asia has performed better, despite the slowdown in China, and can expect 6.0% growth this year.

As a result of the changing economic environment, insolvency conditions are expected to improve in advanced markets but deteriorate in emerging markets. We forecast zero insolvency growth or even a reduction in insolvencies in all advanced countries that we track, except for Italy where we forecast a 5% rise. Denmark, Ireland and the Netherlands are expected to experience the largest reductions in insolvency numbers. The level of insolvencies will, however, remain twice as high in the Eurozone as in 2007 and in the periphery the level will be almost four times as high. Of the emerging market regions, Eastern Europe and Latin America may experience an increase in corporate defaults in 2014, although from relatively moderate insolvency levels.

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1. The global macroeconomic environment

Global growth is picking up…

In last November's Economic Outlook we signalled that the period of global economic decline that began in the second half of 2011 had bottomed out. The Eurozone hesitantly came out of recession whilst the United States continued to grow. In emerging economies, on the other hand, growth had started to slow somewhat. As a result, the growth differential between advanced and emerging economies was narrowing. This trend continued throughout the second half of 2013 and the early months of 2014.

The process accelerated. Growth in the US gained momentum with a fading fiscal drag. Moreover, Eurozone performance turned out to be stronger than previously expected, although growth remained rather muted with credit growth constrained and high unemployment. And, despite an unmistakable slowdown in China, the world's second largest economy, emerging economies still delivered relatively high growth levels. Therefore the picture for global growth remained robust. What we are seeing now is something that has been eagerly awaited since late 2011: evidence of stronger growth. The positive momentum is also expected to strengthen, at least throughout 2015. Global growth is picking up.

However, many emerging markets have faced significant financial unrest. In May last year international investors were spooked by the announcement of a possible reduction in the expansionary US monetary policy. Funds flowed out of relatively risky emerging markets, putting exchange rates under pressure. New shocks to the financial markets occurred in late 2013 and early 2014 and, again, emerging economies were the centre of attention. But this time fundamental political and economic issues were the underlying reasons for the unrest: in Argentina, Turkey, South Africa, Ukraine and Russia.

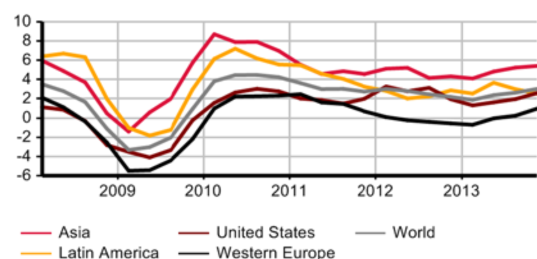
This bout of turmoil served as another reminder of the increased vulnerability of growth conditions in emerging economies. Currently accounting for two thirds of global economic growth, their previous high levels of growth can no longer be taken for granted. The focus of concern about the global economy has shifted away from advanced markets and towards emerging economies.

…due to stronger advanced economies

Global growth bottomed out in the last quarter of 2012 and increased throughout 2013, led by accelerating growth in advanced markets. That global economic growth reached 3% in the fourth quarter, compared to just 2% in the first quarter of last year. On average, the global economy expanded 2.5% for the full year (see Chart 1.1). The impetus came from advanced economies, which grew 2% in the last quarter, and reached 1.2% on average for the full year. Growth in emerging economies, while much higher - at 4.6% for the full year - was essentially stable and therefore contributed little to the overall increase for the year.

Chart 1.1 Real GDP growth

(Annual percentage change in quarterly GDP)



Source: IHS Global Insight

Of all the major regions, the Eurozone showed the largest improvement. On average for the full year, the Eurozone contracted 0.4%, but growth reached 1.1% in the fourth quarter of 2013. Sentiment has improved markedly in the Eurozone, including in its periphery, and the Eurozone crisis has gradually become a distant issue. In Latin America, on the other hand, growth had a rough ride in 2013, with

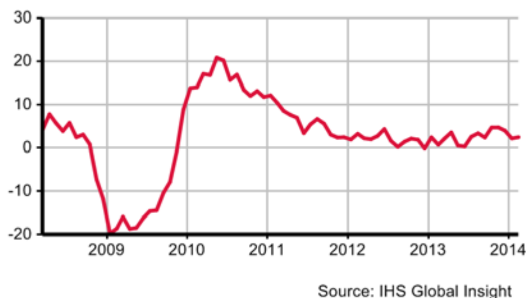
the growth rate in the fourth quarter more or less the same as in the first.

Trade growth: still on the tarmac

As economic growth picked up in 2013, growth in world trade also started to improve[1]. Overall trade growth for 2013 reached 2.2%, slightly higher than in 2012. Trade growth increased across most regions in the second half of 2013, reaching 4% in the last quarter of the year. That growth was strongest in Latin America, where an annual figure of 5.8% was reported. Asia saw a moderation in trade growth which, at 3.1%, was slightly weaker than in the previous year: Chinese trade slowed to 9.3%, markedly down from 2012's 12.3%. In the US and the Eurozone, trade growth remained muted, with annual figures of 0.6% and 1.1%, respectively.

Chart 1.2 World trade growth

(Annual percentage change in global trade volumes)



Source: IHS Global Insight

However, the momentum slowed again in the first quarter of this year (see Chart 1.2). Moreover, the growth rate is still well below the historical average of 5.5% seen since the 1990s. The underlying reasons behind the sluggish trade performance, also discussed in previous editions of our Economic Outlook, are still present. And the situation is not exactly improving.

Firstly, protectionist measures abound - and are still on the rise. According to the WTO[1] 407 new restrictive measures (such as tariffs) were initiated over the November 2012 to November 2013 reporting period, compared to 308 in the previous reporting period. Other measures, such as anti-dumping and safeguarding actions, were also up – with 217 new ones introduced against just 138 cancelled. Finally, the number of import tariff increases rose to 190, from 164 during the previous period. By contrast, measures to facilitate trade fell to 103 from 162. Altogether, around USD 700 billion, or 4% of global trade, was affected by protectionist measures in 2013. And this figure comes on top of the existing measures already taken since the 2008 crisis: it hardly creates an environment in which trade can flourish.

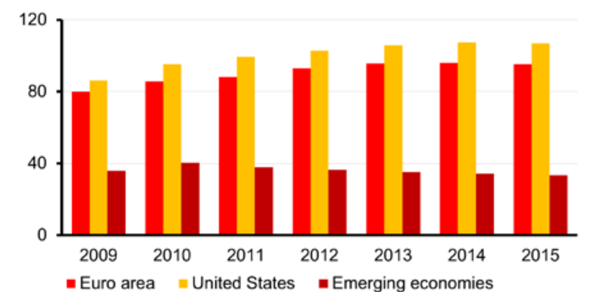
Secondly, trade finance continues to be constrained by tight conditions, with an estimated financing gap in excess of USD 25 billion per annum. Such a gap has been present since the liquidity crunch in 2008 and shows no signs of being plugged - or at least substantially repaired. Regional development banks and the International Finance Corporation (IFC) have stepped up efforts, as have export credit agencies and some central banks, but this seems insufficient. Trade finance, especially with respect to emerging economies, is low: according to an IMF and Banker's Association for Trade and Finance survey, the supply of trade finance is depressed by 6%.[2]

Fiscal consolidation is slowing but ongoing

Large fiscal deficits push up national debt levels and make a country vulnerable to changing investor sentiment. As discussed in previous editions of Economic Outlook, governments in advanced markets are trying to improve their public finances. Due to a mix of bank rescue operations and fiscal stimuli to revive the ailing economy, the aggregate debt level increased to 109% of GDP in 2012: up from 80% in 2008 (see Chart 1.3). Since then, fiscal consolidation has been the buzzword, but cutting government spending or raising taxes puts downward pressure on economic growth. This was also the case in 2013.

Chart 1.3 Government debt

(Gross gov. debt, % GDP)



Source: IMF

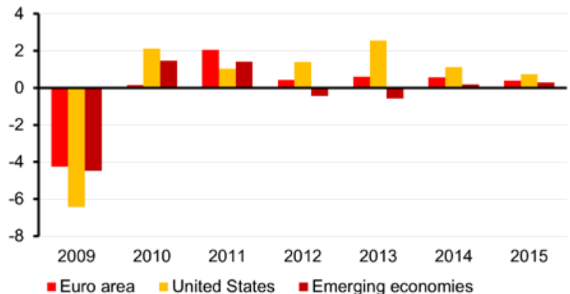
[1] www.wto.org/english/news_e/spra_e/spra8_e.htm

[2] The WTO concludes, however, that the Basel III rules won't be more unfavourable than initially envisaged (17 January).

In advanced economies, fiscal deficits were reduced from 6.2% to 4.9% of GDP, implying a change in the budget balance, or fiscal consolidation, of 1.3%. The effect was most accentuated in the US, where the fiscal drag amounted to 2.4% of GDP (see Chart 1.4). In the Eurozone, the degree of consolidation was more modest, at 0.7% of GDP. This average, however, masks fairly large differences between countries: Spain, Portugal and Greece reduced their fiscal deficits significantly. At 0.3% of GDP, the emerging economies took a less restrictive fiscal stance with Brazil, China and Russia actually stimulating their economies.

Chart 1.4 Fiscal consolidation

(Change in budget balance, % of GDP)



Source: IMF

Because of the still high government debt levels, fiscal consolidation will continue in 2014 and 2015, although at a slower pace. In the advanced economies the effect of fiscal consolidation will be halved compared to 2013. Again, the consolidating efforts in the US will be stronger than in the Eurozone. The emerging economies are also expected to consolidate across the board: particularly China. Overall, the fiscal positions are improving and the drag on the global economy is decreasing, albeit slowly.

Diverging trends in monetary policy

While the fiscal drag on the global economy is easing, the opposite is about to happen with monetary stimuli; at least to the extent that the US Federal Reserve is concerned. In January the Fed started to reduce its USD 85 billion monthly purchases of bonds in incremental steps of USD 10 billion: to USD 45 billion in May. This 'tapering' process of the expansionary US monetary policy is a first step towards normalisation. The bond purchases will be decreased to zero in a number of steps and then followed by Fed fund rate hikes from the current level of 0.25%. These interest rate hikes are expected to start sometime in 2015. The reduction in bond purchases that has taken place since January is reflected in the slowing pace of the Fed's balance sheet expansion (see Chart 1.5).

Chart 1.5 Balance sheet ECB and Fed

(Assets billion of euro)

Source: IHS Global Insight; ECB, FED

At the same time, the European Central Bamk (ECB) is still in an accommodative mood. It has supported the banking system with long-term funding through its Long-Term Refinancing Operation (LTRO) since the autumn of 2011. At that time it was needed to keep the monetary system alive and for the ECB to pursue its main objective: price stability in the Eurozone.[3] The continued low growth across the Eurozone and a gradually decreasing level of inflation below the 2% target has increased pressure on the ECB to apply further monetary easing (see Chart 1.6). Very low inflation, or even deflation, would be detrimental to the weak Eurozone recovery, and arguably the global economy. The ECB is, however, unlikely to act soon, but has indicated that it will take measures if and when needed.

Chart 1.6 Consumer price inflation

(Annual percentage change CPI all items)

Source: IHS Global Insight

[3] Since the beginning of 2013 repayment of a number of loans under the LTRO has taken place, particularly by Spanish banks, shrinking the ECB balance sheet (see Chart 1.5).

Emerging economies become reactive

Fed policy, more than that of the ECB, has a major global impact. You may recall the impact that the first announcement of tapering had in May last year: US bond yields rose quickly, with an impact on Eurozone bonds as well (se Chart 1.7). Markets woke up to the fact that the Fed's expansionary policy would not last forever. Until the Fed's announcement, investors had borrowed at low rates in advanced markets and invested in emerging markets where yields were high. This suddenly became much less attractive as funding costs rose in advanced markets, and funds rapidly flowed out of emerging markets.

Chart 1.7 Long-term government bond yields

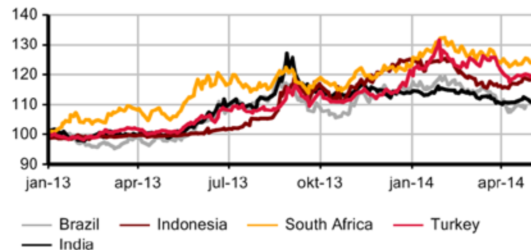
(10-year maturity, percentage points)

Source: IHS Global Insight

Many emerging economies were affected by exchange rate depreciations as investors withdrew their funds. In particular, the so-called 'Fragile Five' (Brazil, India, Indonesia, Turkey and South Africa), experienced sharp corrections (see Chart 1.8). The turmoil slowly settled down and the actual start of tapering in January 2014 went largely unnoticed. However, early in 2014 another bout of turmoil flared up. It started with Argentina, whose currency came under immense pressure due to rampant rates of inflation. In oil-rich Venezuela, foreign exchange reserves also grew increasingly scarce, reflecting the implosion of the revolution of the late Hugo Chavez. The Russian economy, which had been stagnant for a number of quarters, followed suit. And the currencies of Ukraine, Poland and Hungary were affected, all for different reasons.

Chart 1.8 Exchange rates against the USD

(Index, 2 January 2013 = 100)

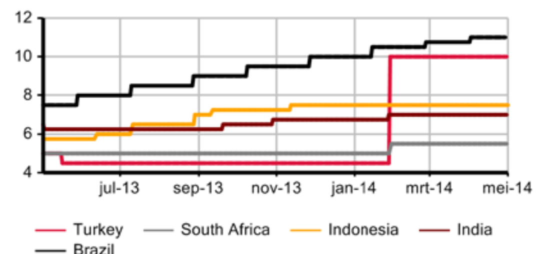


Source: IHS Global Insight

Focusing on the underlying fundamentals, all of the 'Fragile Five' are vulnerable in the sense that they run current account deficits, albeit with significantly different sizes and trends. Turkey (almost 10% of GDP) and South Africa (6%), both with a worsening trend, score poorly in this respect. India, Indonesia and Brazil also run deficits, but to a much lesser extent. By the end of 2013, the deficit trends had improved somewhat on the back of a number of policy rate increases (see Chart 1.9).

Chart 1.9 Fragile Five: Policy Rates

(Central bank policy rates, percent)



Source: IHS Global Insight

Moreover, the interest rate responses helped counter inflationary pressures that come with depreciations. As a result, most of these countries were in better shape by the time of the second bout of financial market unrest. Turkey and South Africa, however, had not undertaken sufficient measures: their current account deficits and inflation were still at vulnerable levels. They therefore had to react more aggressively: in the case of Turkey by way of a single rate hike of 5.5%.

This marks an important difference from the situation in May last year: it is country-specific rather than driven by the Fed's tapering. At the same time, the developments in January should be

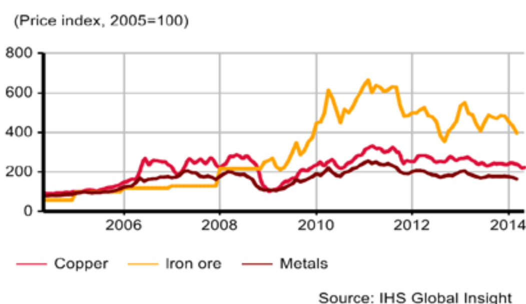
viewed at least to an extent in the context of that tapering. The tapering has made investors aware that money will be less abundant. This causes them to be more critical in their investment decisions, which are then ultimately based on country-specific macroeconomic fundamentals. Moreover, the degree of freedom for monetary policy in emerging economies, and particularly the vulnerable ones, may be much lower than previously perceived. In that respect, emerging economies have become largely reactive.

Commodity prices: soft metal...

After the strong growth in demand for commodities in the first decade of the century, the market has stabilised over recent years. The Chinese slowdown, particularly in the real estate sector, has had its impact on commodity prices: visible in both metals and oil.

Chart 1.10 Global commodity prices

(Price index, 2005=100)



Source: IHS Global Insight

Metal prices have decreased since the last quarter of 2013 and the index is now 30% below its early 2011 peak (see Chart 1.10). The fairly steep decline is due to both supply and demand factors: a continued rise in mining supply and moderating demand due to the slowdown in the Chinese real estate sector. Two major components of the metals index, copper and iron ore, show slightly different price developments.[4] The reduction in the price of iron ore is much more pronounced: a 40% decline, compared to 30% for copper.[5] Iron ore production is expected to increase markedly as new producers in West Africa and Brazil emerge. Under these circumstances, a price recovery appears distant: commodity price futures support this view for 2014 and 2015.[6]

[4] The aggregate weight in the IMF index of the two metals is 55%.
[5] In our report, The Chinese Copper Market: opportunities and challenges, Atradius Economic Research, February 2014, we delve deeper into the copper market.
[6] See IMF, World Economic Outlook April 2014, p.17.

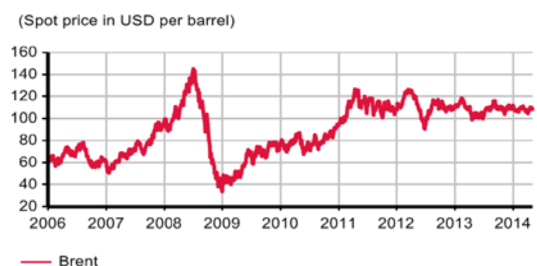
The impact on economic growth in emerging economies is unmistakable. Estimates published by the IMF indicate that net export revenues (and thus GDP) are significantly affected by the Chinese slowdown: the estimates point to 1.5 percentage point lower growth for Chile (copper), 0.5 for Brazil (iron ore) and 0.25 for South Africa (iron ore).[7]

...and rippling oil

Oil prices have moved sideways around USD 110 to 105 per barrel for Brent since the beginning of 2013, somewhat below the 2012 level (see Chart 1.11). Supply from the US, especially shale oil, has continued to surge: as a result, non-OPEC supply grew by 1.3 million barrels per day, above the increase in demand of 1.2 million. In line with slower growth in emerging economies, demand has been rather tepid. At the same time, the price was supported by supply disruptions (in Libya, Nigeria, Syria and Yemen) and continued sanctions against Iran. And by 'swing-production' in Saudi Arabia.

Chart 1.11 Oil prices

(Spot price in USD per barrel)



Source: IHS Global Insight

While the fundamental oil price determinants are expected to remain largely unchanged in 2014 and 2015, the oil price is facing some slight downward pressure as indicated by futures prices. The future-based IMF forecast is USD 108 per barrel Brent for 2014 and USD 105 for 2015. Just as with metals, the IMF expects the reduction in demand from China to have a negative impact on oil revenues. Oil exporting countries in the Middle East are worst affected by the adjustment, with an approximate impact on net revenues of around 2% of GDP. Among other oil exporters the effect is less pronounced: Nigeria (1.5%), Venezuela (1%), Ecuador (0.5%) and Mexico (0.25%).

[7] See IMF, Commodity Market Review, October 2013, p. 5.

Geopolitical tensions rise

A phenomenon that was thought to be long gone has again resurfaced with full force: political tensions between Russia and the West. The first hint of strained relations appeared during the Syrian crisis, in late 2013. To fend off an imminent US military intervention Russia stepped in by launching a diplomatic initiative. Then, in early 2014, in Ukraine, political unrest and a possible move towards the EU and away from Russian influence triggered further Russian assertiveness. Russia annexed the Crimea (part of Ukraine) and fuelled political opposition in the eastern part of the country. The US and EU have backed Ukraine by retaliating with sanctions, while NATO has suspended its cooperation with Russia and started to mobilise troops in countries across Russia's western border. The global political stance increasingly resembles the old cold war situation.

The political tensions have already left a deep imprint on the Russian economy. The Moscow stock exchange index has fallen significantly, the rouble has depreciated and capital flight has accelerated. Sanctions imposed by the US and EU will further eat into confidence and restrain financial flows. Since February the growth forecast for Russia in 2014 has been revised downwards to 0.9%. If additional military steps are taken, or if the sanctions are heightened, even this figure may be overly optimistic: and then the economic impact will be felt outside Russia as well.

An outlook with two faces

This chapter has highlighted the prospects of stronger growth rates in advanced economies and pressure on the high growth rates in emerging economies. Comparing the 2014 forecast in our November Economic Outlook with the current growth expectations, this trend is strong. For the US, growth in 2014 has been revised upwards: from 2.6% in November last year to 2.7% in April this year. Similarly, the Eurozone forecast for 2014 has strengthened from 0.9% to 1.2%. Although small, these revisions are noteworthy.

In emerging economies, we have seen the opposite movement: downward revisions. This holds true in particular for Latin America, for which the growth forecast has been reduced by 0.7 percentage points since November last year to 2.2% in 2014 (see Table 1.1). Some countries have seen quite substantial growth forecast revisions: Brazil (-0.6 percentage points), Argentina (-2.6) and Venezuela (-1.8). However, the growth prospects for Asia in 2014 have changed only marginally (-0.2 percentage points). And the level still remains high at 4.5%.

Table 1.1 Real GDP growth - Major regions

	2011	2012	2013	2014f	2015f
Western Europe	1.5	-0.3	0.1	1.5	1.8
United States	1.8	2.8	1.9	2.7	3.0
Eurozone	1.5	-0.6	-0.4	1.2	1.5
Asia Pacific	4.6	4.6	4.6	4.5	4.6
Latin America	4.2	2.9	2.6	2.2	2.8
Eastern Europe	4.8	2.4	2.0	1.7	2.8
Total	3.1	2.6	2.5	2.9	3.2

Source: Consensus Forecasts (April 2014)

Revisions aside, the growth figures should also be viewed from a relative perspective. The level of growth across emerging economies, and more specifically Asian economies, still dominates that in advanced economies and growth in emerging economies is still driving global expansion. With trade barriers increasing since 2008, trade growth will also remain relatively slow in 2014 and 2015. As global GDP growth picks up, trade growth can be expected to reach 4.5% over the forecast horizon: well below both the long-term average and the underlying potential.

Major risks to the outlook

The baseline forecast presented in Table 1.1 above is based on a number of assumptions about the major issues in the world economy discussed throughout this chapter: the impact of Fed tapering, Chinese growth sustainability, ongoing geopolitical tensions and, finally, the fragility of economic conditions in the Eurozone. We briefly review each issue in turn below (see Table 1.2).

Table 1.2 Risks to the global economic outlook

		Symptons	Effects	Probability	Impact
1.	US monetary policy	Uncertainty and confusion over the rate of change in the US monetary policy.	Financial market volatility. Capital outflows from specific emerging markets.	low/moderate	high
2.	Chinese growth	Signs of an accelerating slowdown in economic activity. Or instability in the banking sector.	Lower Chinese economic growth. Spill-over effects to the rest of the world via trade and commodity price channels.	moderate	high
3.	Geopolitics	Escalating political and social unrest in the Ukraine. Further implementation of US/EU and Russian counter sanctions.	Slowdown of Russian economy. Adverse effects on global trade.	moderate	high
4.	Eurozone growth	Slowing economic growth. Or persistent decline in the rate of inflation.	Stagnation across the Eurozone. Reescalation of sovereign debt issues.	low	moderate

Source: Atradius Economic Research

Fed tapering: As the Fed exits its expansionary monetary policy it has mapped out a trajectory to steer the decisions of investors: so-called 'forward guidance'. This is more an issue of efficient communication than economics. In that respect, as long as the message is consistent and expectations are carefully managed, the risk of sudden shocks may be considered rather low. Moreover, the Fed may have learned from the impact of its May 2013 statement. However, financial market volatility cannot be disregarded and rapid changes in investor sentiment are hard to predict or control. A new period in which funds flow out of emerging markets could take place, putting exchange rates under further pressure, triggering further rate hikes by emerging market central banks and weighing on growth in these economies.

Chinese growth: The economic slowdown in China is a key factor behind weaker performance of emerging economies more generally. The Chinese economy has decelerated from growth of more than 10% in 2010 to 7.7% in 2012 and 2013 as it reduces its credit and investment binge. Spill-over effects to the rest of the world come via trade and commodity price channels. As we argue in Chapter 3 of this Outlook, the Chinese government is set to maintain growth at around 7.5%: and it has ample reserves to support such a growth level if needed. China is likely to use the tools at its disposal, as lower growth levels may trigger social unrest, jeopardising the very existence of the Chinese political system. But the risk of a more marked slowdown in the coming years cannot be discounted and, if it materialised, this would certainly result in a less rosy picture for the global economy.

Geopolitical tensions: We have experienced a dramatic increase in geopolitical tensions as a result of Russia's assertive foreign policy. Although we foresee quite high costs for the Russian economy if it takes further steps against Ukraine, such steps can clearly not be disregarded. Further aggression will almost certainly be answered by more US and EU sanctions and, in turn, Russian counter-sanctions. Those may include the stoppage of gas supplies, in response to 'Iran-style' sanctions imposed on Russian financial institutions. Such measures will hit the Russian economy too, in addition to the already severe impact expected, with capital outflows, higher interest rates and loss of confidence. According to a recent IIF analysis, the impact could amount to 4-5% of Russian GDP.[8] With Russia in recession, or even depression, the spill-over effects via trade and financial channels could derail the fragile European recovery. Economic damage aside, the political consequences of such developments would be rampant.

Eurozone economy: A re-escalation of the Eurozone crisis seen in late 2011 appears to have become a very remote possibility. Financial markets have grown more comfortable with the currency union now that important policy steps have indeed been made (e.g. the European Banking Union, which was previously regarded as unlikely). Even the Greek government managed to make a successful comeback to the capital markets in April (by issuing a EUR 3 billion bond). Despite this progress the recovery in the Eurozone is fragile. It hinges primarily on peripheral countries having exited (or being about to exit) IMF programmes,

[8] IIF, Emerging Europe: Ukraine Crisis and Its Economic Impact, March 2014.

and much improved sentiment. Unemployment and credit constraints, as well as the lingering threat of deflation, hamper a return to more normal post-recession growth levels and a sudden shift in sentiment may easily put growth figures back in the red.

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2. Prospects and risks in advanced economies

Picking up steam

The outlook for advanced markets has continued to improve over the past six months after a decisive turn in the cycle in the second half of 2013. Economic growth is expected to improve further in 2014 and 2015. This suggests a better outlook for credit risk, as we expand on later in Chapter 4 of this report.

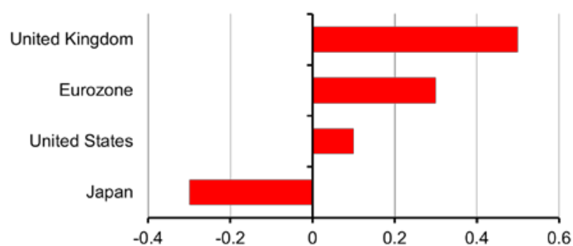
Table 2.1 Real GDP growth - Major markets

	2011	2012	2013	2014f	2015f
Eurozone	1.5	-0.6	-0.4	1.2	1.5
United States	1.8	2.8	1.9	2.7	3.0
United Kingdom	1.0	0.1	1.7	2.8	2.4
Japan	-0.5	1.4	1.5	1.3	1.3

Source: Consensus Forecasts (April 2014)

Economic growth will be much stronger in 2014 than in 2013 (see Table 2.1). The Eurozone officially came out of recession in the second half of last year and has steadily gained momentum: the 2014 growth forecast has been further upgraded since last November (see Chart 2.1).

Chart 2.1 Change in 2014 forecast
(Percentage point change between Nov. and April. 2014)



Source: Consensus Economics

The Eurozone economy is forecast to expand 1.2% this year, up from a 0.4% contraction in 2013. Moreover, the US has cemented its economic recovery over the past six months: following the recent strengthening of the business cycle, attention has now turned to a gradual reduction in monetary policy stimuli. The US economy is forecast to expand 2.7% this year, up from 1.9% last year.

The United Kingdom is also making headway, despite worries over a purely consumer credit driven recovery. The UK economy is forecast to expand 2.8% this year compared to 1.7% in 2013. For Japan, however, the 2014 forecast has been revised downwards over the past six months. The high expectations of the effects of 'Abenomics' have failed to materialise. The Japanese economy is only expected to grow 1.3% in 2014, down from 1.5% last year.

There are still considerable risks to the outlook, although they have diminished since our previous Economic Outlook six months ago. The Eurozone in particular is facing the risk of a further protraction of the economic recovery, possibly as a result of disinflation (or even deflation). To avoid persistent low growth, continued reform efforts to boost productivity are necessary. Reform at the national level as well as at the EU level should help improve credit conditions. For the US, the main challenges lay in managing a cautious exit from expansionary monetary policy and continuing efforts to bring the fiscal position in order.

Eurozone: out of the woods, into the plains

The Eurozone story is about to enter a new chapter. Instead of falling apart, as was feared two years ago, monetary union has expanded. In January this year the currency union welcomed Latvia as its 18th member. The Eurozone economy has picked up across the board with rising consumer spending, business investment and net exports. The latest indicator readings point to a sustained improvement and the general expectation is that the recovery will continue to gain ground over the coming year.

Stuck in second gear

Despite the improved outlook for countries across the Eurozone, growth will remain low by historical standards this year and next. The economy is still weighed down by financial sector frictions and the

continued process of private and public sector deleveraging. Even in 2015 most member countries can expect growth below their pre-crisis averages. Only Germany is forecast to reach the 2% bar in 2015, while Spain (1.5%), Italy (1.1%) and the Netherlands (1.2%) remain stuck at lower growth rates (see Table 2.2). Of the largest Eurozone markets, Italy is showing the weakest performance: the 2014 and 2015 growth forecasts are relatively low and come on top of last year's deep contraction. This is due partly to lack of reform progress and a worse export performance than in countries such as Spain and Portugal.

Table 2.2: Real GDP growth - Major markets

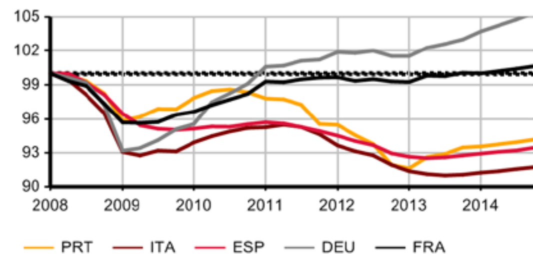
	2011	2012	2013	2014f	2015f
Austria	2.8	0.9	0.4	1.4	1.8
Belgium	1.8	-0.1	0.2	1.2	1.4
France	1.7	0.0	0.3	0.9	1.3
Germany	3.0	0.7	0.4	1.9	2.0
Greece	-7.1	-6.4	-3.9	0.1	1.5
Ireland	2.2	0.2	-0.3	1.6	2.2
Italy	0.6	-2.6	-1.8	0.6	1.1
Netherlands	1.1	-1.3	-0.8	0.9	1.2
Portugal	-1.3	-3.2	-1.4	1.1	1.3
Spain	0.4	-1.6	-1.2	1.0	1.5
Eurozone	1.5	-0.6	-0.4	1.2	1.5

Source: Consensus Forecasts April 2014

Most Eurozone economies are still smaller in terms of economic activity than they were before the crisis. As a result of the deep contraction in 2009 and the subsequent period of low growth and renewed recession in many countries, the Eurozone's economy today is smaller than it was at the beginning of 2008. This is symptomatic of the deep rooted and systematic nature of the crisis: the improved outlook this year and next will only bring most countries a little closer to their previous peak. Italy and Spain are currently 9% and 7% smaller than in 2008, while Greece has lost 25% of its economic output (see Chart 2.2). Germany already surpassed its previous peak in 2010 while France has hovered around its pre-crisis level for the past two years.

Chart 2.2 Real GDP, Eurozone

(Level index, 2008Q1 = 100: forecast for 2013)



Sources: IHS Global Insight; OECD

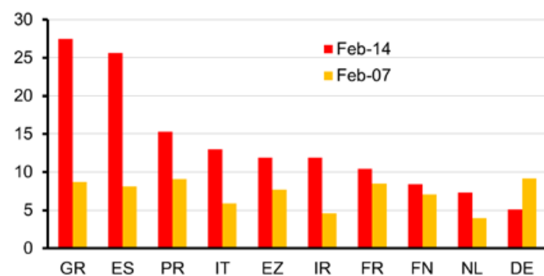
Regaining lost ground

After years of weak growth, most Eurozone countries are still well below full capacity utilisation. According to the IMF, all large Eurozone members, except Germany, face a substantial output gap (defined as the difference between potential output and current output). This largely explains the current high levels of unemployment across the Eurozone. Firms faced with decreasing demand over recent years have either gone bankrupt or shed a large number of jobs.

The Eurozone unemployment rate stood at 11.9% in February this year. It has been stable around this level since January 2013, but is expected to slowly improve as the economy picks up. Only in Germany has unemployment dropped since the onset of the crisis. And, while the rate has increased relatively little in France, it is still twice the level of Germany. Over recent months unemployment has stabilised in most markets but, while unemployment has fallen in Spain and Portugal, it has increased further in Italy (see Chart 2.3).

Chart 2.3 Unemployment rate

(Harmonized Eurostat)



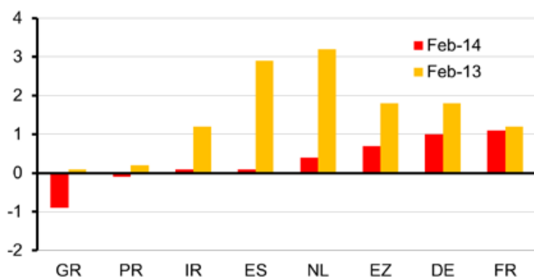
Source: Eurostat

As there is limited need to invest when there is still spare capacity, the large output gaps also explain the low levels of capital investment in recent years. Business investment in the Eurozone dropped to 19% of total turnover in the third quarter of 2013: the lowest level since measurements began in 2002. It also partly explains the low levels of inflation across the Eurozone. With capacity utilisation low and unemployment rates high, there is little room for wage bargaining, and this limits the transmission from higher wages to higher output prices.

Deflation: turning Japanese?

Consumer price inflation has gradually decreased over the past year across many Eurozone markets and has raised fears of imminent deflation. Eurozone inflation dropped to 0.7% in February this year, down from 1.8% a year earlier. Deflation was already seen in Cyprus, Greece and Portugal while prices in Ireland and Spain rose only 0.1% in February (see Chart 2.4). Excluding the volatile items of energy, food and tobacco, Eurozone inflation was 1% in February. If inflation continues to drop further it could tip over into falling prices, or deflation. According to the IMF there is a 20% chance of deflation at a Eurozone-wide level by the end of 2014.

Chart 2.4 Inflation
(Annual inflation rate, percent)



Source: Eurostat

The causes of the low inflation levels are much debated. As previously discussed, one fundamental cause is related to the large capacity under-utilisation across the Eurozone where the lack of demand for additional labour restricts wage growth and keeps prices low. Another fundamental cause has to do with rebalancing within the Eurozone, with countries in the Eurozone periphery trying to regain their international competitiveness by reducing domestic wages and prices. Low prices in those countries are, from this perspective natural and a good thing. Another part of the explanation of the drop in inflation is the fact that many tax increases that were implemented by Eurozone governments no longer impact the figures.

The impact of deflation is greatly feared. The result would be an increase in the real interest rate, pushing up both the public and private debt burden. In addition, a drop in real income makes it more difficult to service debt that maintains its nominal value. Consumers may also postpone large purchases in expectation of lower prices in the future, while business investment falls as the real cost of funding increases. Deflation across the Eurozone would also make it more difficult for periphery countries to achieve their internal devaluation: they need to step up their effort to reduce prices if they are to avoid greater harm to their economies.

Chart 2.5 ECB interest rate
(ECB refinancing rate, percent)

Source: IHS Global Insight

There is no 'silver bullet' to counter deflation. The European Central Bank (ECB) has indicated that it will take measures when it believes deflation to be imminent, but remains uncertain whether it will be ready to revert to large-scale quantitative easing, i.e. purchasing government bonds and private debts. The refinancing rate is currently 0.25% and may be lowered to zero (see Chart 2.5). The accompanying deposit rate could even be reduced to slightly below zero. But those measures are unlikely to provide sufficient power, forcing the ECB to revert to quantitative easing.

Despite an inflation level well below the ECB target of an inflation rate "below but close to" 2%, it has so far refrained from taking any action. The ECB still expects that inflation levels will slowly increase over the course of the year as economic activity picks up. It also argues that increasing inflation across the Eurozone may lead to new asset bubbles in Germany, creating new problems. Moreover, it is also uncertain whether quantitative easing would

be successful in pushing up inflation: given the poor experience of the Bank of Japan in the 1990s and the current low levels of inflation in the US and UK despite their more expansionary monetary policies, the effects are debatable.

Financial market measures bear fruit…

Looked at from the perspective of bond market developments, the Eurozone crisis is quickly resolving. Yields on long-term government bonds of countries in the periphery have been falling since August 2012, when ECB president Mario Draghi announced that the ECB would "do whatever it takes" to prevent the Eurozone from breaking up. Bond markets have further been calmed by the positive signs of economic recovery since the second half of 2013 (see Chart 2.6). Spanish and Italian bonds traded only 1.5% above German bunds in April, down from more than 3% a year ago. As a result of the general spread converging, Greece was able to launch a successful government long-term bond auction in April: the first since 2010. Investors may now also anticipate monetary action by the ECB to address low levels of Eurozone inflation, which would further push down bond yields.

Chart 2.6 Bond spreads within the Eurozone

(10-year bond yields over the German bund, percentage points)

Source: IHS Global Insight

Progress towards banking union is to be applauded. During the crisis many Eurozone banks needed to be bailed out by the government, and some governments had to be bailed out by the European Union and the IMF. That resulted in the creation of temporary backstop funds and later the permanent European Stability Mechanism (ESM), which governments can tap into on strict conditions. It also laid bare the fundamental weakness of the European financial system and called for the creation of a fully-fledged banking union. This banking union would entail three stages; 1) a resolution fund for banks and governments; 2) a supranational supervisor; and 3) a European deposit insurance scheme. Progress has been made on the first two, while the last has been shelved due to political opposition, mainly from Germany.

A bank resolution fund has been created. On 15 April the European Parliament agreed to the creation of a European 'bail in'-mechanism for failing banks. In the event of a bank's failure, creditors and deposit holders (in excess of EUR 100,000) will take the first hit before banks can tap into the newly created EUR 55 billion resolution fund (SRM). This should prevent the burden that falls on a national government from dragging down the sovereign's own debt servicing capacity. But the fund is relatively small: it cost European governments almost EUR 600 billion to bail out failing banks during the last crisis. It remains to be seen whether the current set-up will be sufficient to stop a future crisis from spreading from the banks to the sovereigns. The resolution council which will be responsible for managing the programme will begin operating in 2016.

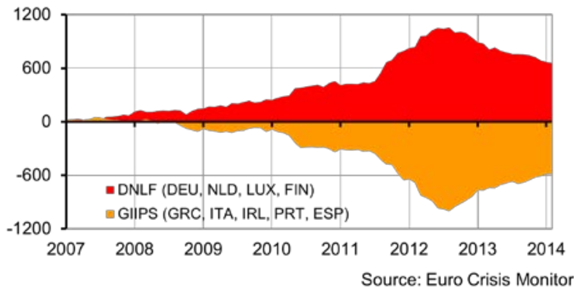
The ECB has agreed to take up the role of supranational supervisor starting in autumn this year. The ECB will directly supervise the largest systematically important banks and indirectly the rest. A review of all major Eurozone banks was a requirement for the creation of a new supervisor. The asset quality review (ASR) covers the 120-130 largest banks across the EU and includes a stress test. This covers around 85% of the Eurozone banking system. The results of the review are expected to be disclosed in November this year. Banks that fail to meet the requirements will be forced to seek additional capital. The goal is twofold; it should rebuild confidence in the solidity of European banks, and it should finally clean the banking sector from bad debt in order to free up space for new lending. Most banks are expected to pass the test without too much trouble as they have been anticipating the review. Others may be forced to raise additional capital on the market.

…but banking fragmentation remains

Financial fragmentation remains a problem. The cleaned up (and backed up) financial sector should reduce the high levels of fragmentation within Europe. As risk conditions escalated with the Eurozone debt crisis, the interbank market dried up for banks in the periphery. The payment settlement shifted from the interbank market to the ECB as banks no longer enjoyed sufficient trust as

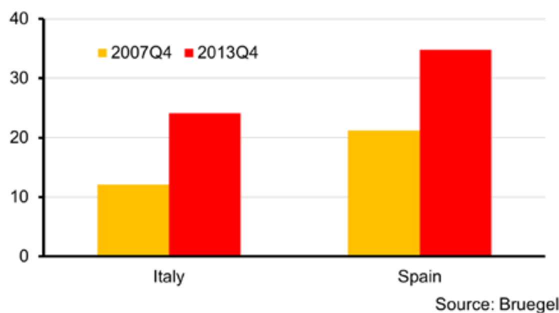
counterparties. As Chart 2.7 shows, this role of the ECB has hardly reduced over recent years, with imbalances within the Eurozone remaining large.

Chart 2.7 Net balance with Eurosystem
(In EUR billion)



Similarly, the share of periphery government bonds held by the domestic banking sector has reduced very little over the past year. Italian banks held only 12.1% of Italian government debt before the crisis but, due to a lack of interest in Italian government bonds from foreign investors, that share increased to 24.1% at the end of 2013 (see Chart 2.8). The share of Spanish government bonds held by Spanish banks increased over the same period, from 23.5% to 29.7%. The share has been stable over the past six months but has not yet started to fall back.

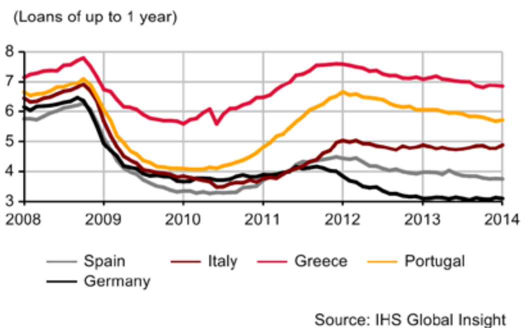
Chart 2.8 Sovereign bond holdings
(% of gov bonds held by domestic banks)



Credit conditions ease

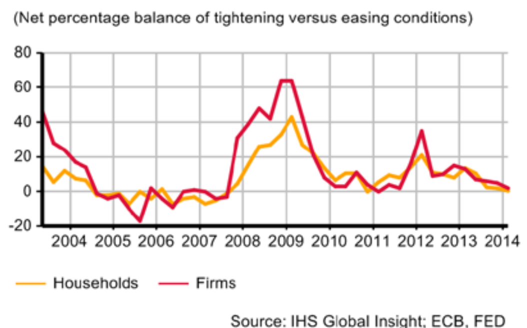
Financial fragmentation translates into large differences in bank lending rates from country to country. Interest rates on corporate loans remain high, at least in the periphery countries. The drop in government bond rates in the periphery has only partly translated to lower rates for companies. Spain, Portugal and Greece have benefitted most, while rates remained flat over 2013 in Italy (see Chart 2.9). Compared to the German lending rate level differences remain large. Progress in the banking sector should reduce the gap between rates as financial fragmentation drops and the system re-integrates.

Chart 2.9 Interest rates on corporate loans



The January 2014 bank lending survey published by the ECB indicates that credit conditions for companies and households in Europe are stabilising. Banks have structurally tightened their lending conditions since the crisis in 2008, but are finally showing signs of easing again for the first time in six years (see Chart 2.10). Both household lending and business lending display a similar trend. This may further stimulate household lending, which, in February, expanded 0.4% year-on-year. Loans to non-financial corporations may need more time to recover, as they continued to contract 3.1% over the same period. Banks are expecting an increase in loan demand in the second quarter of 2014 on the back of the improving economic conditions.

Chart 2.10 Conditions for loan supply

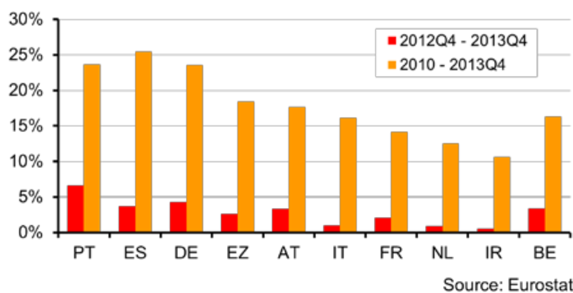


Rebalancing continues…

Eurozone periphery countries continue to improve their trade balances. Spain, Italy and Portugal all recorded positive current account balances at the

end of last year. This will reduce their dependence on foreign funds. Even Greece has achieved a surplus of 0.75% of GDP. This is due to both a drop in imports and a recent recovery of export volumes. Portugal and Spain have been able to boost their exports by 23.7% and 25.5% respectively over the past four years (see Chart 2.11). This was the result of a reduction in unit labour costs, improving their competitiveness internationally. Labour costs dropped 2.8% in Portugal over the same period and 5.2% in Spain. In many 'core' Eurozone countries, such as Germany, the Netherlands and France, labour costs increased. Even Italy saw a 1%. Additional domestic reform should further boost exports and improve the international position of Eurozone member states.

Chart 2.11 Export growth
(Change in real export volumes)

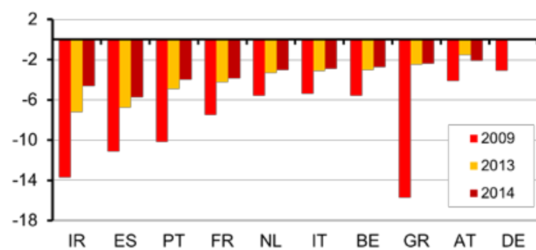


Source: Eurostat

...and fiscal policy stabilises

After years of pressure on Eurozone governments to reduce their fiscal deficits, many are slowing the pace of fiscal consolidation. Ireland, Spain, Portugal and France are expected to run fiscal deficits in excess of 3% at the end of 2014 (see Chart 2.12). However, this does not mean that there has not been any progress. Compared to the huge fiscal gaps seen in 2009, Greece, Ireland, Portugal and Spain have come a long way. This is also reflected in the progress made under their EU bailout programmes. Ireland has cleared its programme, while Greece managed to reach a positive primary balance ahead of target. Portugal is also expected to be able to regain access to the capital markets later this year. Although the pressure recently reduced considerably, it has by no means vanished. Debt levels still remain a concern across the Eurozone: Greece (175% of GDP), Italy (133%), Ireland (124%), Portugal (127%) and Belgium (100%) all face very large debt burdens.

Chart 2.12 Fiscal balance
(Percent of GDP)



Source: IHS Global Insight

United States: gaining strength

Economic growth remains solid despite a cold winter. In annualised terms, US growth reached just 1% in the first quarter of 2014, but recent data suggests that the economy is back on track to achieve the current forecast of 2.7% growth in 2014. The economy grew at a healthy rate of 1.9% in 2013.

Broad-based and solid growth

Consumption contributed to the improving overall economic performance, increasing 2% last year. Consumers benefitted from a 30% rise in the US stock market and a further recovery in the housing market, raising household wealth. Household credit also increased 5.4% over the year, leading to a slight deterioration in the debt-to-income ratio. The labour market also remains a topic of debate. While the headline unemployment rate dropped to 6.7% in the first quarter of 2014, the participation rate (the number of people between 15 and 65 years old who have a job) remains stuck at an historically low level. Consumer spending is forecast to continue to grow this year.

Business investment is also rising. Capital investment increased 4.5% in 2013. Despite the weak output in the winter, caused by poor weather conditions, industrial production in February was 2.9% higher than at the same time last year. According to the Purchasing Manager's Index, output in manufacturing continued its steady expansion in March. Companies are facing easier credit conditions from banks, while interest rates on commercial industrial bonds have been stable over the past six months (see Chart 2.13). Tighter monetary policy by the US Fed may push up the price of credit later this year, but overall investment and production are forecast to remain robust in 2014.

Chart 2.13 Commercial bond yield

(Average yield, 5-yr bond, industrial, S&P)

Source: IHS Global Insight; S&P

The US economy is further stimulated by the ongoing shale oil and gas revolution, decreasing import and pushing down domestic input prices for energy dependent industries. Crude oil production increased from 5.01 million barrels per day (mb/d) in 2007 to 7.4 mb/d in 2013. The International Energy Agency (IEA) forecasts a further increase to 8.4 mb/d and 9.1 mb/d in 2014 and 2015. This has led to a drop of 25% in crude oil import over the period to 7.6 mb/d in 2013. Natural gas production has increased 50% since 2007 and has turned the US into a net gas exporter. This boosts the current account, which dropped to 2.3% of GDP in 2013 and is expected to reduce further this year.

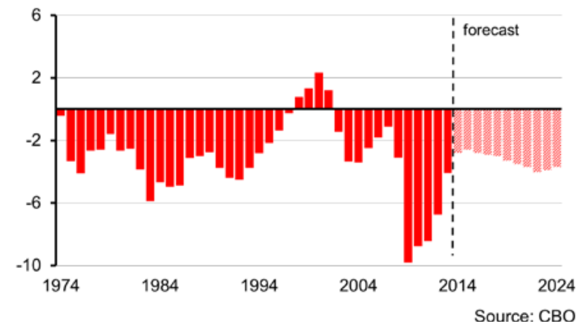
Fiscal calm at last

The government's fiscal situation has improved considerably since our last Economic Outlook and marks a stabilisation from the turbulent past two years. Disagreement over an increase of the debt ceiling in 2012 led to the implementation of strong fiscal measures, resulting in the fear of a 'fiscal cliff' at the start of 2013. This was avoided at the last minute and replaced by the less harmful 'fiscal sequester', which has turned out to have less negative impact on the economy than many expected. Then, in October last year, the government was effectively shut down due to bickering over a new fiscal budget. However, in February this year a new budget was agreed for the next two years: the fallout over the debt ceiling issue in late 2013 in the end resulted in an agreement that saw an increase of the ceiling until March 2015. New battles over the fiscal situation are therefore unlikely, at least until next year.

The fiscal balance has improved markedly over recent years as a result of the fiscal measures taken by the government and the accelerating economic growth. The improvement was also necessary as the fiscal deficit reached 9.8% of GDP in 2009 (see Chart 2.14). It dropped to 6.8% in 2012 and to 4.1% in 2013. For this year, a further improvement to 2.8% is expected. Beyond 2015 the fiscal balance will again come under pressure from factors such as an ageing population, rising healthcare costs and the expansion of federal subsidies for health insurance. According to the Central Budget Office (CBO) the fiscal balance will reach 2.6% in 2015 under current law before increasing again to around 4% in 2022.

Chart 2.14 Fiscal Balance

(Percent of GDP)



Source: CBO

This suggests a slow increase in the government debt level over the coming decade. Central government debt increased from 62% in 2007 to more than 100% last year. However, net interest payment as a percentage of GDP has fallen slightly over the period as a result of lower interest rates. The debt burden has not increased, but a return of interest rates to more normal levels could quickly push up the net level of interest payments given the larger debt pile.

Walking the monetary policy line

Accomplishing a smooth monetary exit may prove difficult. The Fed is planning an exit from the current easy monetary policy and towards a slow normalisation of interest rates, but this is not without risks. An overly slow adjustment, leaving interest rates too low for too long, may lead to excessive risk taking and new bubbles. An adjustment made too rapidly may on the other hand curb investment and consumption that is reliant on low interest rates. Small interest rate hikes are quickly translated into higher rates for mortgages and corporate loans. And this is not just about actual Fed policy changes: financial markets continuously try to gauge the next Fed move based on all available communication. A misinterpretation could have severe consequences.

So far it is going according to plan. In March last year the former chairman. Ben Bernanke, announced the Fed's intention to reduce the quantitative easing programme of USD 85 billion in monthly bond purchases. In January, February and March this year the purchases have been reduced by USD 10 billion each month. With the takeover of the chair by Janet Yellen in February, the Fed also announced that it would drop its previous threshold for a benchmark interest increase – an unemployment level of 6.5% - and instead take a mix of factors into account. Such factors include labour market conditions, inflation expectations and financial market developments. An increase of the benchmark interest rate, currently at 0.25%, is not expected until the middle of 2015.

United Kingdom: leaving the EU behind

The UK economy is performing much better than previously expected. The economy expanded 1.8% last year, propelled by increased consumer spending. The recovery is expected to broaden this year to include an increase in investment and bring economic growth to 2.8% before stabilising at 2.4% in 2015.

Consumers take the lead

Consumer spending increased 2.3% last year on the back of rising house prices, cheap credit and an improving economic outlook. As a result, the savings rate dropped, halting household debt reduction and consequently leaving private debt levels high. Consumer confidence was further boosted by falling unemployment – indeed, with a record number of people employed. Real wages have not increased since 2009 but are likely to start rising soon. In 2014 a further increase in consumer spending is expected. That may take the total amount of real consumer spending past its previous peak of 2007 (see Chart 2.15).

Business investment still lags behind. Despite the uptick in economic output last year and low lending rates, businesses remained cautious with new investment. In 2013 capital investment dropped 0.6% but the outlook looks better. There was strong growth in investment in the fourth quarter of last year and indicators of industrial production and manufacturing point towards further improvement in the sector in the first quarter of 2014. Economic growth in 2014 is therefore likely to become more broad-based with business investment, and consumer spending, contributing positively to growth.

Chart 2.15 Consumer spending

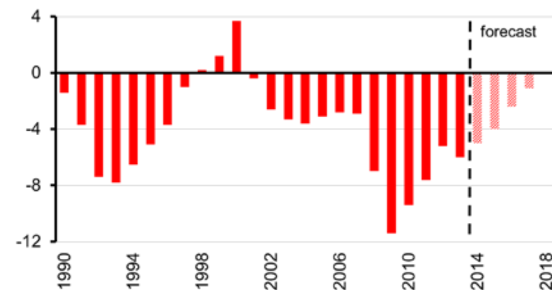
(Real private consumption, billion LCU)

Source: IHS Global Insight

Trade growth was low last year. Net exports barely contributed to economic growth and are not expected to do so in 2014 either. Despite the projected improvement in economic conditions in the most important (EU) trade partner countries, exports are hampered by the strong British pound. The domestic recovery is also boosting imports and reducing the net benefit of exports. To stimulate exports, the government has announced a doubling of export finance funds to GBP 3 billion and a one third reduction in the associated lending rate.

Chart 2.16 Fiscal balance

(Percent of GDP, EMU definition)



Source: Office for Budget Responsibility

The government has announced small tweaks to the budget. In addition to the measures to stimulate exports, it announced that it will reduce energy prices for manufacturing, raise the tax free income threshold and relax the usage of pension funds. This will have a limited impact on the fiscal balance. The government deficit reached 6% of GDP last year and is forecast to drop to 5% this year (see Chart 2.16). This is still rather high. But the outlook for the following years is more benign as many government measures to reduce the fiscal deficit kick-in in later years. The fiscal deficit will reach

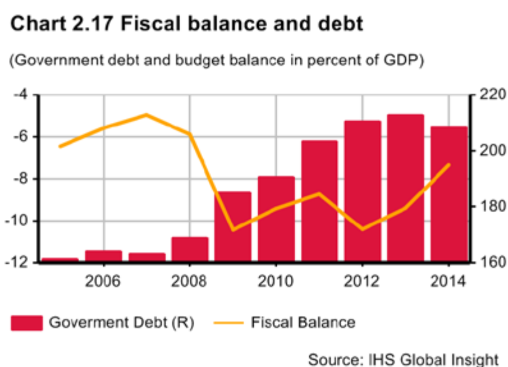
0.1% in fiscal year 2018, according to the Office for Budget Responsibility.

Monetary policy: at ease

The Bank of England is expected to keep rates low. The policy rate is currently 0.5%, where it has been since the beginning of 2009. In view of the much better economic conditions, there is increasing speculation that the Bank is preparing a rate hike. So far it has indicated that it remains cautious and has dropped the explicit unemployment rate target at which it would start to increase rates. This leaves the Bank with more flexibility. Also, the recent drop in inflation, to below 2% for the first time since 2009, leaves room for monetary policy to remain loose for a longer period. Current expectations are for a policy rate increase in the first half or middle of 2015.

Japan: walking a tight rope

Japan has suffered from very low inflation, with bouts of deflation and low economic growth, in the 20 years leading up to 2013. Following a long period of loose fiscal policy, the Japanese government is struggling with an extremely high level of public debt: over 200% of GDP (see Chart 2.17).



Japan relies mostly on domestic creditors to support its government debt, which makes the funding base less susceptible to capital flight. But maintaining this level of debt is not only costly: further growth of the government debt will at some point render it unsustainable. The government has to find a solution to Japan's demographic challenges: the population is shrinking, and the working age population is also declining. Without appropriate measures, the Japanese will inevitably face a shrinking tax base and rising expenditure on retirement benefits.

The first effects of Abenomics…

Prime minister Shinzo Abe, who came into office in December 2012, immediately launched drastic measures to turn Japan's contracting and deflationary economy around. Abe devised the so called 'three arrow' approach, now dubbed Abenomics, consisting of drastic monetary easing, fiscal policy measures and structural reforms. In July 2013, he secured a comfortable majority in the upper house, which firmly places the LDP party in political control with a legislative mandate.

We are now in the second year of Abenomics and 2014 will prove an exceptional challenge for Japanese policy makers. A large fiscal stimulus package to boost the economy was launched in 2013: the larger part in February and a smaller one in December. There are no plans for further fiscal stimulus in 2014 and 2015. The quantitative easing programme that the Bank of Japan is implementing, however, will continue in 2014. This programme aims to generate inflation and to devalue the Japanese Yen, in order to promote exports and discourage imports. And indeed, inflation (and inflation expectations) have risen steadily towards the 2% target (see Chart 2.18).

However, structural reforms have been slow. Deregulation is vehemently opposed by vested companies. Implementation of economic zones for relaxed corporate litigation, and corporate tax cuts, are to be expected. Another opportunity to obtain economic growth is an opening of the electricity market and a restarting of Japan's nuclear reactors.

On 1 April Japan launched its first fiscal reform, increasing the value added tax from 5% to 8%. A

further increase from 8% to 10% is planned for 2015. The effects of this policy change have been substantial. Durable goods purchases increased sharply in the months leading up to the tax rate hike, while a similarly sharp decrease is expected for the second quarter. A gradual return of normal purchasing is expected for the second half of 2014.

…and the balancing act to come

Responding to the implemented policy measures, the Japanese economy grew 1.5% in 2013. Growth is expected to slow to 1.3% in 2014 and 2015. Now that quantitative easing has increased the competitiveness of Japanese exports, inflation is increasing and fiscal stimuli are coming to an end, Japan's economic future depends on firm implementation of structural reforms. Opening up markets, reforming the labour market and obtaining sound government finances are necessary components for financial market confidence.

The main challenge is to correctly time these structural reforms. If implemented too early, growth and inflation might prove too frail. If implemented too late, the burden of public debt might become unsustainable. This balancing act will be performed in the wake of growing disputes with China and US policy makers. The new Fed Chairman Janet Yellen recently demanded an end to Japan's expansionary monetary policy. To be continued…

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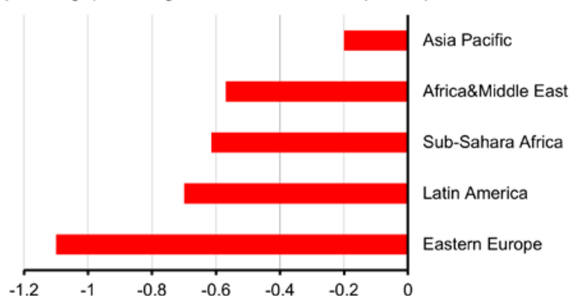
3. Prospects and risks in emerging economies

Softening growth, growing divergence

Credit risk is on the rise in emerging markets. The emerging markets still deliver quite high growth levels, despite an unmistakable slowdown in China, the world's second largest economy. Real GDP in emerging markets grew 5% in the last quarter of 2013, reaching 4.6% for the full year. But forecasts for this year have been revised downward since our November Economic Outlook and differences between countries are growing (see Chart 3.1).

Chart 3.1 Change in 2014 GDP forecast
(Percentage point change between Nov. 2013 and April 2014)



Source: Consensus Economics

Lower global monetary liquidity, better conditions in advanced markets and closer scrutiny of emerging market weaknesses by investors have adversely impacted many emerging markets. Russia's seizure of the Crimea recently added to the degree of uncertainty and to investors' concerns. Emerging markets with relatively weak fundamentals, high external financing requirements, low international reserves, poor performance on structural reforms or increasing political uncertainty have faced a turbulent environment over the past six months. They have experienced significant depreciation and have had to defend their currencies by raising interest rates as international investors withdrew funds.

Countries belonging to this group are the so-called 'Fragile Five'; Brazil, India, Indonesia, South Africa, and Turkey. Argentina, Russia, Ukraine and Venezuela are also examples of countries that suffer from sharply deteriorating conditions. As this group contains some of the largest emerging markets, its declining growth drags down growth forecasts for emerging countries as a whole.

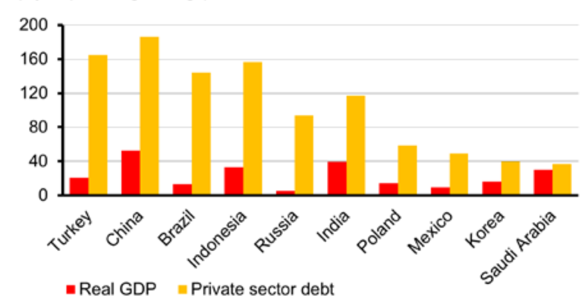
Table 3.1 Real GDP growth - Regional aggregates

	2013	2014f	2015f
Asia (excluding Japan)	6.1	6.0	6.1
Eastern Europe	2.0	1.7	2.8
Latin America	2.6	2.2	2.8
Middle East & North Africa	2.3	3.1	4.3

Source: Consensus Forecasts, IHS Global Insight (April 2014)

On the other hand, emerging markets with generally sound fundamentals and close relations with the US and the EU are set to benefit from the improving economic conditions in these blocs (see Chapter 1). They were also less affected by last year's turbulence following the Fed's 'tapering' announcement and the renewed turmoil early this year. Some of them were even able to loosen monetary policy. These countries have also seen a more moderate increase in domestic credit growth over the past five years, rendering their economies less prone to crisis (see Chart 3.2). Mexico, South Korea and Poland stand out in this regard.

Chart 3.2 Top 10 EMEs Credit boom indicators
(5 year percentage change)



Source: IMF, BIS

Currency volatility is set to remain an important issue in the period ahead. Many of the larger emerging markets, including Brazil, India, Indonesia, South Africa and Turkey, have general elections this year. Geopolitical risks will remain a live issue, not only for the Middle East and North Africa, but

also on the European continent, due to the conflict between Russia and Ukraine. And, although the Fed's 'tapering' has passed smoothly so far, this might quickly change. As developments since last year have shown, international investors increasingly assess countries on their merits and weaknesses. They will not, as they have done over the past couple of years, condone the economic weaknesses of emerging markets in their search for yield. This means that we have to monitor emerging markets and developing countries more closely than before: high economic growth and relatively low risk can no longer be taken for granted.

Asia: elections and political uncertainty

Asia is facing concerns over its economic growth potential and political uncertainty. Economic growth is decelerating in a number of the largest Asian economies. The most obvious example is China, where tightening of monetary conditions is slowing investment growth. The Chinese slowdown is having an impact on the region and (commodity) exporting emerging markets outside of Asia. In India too, the 2014 economic growth forecast has been cut by 0.5 percentage points over the past six months, reflecting a weakening outlook. Overall growth is nevertheless expected to remain high, projected to be 6.0% in 2014 and 6.1% in 2015.

Table 3.2 Real GDP growth - Asia

	2012	2013	2014f	2015f
China	7.7	7.7	7.3	7.2
Hong Kong	1.5	2.9	3.4	3.5
India	5.0	4.7	5.4	6.0
Indonesia	6.2	5.8	5.4	5.8
Singapore	1.3	4.1	3.8	4.0
Taiwan	1.5	2.1	3.3	3.6

Source: Consensus Forecasts (April 2014)

This somewhat lower growth outlook is partly due to a lack of progress in economic reform. Since the 'tapering turbulence' of 2013, international investors and creditors are focusing more on fundamental risk factors: and many Asian markets display structural economic weaknesses that need to be addressed forcefully. Energetic pro-business oriented governments are highly desirable in this context. For this reason the outcomes of the ongoing elections in India and Indonesia are of great importance. Elections were also held in Thailand and Bangladesh in January, but both failed to provide new and uncontroversial governments. The political situation in both countries has remained uncertain since.

China: slowing growth, rising risk

Economic growth is decelerating in China and concerns about financial stability are rising. In 2013 overall economic growth was 7.7%. In the first quarter of this year, growth slowed to 7.4% (see Chart 3.3). Although a slowdown in the first quarter is not uncommon, with many factories and businesses closed for two weeks during the New Year holidays, there are more signs of weakening activity in the manufacturing and industry sector. Industrial production has declined for some months now and the manufacturing purchasing managers index (PMI) has been below 50 for three months in a row, indicating contracting output.

Chart 3.3 Economic growth, China

(Annual percentage change in quarterly GDP)

Source: IHS Global Insight

Additionally, export growth has slowed to below 10% annually on a rolling 12-months basis. This is the lowest level since China joined the World Trade Organisation (WTO) and indicates that the 'WTO dividend' has come to an end. Retail sales growth is at 12% in the first quarter of this year: still below last year's average annual growth of 13%. Although momentum picked up somewhat in March, boosted by higher wages and solid employment growth, rebalancing the economy towards consumption-led growth instead of investment is proving difficult to put in practice. Overall, retail sales growth rates have been pretty flat since the end of 2012, while the investment ratio picked up to 47% of GDP in 2013 (from 46% in 2012).

Authorities have responded to slowing growth in the first quarter with a mini-stimulus fiscal package announced in early April, which includes an acceleration in investments in infrastructure. In addition, steps have been taken to stop the appreciating trend of the yuan. These measures

should limit further economic slowdown – for the whole year 7.3% growth is expected – but at the expense of rebalancing the economy.

Meanwhile, concerns about financial stability are rising. China's reliance on credit and investment in the past resulted in high leverage in the financial sector, local governments and companies. At the same time, excess capacity has spread to most industrial sectors. The central bank responded last year by draining liquidity by open market operations and by tightening its monetary stance.

Although just 1% of the loan portfolio is non-performing the rapid credit growth in recent years will probably lead to deterioration in asset quality. Many loans have been rolled over instead of repaid. Moreover, in the past couple of years off-balance sheet credit has grown steeply. Total social financing amounted to 200% of GDP in 2013, compared to 127% in 2008. Private sector debt in China stands at 180% of GDP: the third highest among emerging markets after Hong Kong and Korea and at a level that significantly increases its vulnerability to shocks.

Curbing these shadow banking activities and tightening credit conditions will lead to more volatility in the banking sector and could cause a systemic crisis, which could have a substantial impact on the economy. We assume that the government will step in if banks get into trouble and/or the Chinese economy decelerates sharply. We also assume that the Chinese will take a gradual approach to introduce reforms in the financial sector. One of the steps taken is the gradual liberalisation of interest rates, which will result in more accurate risk pricing. That the authorities are serious about containing credit growth was evident in the first quarter of this year as total social financing, the widest measure of credit, dropped 9% year-on-year.

The medium-term growth outlook for China is also challenged by China's demographic developments. Last year, for the first time, China's working age population declined. To sustain annual economic growth at the government's target of 7.5%, China needs to raise its participation rate and achieve productivity growth of 6-7%. Excess capacity in most industrial sectors means that the latter needs to be achieved in the agriculture and services sectors. The road to rebalancing the economy and reforming the banking sector is therefore likely to be a bumpy one. That said, China's shock absorbing capacity is strong and supported by the low external debt of the government and plentiful foreign exchange reserves.

India: structural reform to boost growth

The creation of new government after the general elections held in April and May should set the stage for large-scale structural reform in India. At the time of writing, the result of the election is yet to be announced, but there is a significant chance that the current ruling United Progressive Alliance (a centre-left coalition led by the Indian National Congress) will be succeeded by the opposition led by the Bharatiya Janata Party (BJP). On the one hand, the BJP is considered pro-market liberal, and on the other Hindu nationalist, making it difficult to assess its future policy. The victory of the BJP could nevertheless provide a new impetus to India's jammed economic reforms. International financial markets are expected to welcome the BJP's Narendra Modi as India's new prime minister.

Chart 3.4 Economic growth, India

(Annual percentage change in quarterly GDP)

Source: IHS Global Insight

The challenges for India's new government are numerous. Firstly, it needs to improve public governance by reducing bureaucracy and combatting corruption. Secondly, significant investment in the country's inadequate infrastructure and education system is required. And thirdly, it must establish a credible fiscal framework and strive to modernise the agricultural sector. In addition, liberalisation of the financial system and labour market is much needed. In the field of international relations, India ought to strive for stronger intra-regional trade relations and maintain a workable relationship with neighbouring China. The strained relationship with arch rival Pakistan remains an obstacle in this context.

Reform progress and renewed confidence from international investors are urgently needed as

India's economy has been facing downward pressure on growth since 2011 (see Chart 3.4). Economic growth is forecast to pick up slightly this year: 5.4% compared to 4.7% in 2013. For 2015 further acceleration to 6% is expected.

In an attempt to defend the exchange rate and fight inflation, the Reserve Bank of India (RBI) raised the interest rate by 25 basis points to 8% in January. The sharp depreciation of the rupee in 2013, triggered by the US Fed's 'tapering' announcement, has been halted (see Chart 3.5).

Chart 3.5 Exchange rate to the USD

Source: IHS Global Insight

Inflation remains high at 8%, however, suggesting that there will be limited scope for the RBI to lower interest rates. Hopefully, India can profit from lower real labour costs in its successful business service outsourcing industry. Because of India's low external debt, depreciation is not an imminent risk for its sovereign payment capacity, but some segments of the private sector may have accumulated significant amounts of foreign debt. The banking sector may be confronted with a deteriorating credit portfolio because of the disappointing real economic growth. Non-performing loans currently stand at 5.6%: a fairly high but still acceptable level. Banks that are heavily exposed to sectors such as infrastructure, iron and steel, textile, aviation and mining run a greater risk of credit losses.

The new governor of the Reserve Bank of India (and former chief economist of the IMF), Raghuram Rajan took over the position in September 2013 and is committed to carrying out substantial reform of India's rigid financial sector. He has outlined five pillars that will be the basis of his monetary policy in coming years: (1) clarifying and strengthening the monetary policy framework; (2) reforming the banking sector by allowing new entries, new branches and encouraging different varieties of banks; (3) broadening and deepening of financial markets; (4) financial inclusion of SMEs, the poor and remote areas; and (5) improving the system's ability to deal with corporate distress. If this blueprint were to be implemented, it would be an important step towards a broader financial sector able to facilitate economic progress.

Indonesia: moderating growth

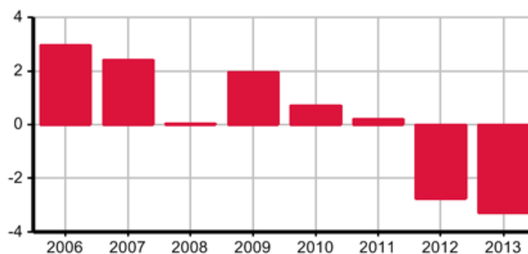
In contrast to India, economic growth in Indonesia is expected to decelerate slightly this year: from 5.8% in 2013 to 5.4% due to monetary tightening, high inflation, falling commodity prices and less generous external financing conditions. Indonesia is Asia's fourth largest economy. As in India, national and parliamentary elections will define future economic policies.

The election is likely to lead to a broad coalition government and fragmented parliament, hampering the implementation of new policies. The legislative elections took place on 9 April and results were still pending at the time of writing. According to the exit polls, the largest party will be the Indonesian Democratic Party-Struggle (PDI-P), led by former president Megawati Sukarnoputri. Despite being the largest party in the polls, PDI-P is expected to have won no more than 20% of the votes. If these polls prove to be accurate, this implies a coalition of a large number of parties without a clear policy direction. Presidential elections will also take place on 9 July.

The Indonesian economy needs a wind of change. President Yudhoyono was successful during his first term but during his second term his reform programme stagnated and his party was plagued by corruption scandals. Economic policy has been erratic in the past and in January this year the government imposed a moratorium on export of unprocessed minerals. This inflicted damages on exports and damaged the current account balance, which turned negative in 2012 (see Chart 3.6).

Chart 3.6 Current account, Indonesia

(Current account balance, percentage of GDP)



Source: IHS Global Insight

In addition, the persistent failure to improve Indonesia's poor business environment impedes foreign direct investment. Incidentally, fuel prices were raised by 44% in July last year: an important – and difficult – step towards a more sustainable fiscal policy. Like India, Indonesia has experienced a large depreciation in its exchange rate, but the rupiah has not recovered as strongly as the Indian rupee. However, the Indonesian stock exchange has largely made up for the 2014 loss and Indonesian sovereign bonds are still in high demand.

Indonesia's macroeconomic fundamentals remain quite strong: low external debt, ample liquidity and a credible fiscal policy framework that caps the fiscal deficit and total public debt ratio. Inflation reached 6.4% in 2013, above the 3.5%-5.5% target band set by the Bank Indonesia (BI). The BI therefore raised the interest rate to 7.5% in November last year, although further tightening is not expected for the rest of this year. Indonesia has a significant external financing requirement, due to the current account deficit and maturing debt obligations, making the country dependent on foreign capital inflows. The negative impact on foreign investor sentiment has now been recognised by the authorities and restoring investor confidence will be the major challenge for the new government.

Bangladesh: disputed elections

Economic growth in Bangladesh is burdened by the political chaos in the country. Last year the ruling Awami League announced general elections, but subsequently refused to hand over power to an interim government. The opposition led by the Bangladesh National Party (BNP) responded by organising violent mass protests. The protests quickly degenerated into massacres, with more than 200 people killed. The elections in January this year were boycotted by the opposition and the voting turnout was low. The result, not surprisingly, was a victory for the ruling Awami League: the legitimacy of the new government may be questionable, but the protests did not intensify as feared. Neither was there a strong reaction by the international community.

Bangladesh has been able to build up a successful textile industry and is now the world's second largest textile producer next to China, but the industry is tarnished by poor social conditions. This became evident in April last year when the Rana Plaza textile factory collapsed, with over 1,100 people killed and another 2,500 injured. The sector's success is founded on low wages and the disaster led to international public outcry, with repercussions on international investment.

Growth is high but decelerating due to the political uncertainty, cautious foreign investment and somewhat disappointing remittances: 5.7% is expected in 2014. The economy shows remarkably strong macro fundamentals: the balance of payments is strong, economic growth is relatively high, external debt is low and the liquidity situation is sufficient. Altogether this results in a fairly good payment capacity. Inflation is expected to decrease somewhat, to 6.7% in 2014, as a result of lower energy prices. Provided that the political instability does not escalate, the outlook for Bangladesh is still reasonably good.

Thailand: political unrest takes its toll

Earlier this year the government fell as a result of unpopular policies, corruption charges and deep rooted tensions. On 2 February the Thai government of Yingluck Shinawatra called for early elections after weeks of mass protests against her cabinet. However, on the 7 May the Constitutional Court ruled that Yingluck had abused her powers by transferring the former national security chief in 2011. The Court has ousted Yingluck from her position as prime minister together with nine of her cabinet ministers. A caretaker government is likely to be installed until new elections take place. Yingluck has pursued increasingly populist economic policies of which the massive rice subsidising programme is one of the most costly and ineffective. Moreover, her attempt to grant amnesty to her brother and former prime minister Thaksin, who has been accused of corruption, has created ill feeling in her opponents. New elections are expected to be held in July. Whatever the outcome of these elections, Thailand's political

scene will remain volatile in the short and medium term.

Although the Thai economy has traditionally been quite resilient to prolonged political uncertainty, it seems as if the worsening political unrest is starting to affect economic performance. Consumer confidence has fallen and tourism has dropped significantly. Public debt is rising due to the expansive fiscal policy, but remains manageable. Thanks to low external debt, ample liquidity and a quite well developed and diversified economic structure, the country's payment capacity is expected to remain intact. Nevertheless the short-term outlook is rather bleak: economic growth is forecast to moderate to 2.5% in 2014 from 2.9% last year. Private consumption is expected to grow by less than 1% while investments are contracting. In 2015, however, a rebound in growth to 4.2% is expected.

Singapore: stable conditions

As one of the world's most open economies, Singapore is very sensitive to developments in the global economy. The gradual economic recovery in the US and (to a lesser extent) Europe had a favourable impact on this city state and economic growth reached 4.1% in 2013. The pace of growth is forecast to remain robust at 3.8% in 2014 and 4.0% in 2015. Inflation will likely rise somewhat, to 2.7% this year, driven by higher wages. Singapore's long-term growth strategy is to move away from being only a trade, transport and financial hub towards becoming a centre of high-tech industry. As this strategy is starting to bear fruit in the bio-medical sector, the traditionally important electronics sector is benefitting from the global recovery.

Taiwan: stronger growth

Under the presidency of Ma Ying-jeou (in office since 2008) the relations between Taiwan and China have improved and China is now by far Taiwan's most important trading partner. Since Taiwan's economy is export-driven, the Chinese slowdown will also affect Taiwanese growth prospects; although this is expected to be partially offset by the recovery in advanced economies. Economic growth reached 2.1% in 2013 and is expected to accelerate to 3.3% this year. Growth is forecast to strengthen further at 3.6% in 2015. Taiwan faces a number of structural challenges that will affect its growth potential beyond the forecast horizon. Firstly, the traditionally important electronics sector runs the risk of falling behind regional competitors. Secondly, Taiwan has one of the most rapidly ageing populations in the world, and this will result in a shrinking work force from 2016.

South Korea: maturing

South Korea has in the past been vulnerable to jitters on the international financial markets, but the Korean currency has gained in value since May last year. The country is generally showing very strong macroeconomic fundamentals: structurally high growth rates, current account surpluses, low inflation, low external debt and a comfortable level of reserves. It is expected to benefit from the global recovery in coming years and the accommodative stance of its central bank. Economic growth is expected to reach 3.5% this year and 3.7% in 2015.

Although the outlook is bright, some structural issues remain. While South Korea seems to have outgrown its emerging market status, transforming into a mature industrial country, there are still some challenges ahead. Its economic growth model is export-driven and built on large family-owned manufacturing conglomerates (so-called chaebols). As in China, a shift towards a more domestically oriented economy is desirable. Another risk is the high level of household debt, which is often related to small enterprises.

Latin America: negative momentum

The economic environment has become more challenging for the Latin American region and, on balance, risks are rising. The region grew by only 2.6% in 2013, hindered by weak domestic demand, while exports remained healthy (+5.2%). Moreover, the region is set for another year of disappointing growth, at 2.2% in 2014, and relatively high inflation (10.8%). At the same time, growth and inflation dynamics are increasingly diverging across the region. This reflects improved earnings capacity and resilience to shocks in the Pacific Alliance countries, and particularly Mexico which has made further progress with its structural reform agenda.

Table 3.3 Real GDP – Latin America

	2012	2013	2014f	2015f
Argentina	1.9	3.0	-0.5	0.8
Brazil	1.0	2.3	1.8	2.0
Chile	5.6	4.1	3.3	4.1
Colombia	4.2	4.3	4.7	4.6
Mexico	3.9	1.1	3.0	3.9
Peru	6.3	5.0	5.4	5.7
Venezuela	5.6	1.3	-1.4	1.1

Source: Consensus Economics (April 2014)

Brazil's unbalanced policy mix and limited structural reforms are detracting from its shock absorbing capacity and economic growth. Finally, rising political and stagflation risks and dwindling reserves in Argentina and Venezuela are undermining their already weak economies and earnings capacity.

The response to last year's tapering turbulence and the renewed increase in financial volatility in January highlights these growing divergences. Whereas the Pacific Alliance countries of Chile, Mexico and Peru were able to cut central bank policy rates, Argentina and Brazil had to raise their rates. This difference in policy response can be explained by the degree of inflationary pressures fuelled by private sector credit growth and the vulnerability of their external accounts.

Meanwhile, the region is becoming more dependent on developments in China: not only with demand for natural resources, but also for financing. This is particularly true for resource rich countries where risks are rising and financial markets are wary: Venezuela, Argentina and Ecuador. But Brazil, with its huge financing needs to develop its oil and gas sector, is also becoming increasingly dependent on Chinese funding.

Mexico: a rebound in economic performance

The economic outlook for Mexico is improving, and that is positive for credit risk. After slowing to a disappointing 1.1% in 2013, Mexico's GDP growth is expected to strengthen this year on the back of the lagged effect of monetary easing, increased government spending on infrastructure, expeditious reforms and positive spill-overs from higher US growth.

Mexico has made further progress with its ambitious reform agenda. Last December the long awaited energy reform bill became effective. The reforms, if effectively executed, will boost productivity, increase investment and raise potential GDP growth to 5.5% from its current 3.5%. Successful reform implementation will also strengthen the economy's ability to withstand shocks, reducing the country's reliance on foreign capital.

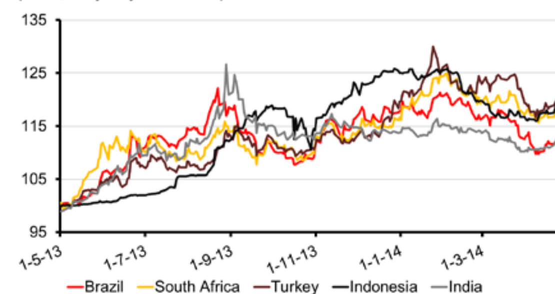
Table 3.4 Inflation – Latin America

	2012	2013	2014f	2015f
Argentina	10.8	10.9	28.9	26.8
Brazil	5.8	5.9	6.3	5.8
Chile	1.5	3.0	3.4	3.0
Colombia	2.4	1.9	3.1	3.2
Mexico	3.6	4.0	4.0	3.5
Peru	2.6	2.9	2.8	2.6
Venezuela	19.5	52.7	59.2	45.9

Source: Consensus Economics (April 2014)

Mexico has been largely unscathed by recent emerging market stress, as its ability to withstand macroeconomic shocks has been significantly strengthened in the past two decades. This is underpinned by a floating exchange rate, credible macroeconomic policies, solid internal and external balances, and access to an IMF Flexible Credit Line (which has so far not been needed). Increased confidence is also reflected in Mexico's ability to issue several bonds on the international capital market earlier this year, including a 100-year bond denominated in British pounds in mid-March.

Chart 3.7 Exchange rate against USD
(Index, early May 2013 = 100)



Source: IHS Global Insight

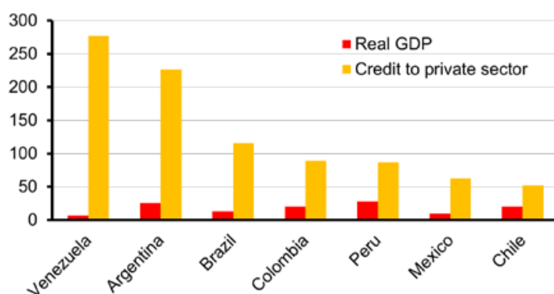
In the other Pacific Alliance member countries and main commodity producers **Chile, Colombia** and **Peru,** economic growth will continue to be supported by strong domestic consumer demand emanating from record-low unemployment rates and real wage increases. In Chile this provides some,

but not enough, counterweight to falling mining activity due to slowing demand from China, and the associated lower price of copper (down 29% from its early 2011 peak). The peso has been hit badly by the recent emerging market sell off, but this is not a concern (see Chart 3.7). Low inflationary pressures even provided room for a future interest rate cut to stimulate the economy.

Brazil: stuck in low gear

Brazil, Latin America's second largest emerging market, is confronted with a more challenging economic environment. Rising interest rates, weakening earnings and currency depreciation will heighten credit risks, particularly in the corporate sector. The Brazilian economy recovered moderately in 2013, up by 2.3%, due to stronger investment demand, expansionary fiscal policies (in the pre-election year) and rising exports (up 3.1% after having shrunk in 2012). But growth has remained weak and below-trend since 2011, with earnings capacity undermined by supply side constraints (low investment and savings ratios, weak infrastructure, complex business and regulatory environment), slowing demand from China and tigher external financing conditions. The economy is forecast to grow 1.8% this year, down from 2.3% last year, and 2.0% in 2015.

Chart 3.8 Policy misalignment indicators
(5Y % change)



Source: EIU, IFS

Recent developments have once again underlined Brazil's increased vulnerability to external shocks. Policy inconsistencies have resulted in a weakening of the fiscal position, relatively high growth of credit to the private sector and above target inflation (see Chart 3.8). This has had a negative effect on investor confidence and limited the central bank's ability to use the exchange rate as a shock absorber. Unlike Mexico, Brazil had to raise interest rates (by 375 basis points since April 2013, to 11%) and intervene heavily to reduce downward pressure on the currency.

Real depreciation has ended, but at the cost of rising credit risks. Rising borrowing costs are dampening already weak investment. This, combined with cooling commodity prices and contagion from Argentina and Venezuela – among Brazil's major trading partners and key importers of its manufactured goods, will weaken Brazil's short-term economic outlook and government finances. The latter resulted in a downgrade of Brazil's sovereign risk rating by S&P's last March to BBB-, the lowest investment grade rating.

Risk mitigating factors remain strong and international reserves are still substantial. Additionally, earnings capacity in the longer term is set to improve due to developments in infrastructure and particularly the energy sector. Under its Growth Acceleration Programme, the government has allocated USD 57 billion (2.5% of GDP) to improving transport infrastructure and a further USD 255 billion (11% of GDP) to a wide-ranging energy plan (of a cumulative USD 2.1 trillion up to 2035). This plan covers power generation and transmission, and oil and gas exploration and production.

After the discovery of the huge 'pre-salt' fields in the Santos basin in 2006, Brazil has the potential to emerge as a leading force in the oil sector. Its proven oil and gas reserves amount to the equivalent of 18.2 billion barrels of oil, while recoverable resources are estimated by the IEA to be around 120 billion barrels. Brazil is set to join the ranks of the ten largest global producers by 2015 and to play a central role in meeting the world's oil needs until 2035, accounting for one-third of the net growth in global supply.

The planned investments will more than double Brazil's oil production, to 4.2 million barrels per day in 2020, and could raise net annual oil exports to USD 50 billion (2.5% of 2013 GDP) over the same period (from almost zero today). However, this will all be heavily dependent on highly complex and capital-intensive deep-water developments. Even though Brazil is a global leader in the latter, these investments will keep the economy vulnerable to shocks in the medium term.

Venezuela and Argentina: crisis conditions

Political and stagflationary risks are rising in commodity-dependent Argentina and Venezuela. Both countries are struggling with rampant inflation and dwindling foreign currency reserves after years of erratic economic policies and were forced to devalue the currency. Argentina did so officially, by a moderate 15% last January, and raised interest rates. This devaluation triggered a new bout of emerging market turbulence. Venezuela devalued its currency after reintroducing a multiple exchange rate system last February. The continued drop in foreign reserves raises questions about debt sustainability in both countries and keeps the risk of a sudden sharp and uncontrolled devaluation high.

Meanwhile, social unrest is rising in both countries amid acute hard-currency shortages, rising inflation, a stalling economy and, for Venezuela, an increased scarcity of basic goods. Since last February, unrest has spread and become more violent in Venezuela, where student-led protests are calling for the resignation of President Maduro, who succeeded the late Hugo Chavez in April last year. The country's role as one of the region's leading oil producers means that a crisis in Venezuela would have regional and international ramifications if the oil flow were disrupted. Most vulnerable would be the high-risk countries of Cuba, Jamaica, and Nicaragua. Uruguay is vulnerable to contagion from its key trading partners Argentina and Venezuela as well, but its shock resistance is underpinned by strong liquidity buffers.

Central and Eastern Europe: rising risks

Last March's seizure by Russia of the Crimea, part of Ukraine, was a brutal reminder of geopolitical risks on the European continent and has raised credit risks in Eastern Europe. Tensions have spread to Eastern Ukraine, with its sizeable Russian minority, and have the potential to escalate further. The conflict has raised tensions between Russia and the US/EU, and could result in further economic sanctions against the country. Besides Russia and Ukraine, the impact for most other countries in the region should be manageable, unless the hostilities spread into mainland Ukraine.

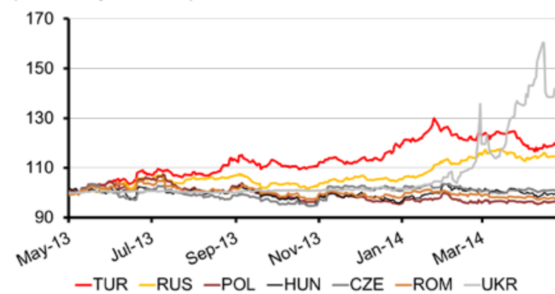
Table 3.5 Real GDP (annual % change)

	2012	2013	2014f	2015f
Czech Republic	-0.9	-0.9	2.1	2.6
Hungary	-1.7	1.1	2.2	2.2
Poland	1.9	1.6	3.1	3.5
Romania	0.7	3.5	2.8	3.2
Russia	3.4	1.3	0.9	1.9
Turkey	2.2	4.0	2.3	3.7
Ukraine	0.2	0.0	-3.9	1.3

Source: Consensus Economics (April 2014)

Growth forecasts for the region as a whole have been significantly revised downwards (by 1.1 percentage points) since last November's Economic Outlook, to a meagre 1.7% in 2014. This is due mainly to worsening prospects in Russia and Turkey, by far the two largest economies in the region (see Table 3.5). In both countries, credit risks are rising as a result of slowing earnings growth, tighter financing conditions on international capital markets, currency depreciation and monetary tightening to defend exchange rates. In the case of Turkey, this followed rising political risks since early 2014. The lira is among the currencies hit worst by the change in sentiment among international investors, highlighting its weak resistance to shocks (see Chart 3.9).

Chart 3.9 Exchange rate against the USD
(Index, 1 May 2013 = 100)



Source: IHS Global Insight

That is even more true of Ukraine, where the economy has collapsed following the conflict with Russia, bringing its government to the brink of default. The IMF has agreed a EUR 12 billion rescue package, with more financial aid from the EU expected. In most of the other countries of emerging Europe, credit risk is improving, with economic prospects brightened by stronger growth in the Eurozone and monetary easing in Hungary, Poland and Romania. Generally, this has been helped by low inflation and, for Romania, fewer

macroeconomic imbalances over recent years (see Table 3.6).

Table 3.6 Inflation (annual % change)

	2012	2013	2014f	2015f
Czech Republic	3.3	1.4	1.0	2.2
Hungary	5.7	1.7	1.0	2.9
Poland	3.7	0.9	1.3	2.3
Romania	3.3	4.0	2.2	3.0
Russia	6.6	6.5	6.1	5.3
Turkey	8.9	7.5	8.1	6.7
Ukraine	0.6	-0.3	6.6	6.7

Source: Consensus Economics (April 2014)

However, for Hungary, monetary easing might prove to be a risky strategy, given steady outflows from the government bond market in response to rising policy risks. Although these countries' resilience to shock has been generally good during the current financial market volatility, they are vulnerable to shocks stemming from the Eurozone. This is due to still significant external debt and, for Poland and Hungary, relatively high portfolio inflows.

Turkey: vulnerable to global risk aversion

Tighter financial conditions, weakening earnings and currency depreciation are clouding the economic outlook for Turkey and increasing credit risk, particularly in the private sector. Economic rebalancing in Turkey came to a halt in the second half of last year and the current account deficit increased to 8% of GDP. Four fifths of this is funded by volatile portfolio and short-term capital inflows. The resulting large gross external financing needs and weak international liquidity make Turkey very vulnerable to changes in market sentiment.

A renewed bout of investor unease arrived at Turkey's shore at the turn of the year, as a deepening corruption investigation and repeated attempts by the government to suppress it rattled financial markets. The lira came under renewed downward pressure, to which the central bank responded by sharply raising interest rates to 10% at the end of January (see Chart 3.10). For now, this seems to have worked, as the lira has recovered some lost ground and official reserves have rebounded.

Chart 3.10 Exchange rate against USD, Turkey
(Sport market rate)

Source: IHS Global Insight

In this environment, credit risks are rising, as growth looks set to slow and inflation to remain elevated as a result of a depreciating currency and tighter financing conditions. Meanwhile, the corruption investigation and the government's response to it seem to reflect deep rifts within the ruling AKP that are unlikely to be resolved soon. Political tensions, also reflecting rising dissatisfaction with a rather autocratic ruling style, are likely to remain high, at least until after the August presidential elections, discouraging capital inflows and weighing negatively on the lira.

Table 3.7 Key data Turkey

	2013	2014f	2015f
Real GDP (% change)	4.0	2.3	3.7
Inflation (% change)	7.5	8.1	6.7
Private sector credit (%	34	21	20
Current account (% GDP)	-7.9	-6.3	-6.1
Portfolio invest. stock (%	158	158	158
Gross external debt (in %	49	53	55
Net external debt (in % xgs)	111	121	123

Source: Consensus Forecast (April 2014)

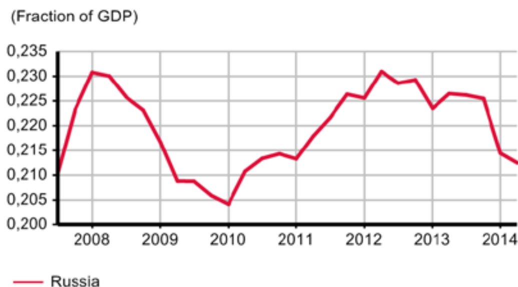
With net external debt ratios on an upward trend, Turkey will remain highly vulnerable to changes in market sentiment in general and to a downside scenario for Russia/Ukraine in particular: Turkey gets 40% of its natural gas via Ukraine and Turkish companies are heavily involved in construction projects in both Russia and Ukraine. Most exposed to shocks is the non-bank private sector.

Russia: decline as Ukraine crisis unfolds

In our last Economic Outlook we signalled that Russia's oil and gas driven economic growth was under pressure. This was due to slower export growth, slower growth in private consumption and

shrinking investment: the latter added to a downward trend in investment that had started in early 2012 (see Chart 3.11).

Chart 3.11 Fixed Investment



Source: IHS Global Insight

Economic growth fell back to 1.3% in 2013, from 3.4% in 2012. Export volumes declined 2.8% in 2013, while private consumption growth was almost halved to 4.7%. Investment stagnated at -0.1% in 2013, compared to a 6.4% increase the year before. The dismal investment figure was clearly not helped by the lack of reform progress. Although Russia's standing in the World Bank's 'Ease of Doing Business' index improved, from 129 to 92, the performance is still lacklustre. Longstanding issues like corruption, red tape, judiciary independence and the role of security services need to be addressed urgently, but the political elite shows little appetite for reform. No wonder another USD 60 billion capital fled the country in 2013, adding to a total of USD 1.6 trillion since 2005.

Instead of opting for reform, Russia has decided to move the other way and step up its political and military assertiveness, specifically in Ukraine. The Crimean peninsula has been brought into its sphere of influence and it is evident that Russia supports anti-government forces in the southern and eastern parts of Ukraine. Russian troops have moved to the Ukrainian border, signalling a hightened risk of Russian military intervention. The situation, which is still unfolding, has triggered US and EU sanctions and the largest political crisis since the cold war. The impact on the Russian financial and economic situation has already been substantial.

Chart 3.12 Russian rouble

(Sport market exchange rate, per USD)

Source: IHS Global Insight

The Moscow Stock market has lost around 20% of its value since the Ukraine crisis erupted, of which half was lost after Russian forces entered the Crimea. The Russian rouble has depreciated by 10%, a slide the Russian central bank has attempted to counter with an interest rate hike from 5.5% to 7% and sale of foreign exchange reserves (see Chart 3.12). That sale has cost USD 41 billion in the first quarter of 2014: 10% of the sizeable war chest. External debt spreads have doubled from a year ago, to more than 3%, and government bond yields have shot up, to nearly 9% from 7%. Capital flight has intensified, to USD 55 billion in the first quarter, while non-resident capital inflow was only one third the size of a year ago: FDI inflows fell by one half, borrowings by banks by two thirds. Rating agencies Moody's and Fitch have put Russia on negative watch, while Standard and Poor's has downgraded the country by one notch to BBB-. As the crisis unfolds, financial markets are anticipating further damage to the economy.

The level of economic damage already inflicted should not be underestimated. According to the IIF[9] the Russian economy grew at a pace of 0.8% year-on-year in the first quarter of 2014. Investment fell by 5% year-on-year as capital outflow surged. The rapid rouble depreciation has led to rising import prices and higher inflation (nearing 7%), putting pressure on real incomes, and private consumption. Private consumption was also affected by a sharp slowdown in lending by banks, as they face funding constraints on international markets. However, GDP was boosted by net exports, as the oil price remained fairly stable. Indeed, higher oil prices were helped by the crisis. The 2014 growth forecast has been revised sharply downwards over recent months. The April consensus forecast was 0.9%,

[9] IIF, April 21, 2014. Russia: Going the Wrong Way.

while the IMF revised its forecast down to 0.2% for 2014 and 1% for 2015. Even so, these may still be too optimistic.

There are a number of possible future scenarios. In the most positive scenario, de-escalation in southern and eastern Ukraine will take place with no further sanctions imposed. This would lead to gradual easing of tensions in the financial market. Capital inflows would resume and foreign investor confidence would gradually return. Still, capital outflows would be in the range of USD 150 million for 2014. This would leave investment constrained, and may push Russia into a recession in 2014. Government finances would deteriorate due to subsidies for the Crimea and higher defence spending, but would remain manageable (helped by the oil price that is expected to remain high). Central Bank intervention would be phased out, leaving the foreign reserves at a reasonable level of USD 360 billion by the end of the year. Liquidity would remain acceptable with import cover at 7 months.

But this scenario is by no means certain. Firstly, tensions in southern and eastern Ukraine may escalate further and lead to a situation where there is de facto autonomy for these regions. If that happened, Russia would have to support them, putting a drain on government resources, and stepping up defense spending. The mechanism described above would be reinforced, and natural gas exports channeled through the Ukraine may be disrupted, leading to a GDP decline of 4-5%. Secondly, economic growth may be damaged further if sanctions, such as Iran type sanctions on Russian banks, are imposed by the US and/or EU. That would create a situation similar to the 2008/09 crisis: an 8-9% decline in Russian GDP.

Ukraine: in political and economic crisis

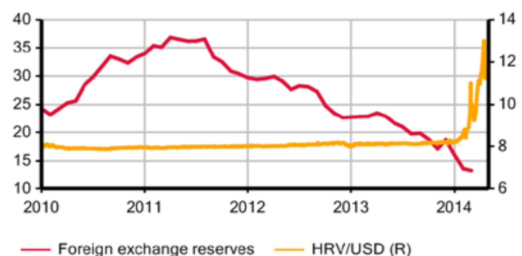
Ukraine fell into crisis in November 2013 when the former president Yanukovich chose a USD 15 billion Russian bailout over a trade deal with the European Union. Three months of protests ensued, culminating in a truce signed between the opposition and Yanukovich to end the violence. By this time the revolt had already cost the lives of 77 people. On the day following the truce Yanukovich was overthrown and fled to Moscow. Russia declared the overthrow to be an illegitimate coup d’état and refused to recognise the new Ukrainian authority. President Putin further declared that Russia had every right to defend ethnic Russians in Ukraine, and thereby deemed military action legitimate. On 2 March Russia deployed soldiers to Crimea and two weeks later the Crimea was absorbed by Russia in a referendum with an alleged majority of over 83%.

In response to the forced annexation of Crimea, the US and the EU froze assets, and put in place visa bans on targeted individuals of Ukrainian and Russian nationality. On 27 March, the IMF stated that it had reached an agreement with Ukraine's interim government for a stand-by loan worth between USD 14 billion to 18 billion. The package includes a move to a floating exchange-rate regime in an attempt to boost exports and protect foreign reserves. Stabilisation of public finances and energy sector reform is planned as part of the programme. Since the annexation of Crimea, pro-Russian protesters in the eastern part of Ukraine (primarilly in Donetsk and Charkov) have voiced their will to join Russia. Similar movements have also taken place in Transnystria, part of Moldova.

Russia is employing propaganda and threats to raise gas prices and block supplies, to coerce Ukraine (and to a lesser extent the European Union) to refrain from formal action. However, the US and EU have declared that the sanctions imposed so far are only the first steps intended to be taken against Russia. The political unrest around the Crimea and in the eastern parts of the country is disastrous for the Ukrainian economy.

Chart 3.13 Reserves and USD exchange rate

(Foreign exchange reserves in USD billion; HRV/USD)



Foreign exchange reserves — HRV/USD (R)

Source: IMF; IHS Global Insight

Ukraine has struggled with its economic performance in recent years, and its economy stagnated in 2013. This year its economy is expected to shrink 3.9%: the budget balance is in deep negative territory (-5%), as is the current account (-9,7%). Foreign exchange reserves have dropped 55% since 2011 (to USD 13.6 billion from 30.4 billion) and the currency has lost 40% of its

value since the start of the year (see Chart 3.13). The economic situation is acute and, without IMF intervention, the country is on the verge of bankruptcy. This is reflected in Ukraine's sovereign risk rating from the three major agencies, which has been downgraded to CCC. From this perspective the expected growth of 1.3% in 2015 provides little comfort: Ukraine will remain a troubled market over the forecast horizon.

MENA: political uncertainty remains

Three years after the 'Arab Spring' several countries in this region still face political turmoil to various degrees. Most striking is the devastating civil war in Syria, which has led to an estimated 150,000 deaths and millions of refugees. The Syrian conflict has had a considerable spill-over effect on neighbouring countries, with the enormous inflow of refugees increasing the financial burden on Jordan and Lebanon and constraining economic growth. More importantly, it has led to a sharpening of the sectarian tensions in the region. The political system in Lebanon is paralyzed, sectarian violence in Iraq has increased and the historical distrust between Saudi Arabia and Iran has flared up.

Table 3.8 Real GDP growth - MENA

	2012	2013	2014f	2015f
Egypt	2.2	2.1	1.5	3.7
Morocco	2.7	4.4	4.2	4.9
Qatar	6.2	5.6	5.1	5.7
Saudi Arabia	5.8	3.8	4.4	4.6
Tunisia	3.6	2.9	3.3	5.5
UAE	4.4	4.1	3.1	3.9

Source: IHS Global Insight (April 2014)

Since 2010 the divergence between oil importing and oil exporting countries has increased. Oil importing countries in particular have experienced political instability, resulting in low economic growth and macro-economic imbalances. Many eventually needed financial aid from other Gulf countries. On the other hand, the oil exporting countries have large financial surpluses and have been able to increase government spending to prevent social unrest. However, in 2013 disruptions in oil supply resulted in lower economic growth.

The outlook for the MENA countries is dependent on political developments and is therefore highly uncertain for some of them. High oil prices and a recovery in oil production will support economic growth in the oil-exporting countries and non-oil growth will increase as a result of government spending. That growth in the non-oil sector is also necessary to diversify economies and generate jobs for a young population.

For the oil importing countries, economic growth is expected to increase but remain weak. A further recovery in the Eurozone will support these countries through increasing tourism, exports and remittances. However, fiscal consolidation is necessary to improve government finances. For Egypt in particular this is a priority as the high deficits on the government budget have resulted in large imbalances. Economic growth is expected to remain weak in Egypt as the elections later this year create uncertainty and weigh on tourism and foreign direct investments.

Sub Saharan Africa: continued high growth

In spite of negative trends in some commodity prices, the economy of Sub Saharan Africa is expected to grow at 6% this year compared to 5% in 2013. Economic growth is currently driven largely by (overdue) investment in infrastructure. As explained in our previous Economic Outlook, a number of African economies are very vulnerable to corrections in commodity prices and the anticipated slowdown in China could therefore pose a risk.

Table 3.9 Real GDP growth - Sub-Saharan Africa

	2012	2013	2014f	2015f
Ghana	7.9	7.5	6.8	6.2
Kenya	4.6	4.9	5.3	5.7
Nigeria	6.5	6.9	6.8	6.7
South Africa	2.5	1.8	2.8	3.8

Source: IHS Global Insight (April 2014)

South Africa: no longer the largest economy

South Africa lost its status as Africa's largest economy to Nigeria in April. Although this was merely the result of a statistical revision of Nigeria's GDP, it was nevertheless an event of some significance. South Africa's economic growth has been disappointing since the global financial crisis, in spite of prolonged high economic growth in the rest of Sub Saharan Africa. Real economic growth is forecast to be 2.8% this year, and to accelerate to 3.8% in 2015. The exchange rate suffered a heavy blow last summer due to a massive sell-off of assets

by foreign investors. South Africa has a large current account deficit and an even larger external financing requirement, making its balance of payments dependent on foreign capital inflows. Since the crisis, South Africa has struggled to balance its budget and ongoing deficits have resulted in persistently increasing public debt.

Although the ANC won a victory in the May elections, it has lost some of its lustre. The misuse of public money by president Jacob Zuma was the latest example of the increasing corruption within the ANC and the government. South Africa still benefits from its relatively strong business environment, but there is a risk of a gradual erosion of its institutions. South Africa's economic performance depends increasingly on structural economic reforms. The mining industry is suffering from constant power shortages and ongoing labour unrest that may spread to other segments of the economy. Investment in power generation and education and a reform of the labour market should be key priorities in South Africa's economic policy, but will take a long time to implement.

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4. Implications for the insolvency environment

Diverging insolvency risk trends

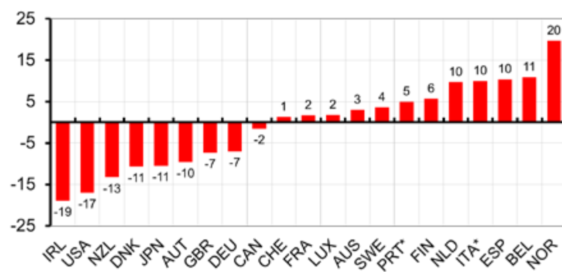
The somewhat brighter economic conditions in advanced economies also bode well for company solvency conditions and payment behaviour. Following the return to economic growth in the Eurozone in the third quarter of 2013, insolvencies have shown a clear tendency to recede in a number of member countries, and in the UK and the US. However, as discussed in last November's Economic Outlook, this expected improvement starts from already elevated insolvency levels.

For many emerging markets, however, the trend is in the opposite direction. With economic growth slowing and Fed tapering looming on the horizon, it is reasonable to anticipate a worsening trend in business failures this year. Eastern Europe and Latin America may both experience an increase in corporate defaults in 2014, although from relatively moderate insolvency levels. We will describe these two diverging trends in turn, starting with the situation in the major advanced markets.

Brighter outlook in advanced markets

Insolvency conditions across advanced economies showed mixed developments in 2013 (see Chart 4.1). Nine countries - Austria, Canada, Denmark, Germany, Ireland, Japan, New Zealand, the UK and the US - experienced an improvement for the full year, i.e. falling insolvency numbers.

Chart 4.1 Change in insolvencies 2013
(Insolvency growth expressed in %)



Source: Atradius Economic Research

In contrast, the number of insolvencies increased in twelve countries: Switzerland, France, Luxembourg, Australia, Sweden, Portugal, Finland, the Netherlands, Italy, Spain, Belgium and Norway. In many of these countries this increase came on top of a continuing rise in insolvencies over recent years.

However, some improvement was visible towards the end of 2013. The Netherlands and Spain, for example, have both seen insolvencies falling back since the fourth quarter of last year. Similarly, the positive insolvency trend strengthened over the same period in Denmark and Ireland. In most of these countries we have seen improving or stabilising insolvency dynamics, consistent with the better economic conditions that materialised late last year.

Better prospects in 2014...

That positive trend is likely to continue in 2014. Table 4.1 shows the updated insolvency forecasts for 2014 for the advanced markets that we track.

Table 4.1: Insolvency growth (% per annum)

f=forecast	2011	2012	2013	2014f
Australia	5	1	4	0
Austria	-8	3	-10	-2
Belgium	7	4	11	0
Canada	-11	-12	-2	0
Denmark	-15	0	-11	-10
Finland	3	0	6	0
France	-1	3	2	0
Germany	-6	-6	-8	-2
Ireland	7	3	-19	-15
Italy*	8	14	10	5
Japan	-4	-5	-11	0
Luxembourg	5	8	2	0
Netherlands	-1	21	10	-10
New Zealand	-12	-8	-13	0
Norway	-2	-12	20	0
Portugal*	18	42	5	-5
Spain	14	38	10	-5
Sweden	-4	7	4	-2
Switzerland	7	3	1	0
United Kingdom	5	-4	-7	-3
United States	-15	-16	-17	-5

Source: National bureaus, Atradius Economic Research
*The 2013 figure represents an estimate.

The current projection suggests lower frequency risk in the period ahead: we expect zero or negative insolvency growth in all countries but Italy. In

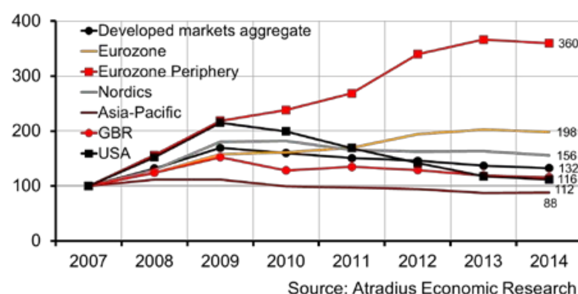
general, the expected changes are small relative to the most recent insolvency growth figures. Denmark, Ireland and the Netherlands are expected to experience the largest reduction in insolvency numbers.

…but insolvency levels remain elevated

The insolvency growth forecasts show that we are likely to head in a positive direction this year, but they say little about the level of risk in the countries. Several years of aggressive insolvency growth has brought insolvency numbers to historical highs in many countries. For this reason the forecast improvement must be viewed in a longer term perspective.

On average, the number of business failures is still high in the tracked advanced markets: 37% higher in 2013 than in 2007. Although we expect insolvencies to decrease somewhat in 2014, the forecast represents only a slight improvement on 2013: the number of insolvencies will still be 32% higher than before the onset of the crisis for the developed market aggregate (see Chart 4.2).

Chart 4.2 Insolvency developments
(Index, 2007 = 100)



Source: Atradius Economic Research

It is evident that the insolvency dynamics over the past seven years show substantial variation in regional performance. The developed part of Asia-Pacific is the only region where the level of insolvencies is lower (-12%) than in 2007. The UK and the US have also experienced better default dynamics over recent years than the average for advanced markets. In the US the level of insolvencies have decreased since 2010, but insolvencies are still 12% higher than in 2007. The corresponding figure for the UK is 16%.

In the Nordic region the number of insolvencies is still considerably higher than before the crisis: 59% higher than in 2007, factoring in the expected improvement in 2014. The level has decreased gradually since 2011, but only slowly.

In contrast, insolvencies in the Eurozone have continued to rise steadily since 2007. Despite the expected improvement in 2014 the level of insolvencies will remain roughly twice as high as in 2007 (+98%). This is consistent with the difficult economic climate in recent years – three out of seven years with negative economic growth – and, given the slow pace of the recovery, we may expect insolvency risk to remain high througout the next couple of years.

The poor insolvency dynamics in the Eurozone aggregate have been driven mainly by the steep deterioration in Spain, Italy, Ireland, Portugal and Greece. In this regional cluster the level of business failures is almost four times higher than before the crisis. As the economic outlook is for a return to growth in these markets, we expect the insolvency index for the Eurozone periphery to reach 360 in 2014 compared to 366 in 2013: i.e. stabilisation at a very high level.

Combining level and trend: an overview

Our expectation for the insolvency environment in advanced markets for 2014 is a direct consequence of the somewhat brighter general economic outlook as outlined in Chapter 2 of this report. We project a small improvement in the insolvency environment in broad terms, but with the level of insolvencies remaining high. The underlying assumption for this expectation is, in essence, gradually accelerating economic growth combined with somewhat easing credit conditions in advanced countries. These broad-based insolvency trends apply to both small and large firms, but are perhaps most representative of the SME segment.

The insolvency index evolution presented in Chart 4.2 provides a picture of absolute default risk performance, but does not show how different countries compare to each other. Two individual countries displaying similar insolvency growth trajectories over time may end up with substantially different default rates, depending on the level from which they started. The countries included in our insolvency assessment framework are therefore classified according to both their level of insolvency and expected change (see Figure 4.1).

Figure 4.1 Insolvency matrix 2014

	Low	Average	High
Deteriorating			Greece, Italy
Stable	Austria, Canada, Germany, Japan, New Zealand, Sweden	Australia, Finland, Norway, Switzerland	Belgium, France, Luxembourg
Improving		Netherlands, United Kingdom, United States	Denmark, Ireland, Portugal, Spain

The vertical axis in Figure 4.1 depicts the expected change in the default level in 2014 (i.e. whether the insolvency growth forecast is improving, stable or deteriorating). As such, all countries expected to see deterioration in their insolvency environment this year are to be found in the top segment of the grid. As already mentioned, Italy and Greece are the only two countries where insolvencies are expected to increase in 2014. The bulk of countries included in the forecasting exercise are expected to display stable insolvency developments (i.e. insolvency growth around zero).

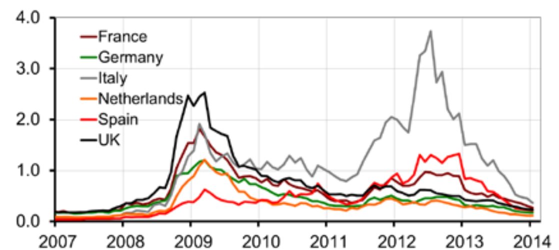
The horizontal axis in Figure 4.1 depicts the absolute level of default in a comparative context (i.e. whether the frequency of defaults in a country is assessed as low, average or high). As such, all countries with comparatively high default frequencies are found in the right-hand segment. Italy and Greece will as such experience deterioration from already high default levels.

This classification provides a high-level overview of trends in insolvency risk across some of our most important markets for short-term credit insurance. This summary suggests that we may expect frequency risk to decrease in four markets currently characterised by high default rates: Denmark, Ireland, Portugal and Spain. Similarly, we expect frequency risk to level off in three 'average' default-type markets: The Netherlands, the UK and the US. The signs of a trend-shift in insolvency dynamics, as communicated in our previous Economic Outlook, have strengthened: we appear to have turned a corner in terms of frequency risk.

Credit risk developments across large firms

In parallel with the stabilising frequency risk conditions across advanced markets, we have also seen further improvement in default expectations across large firms. Expected Default Frequencies have recently trailed back to pre-crisis levels in both Europe and the US.[10] The median EDF among US firms was 26 basis points in January, compared to 40 basis points a year ago. Benign stock market developments and the low volatility environment in that period lies behind this improvement. The EDFs have broadly also declined since the middle of last year across European countries (see Chart 4.3).

Chart 4.3 Median EDF - Europe
(Default risk 12 months ahead, percent)



Source: Moody's KMV

Across the Eurozone markets directly affected by the Eurozone debt crisis, the risk still lingers at somewhat higher levels, in spite of recent improvements. The Greek median default expectation is still in excess of 4% and the corresponding figure for Portugal is just below 1%. The median EDF among Italian corporates, however, has fallen back considerably over the past year, to 37 basis points.

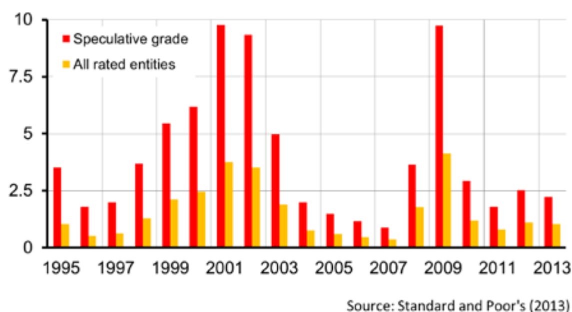
Chart 4.4 Investment grade credit risk
(CDS spreads, 5-year segment)

Source: Bloomberg; Atradius Economic Research

[10] The Expected Default Frequency (EDF) tracks default risk among stock listed companies. Combining balance sheet and stock market information for a particular firm yields a 1-year default forecast. The median EDF, as referred to in the charts below, represents the 50th percentile in the total country aggregate of firms.

Similarly, Credit Default Swap (CDS) spreads, an external benchmark for the degree of perceived credit risk, have continued to narrow over the past year (see Chart 4.4). Notably, for the first time since the middle of 2010, the default premium for European investment grade credit has converged to its US counterparty: 72 against 68 basis points.

The current CDS levels indicate that the perception of corporate credit risk remains higher than before the crisis, and this corresponds to actual default rates. The global default rate among companies rated by Standard & Poor's fell only slightly in 2013, to 1.04% (see Chart 4.5). This may be compared with a rate of 0.37% in 2007: from a longer perspective it is evident that the period between 2006 and 2007 represented an unusually benign default environment. This also holds true for the broad-based frequency risk conditions discussed previously and should be borne in mind when interpreting the insolvency indices.



The development in the financial health of the corporate sector, as reflected in the actions of rating agencies, also shows signs of improvement across advanced markets. In terms of companies' credit rating developments, the multi-year trend of deterioration in credit quality turned in 2013.

Table 4.2 S&P Rating trends - Major Regions

	2012	2013	2014Q1
Asia	0.66	0.50	0.40
Eastern Europe	0.96	0.86	0.06
South America	1.13	0.77	0.12
North America	0.87	1.15	1.47
Western Europe	0.23	0.61	1.01

Source: Bloomberg

In North America, the ratio between upgrades and downgrades in the S&P rated universe climbed above one, with an accelerating trend in the first quarter of this year (see Table 4.2). The situation in Western Europe, on the other hand, was still negative in 2013: the upgrade-to-downgrade ratio reached just 0.61. Consistent with expectations of a strengthening recovery, however, the number of upgrades turned slightly higher than the number of downgrades in the first quarter of 2014.

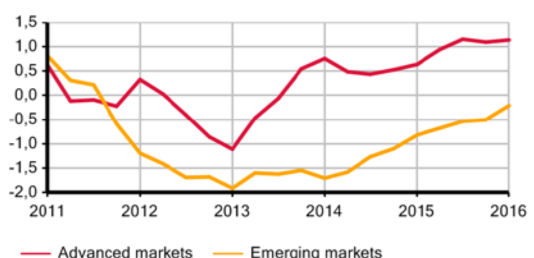
While the rating agencies are awarding more positive ratings to advanced markets, the trend is the opposite across emerging markets. In these markets credit ratings are declining. Although the number of rated firms is much smaller in these regions, the trend is clearly negative and accelerating. This is not surprising given the economic developments sketched in Chapter 3: the expected slowdown across so-called growth markets is in line with upward pressure in corporate default risk.

Business failure trends in emerging markets

The cooling economic conditions in emerging economies don't bode well for business conditions in those regions. Slower growth momentum and vulnerability to external financing flows suggest that we may expect some deterioration in solvency conditions and payment behaviour among firms in a number of key markets.

Slowing growth momentum…

Even though emerging economies are still expected to drive global growth over the medium and long term, the current softening in performance implies that they are operating below what may be considered trend growth (see Chart 4.6).

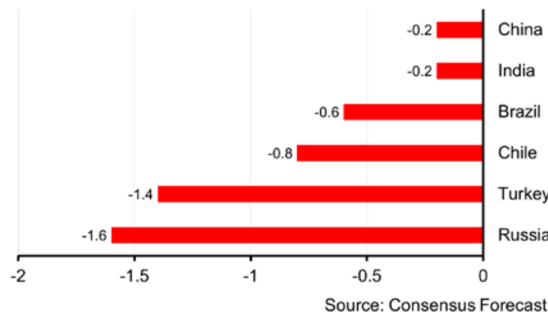


In advanced markets, growth is picking up above trend, albeit from a low absolute level. The bottom line is that the 'shortfall' in economic growth in

emerging economies is likely to affect businesses that are operating on increasingly tight margins.

In this context it is also important to note how quickly expectations are being adjusted. Expectations for this year have been downgraded sharply across a number of important markets since our previous Economic Outlook was published six months ago (see Chart 4.7 below). Since then the GDP growth forecast for 2014 has fallen by 0.6 percentage points in Brazil and 0.8 percentage points in Chile. The prospects for Turkey and Russia have changed even more starkly: by 1.4 percentage points and 1.6 percentage points respectively.

Chart 4.7 Change in 2014 GDP growth forecast
(Percentage point change between Nov. 2013 and April 2014)



Source: Consensus Forecast

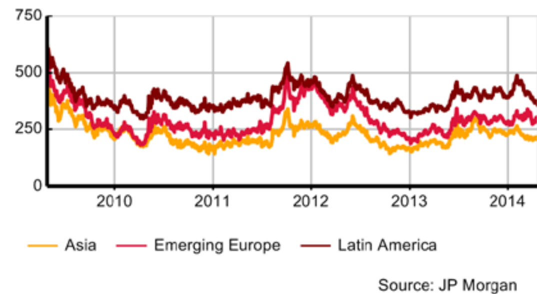
The large economies in emerging Asia - China and India - are also slowing down this year, as described in Chapter 3. But in these cases expectations are less fluid: the GDP outlook for India and China for this year has been reduced by 0.2 percentage points. This may be considered a somewhat cushioning factor for Asia in terms of future credit risk developments.

…and tighter credit conditions…

Cheap financing is also likely to become relatively less abundant over the forecast horizon. As monetary policy in the US is becoming less expansionary, the relative attractiveness of emerging markets for foreign capital decreases. Tightening of domestic monetary policy to address structural economic issues and support exchange rate positions also works in the direction of a higher interest environment. Bond spreads have increased since spring last year, especially in emerging Europe (see Chart 4.8).

Chart 4.8 Emerging market bond spreads

(EMBI spread over U.S. government bond, in basis points)



Source: JP Morgan

Overall, the diminishing growth advantage in comparison to advanced markets, together with less favourable conditions for funding, translates into increased risk of business failures.

…forebode an increase in corporate defaults

Table 4.3 summarises our perception of business failure risk in Central and Eastern Europe (CEE), Latin America (LA) and Emerging Asia (EA) for this year.

Table 4.3 Business failure trends - Major Regions

	Default level assessment 2013	Trend in 2014
Central & Eastern Europe	High	Increase
Russia	High	Increase
Turkey	High	Increase
Latin America	Low	Increase
Brazil	Low	Increase
Chile	Low	Increase
Emerging Asia	Low	Mild increase
China	Low	Mild increase
India	Low	Mild increase

Source: Atradius Economic Research

The number of insolvencies has increased steadily across the CEE region over recent years and the default level is currently assessed as relatively high. This region is also likely to see an increase in insolvencies this year. In the LA region insolvencies have developed in a more stable fashion and the default level is currently assessed as relatively low. Similar to the CEE, however, we forecast an increase in defaults. Asia also represents a low default market, but here a mild increase is expected.

Risks to the insolvency projections

The main scenario for macroeconomic performance in 2014 suggests a somewhat brighter climate for businesses in advanced markets; an improvement in the current rather strained environment, especially in Europe. Although an improvement is expected for 2014, as discussed in this report, performance still reflects sluggish economic conditions. And there are downside risks to this already stretched scenario throughout the forecast horizon. The slow economic recovery will only gradually reduce the pressure on business failures in markets already characterised by high default rates.

Our anticipation of gradually easing financing conditions, although restrictive by historical standards, supports this view. Corporate sector leverage is relatively high, and this remains a risk factor. Against the background of the strengthening growth outlook and slightly reduced financial sector vulnerabilities, we can now make a more balanced risk assessment in our insolvency forecasts for advanced markets. Judging from the most recent speed of correction in insolvencies across a number of countries, the likelihood of seeing a more pronounced improvement in insolvencies might even be greater than anticipated. This is a major difference between the message in this Economic Outlook and our previous one.

For emerging markets, on the other hand, there are plenty of reasons to expect more business failures. Growth expectations are still negative and credit conditions may be deteriorating. In this context the outlook for insolvencies and protracted default conditions is not only negative, but also tilted to the downside. The confluence of traditional political risk factors and pure commercial risk in business transactions with firms in these markets complicates the picture. Moreover, this trend has recently reversed: political risk is no longer receding in emerging markets. On the contrary, the events in and around Ukraine shows that it has returned with a vengence.

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Appendix I: Forecast tables

Table A1: Macroeconomic headline figures - Developed markets

	GDP growth (%)			Inflation (%)			Budget balance (% of GDP)			Current account (% of GDP)			Export growth (%)		
	2013	2014	2015	2013	2014	2015	2013	2014	2015	2013	2014	2015	2013	2014	2015
Australia	2.4	2.6	2.9	2.4	2.8	2.5	-1.4	-2.1	-1.5	-2.9	-2.5	-3.3	6.8	5.0	4.9
Austria	0.4	1.7	2.0	2.0	1.6	2.0	-1.5	-2.1	-1.3	1.9	2.6	2.8	2.4	4.6	4.7
Belgium	0.2	1.3	1.8	1.1	1.2	1.7	-3.0	-2.7	-2.0	-1.0	-0.4	0.1	1.8	2.3	4.1
Canada	2.0	2.2	2.6	0.9	1.4	1.8	-3.0	-1.5	-0.8	-3.2	-2.3	-1.7	2.1	3.6	5.5
Denmark	0.4	0.9	2.0	0.8	1.0	1.8	-2.3	-1.9	-1.4	7.1	7.6	7.9	1.2	3.3	4.6
Finland	-1.4	0.4	1.5	1.5	1.5	1.7	-2.5	-3.0	-2.3	-0.7	-0.2	-0.5	0.3	2.9	3.6
France	0.3	0.6	1.2	0.9	1.0	1.4	-4.2	-3.9	-3.4	-1.7	-1.6	-1.2	0.8	1.8	3.2
Germany	0.5	2.1	2.0	1.5	1.3	1.8	0.0	0.1	0.1	7.3	6.7	6.6	1.0	5.6	4.3
Greece	-3.9	-0.2	1.7	-0.9	-0.5	0.3	-2.5	-2.4	-2.0	0.6	1.0	1.4	1.8	1.7	3.1
Ireland	-0.3	1.5	2.4	0.5	0.3	1.0	-7.2	-4.6	-2.8	4.9	4.6	4.6	0.1	3.2	2.6
Italy	-1.8	0.4	1.0	1.2	0.6	1.1	-3.1	-2.9	-2.0	0.7	1.1	0.9	0.0	2.5	1.6
Japan	1.5	1.4	1.3	0.4	3.0	2.0	-9.4	-7.3	-6.5	0.7	-0.4	-0.4	1.6	5.8	7.8
Luxembourg	2.0	2.4	2.9	1.7	1.4	2.3	0.1	0.2	0.0	5.5	6.3	5.8	2.4	6.3	5.2
Netherlands	-0.8	1.1	1.5	2.5	1.2	1.5	-3.3	-3.0	-2.3	11.6	12.2	12.0	1.4	2.9	5.1
New Zealand	2.5	3.0	2.9	1.1	2.1	2.4	-2.8	-1.5	-0.5	-3.2	-3.2	-4.6	0.9	3.1	3.5
Norway	0.8	1.6	1.4	2.1	1.9	2.2	11.7	11.3	10.4	8.6	7.2	10.1	-3.8	0.4	1.8
Portugal	-1.4	1.3	1.3	0.3	0.2	0.7	-4.9	-4.0	-2.8	0.5	0.9	1.3	6.1	3.4	3.7
Spain	-1.2	0.6	1.3	1.4	-0.1	0.6	-6.8	-5.7	-4.6	1.0	1.0	1.5	4.9	4.4	3.6
Sweden	1.5	2.0	2.2	0.0	0.2	1.6	-1.2	-0.8	-0.4	6.5	6.4	6.6	-0.9	2.1	3.4
Switzerland	2.0	2.2	2.3	-0.2	0.1	0.5	0.2	0.3	0.3	13.0	11.8	10.8	2.0	4.0	4.9
United Kingdom	1.7	2.8	2.6	2.6	1.8	2.1	-5.7	-5.4	-4.2	-4.4	-3.1	-2.3	1.0	4.4	5.5
United States	1.9	2.4	3.0	1.5	1.8	1.6	-4.7	-5.0	-4.2	-2.3	-1.8	-2.0	2.7	4.1	4.0
Eurozone	-0.4	1.1	1.5	1.3	0.9	1.4	-2.9	-2.5	-2.0	2.8	2.9	3.0	1.4	3.8	3.8
European Union	0.1	1.5	1.8	1.4	1.0	1.6	-3.2	-2.8	-2.3	1.8	1.9	2.0	1.6	3.9	4.2

Source: IHS Global Insight

Note: IHS Global Insight forecasts for 2014 and 2015 (Data edge 2013 Q4). Date of forecast, 29 April 2014. These forecast values are provided as an indication of direction, representative of one vendor's view only. The values in the table may therefore differ from the Consensus values quoted throughout the report.

Table A2: Macroeconomic indicators - Developed markets

	Private cons. (%)			Fixed inv. (%)			Gov. cons. (%)			Retail sales (%)			Industrial prod. (%)		
	2013	2014	2015	2013	2014	2015	2013	2014	2015	2013	2014	2015	2013	2014	2015
Australia	2.0	2.9	3.3	-1.2	-0.5	2.2	1.1	0.9	-0.2	0.7	3.3	2.6	3.6	2.5	3.5
Austria	0.0	0.8	1.5	-0.6	3.1	3.7	0.3	1.1	1.0	-0.6	0.7	0.0	0.4	4.5	2.2
Belgium	0.7	1.7	1.5	-2.4	2.0	2.1	0.7	0.1	0.4	-0.1	-0.2	0.1	0.8	2.2	2.3
Canada	2.2	2.7	2.5	0.1	0.8	2.9	0.8	1.6	1.8	1.6	1.9	1.9	1.5	3.0	2.0
Denmark	0.0	-0.7	0.8	0.7	0.9	3.8	0.8	2.9	1.9	-2.3	-0.9	-0.6	1.2	0.6	1.7
Finland	-0.8	0.1	0.7	-4.6	-2.0	2.6	0.8	0.5	0.8	-2.4	-0.4	1.2	-3.6	0.9	3.1
France	0.4	0.4	1.1	-2.1	0.6	2.2	1.8	1.0	0.8	0.2	0.5	1.1	-0.5	0.5	1.5
Germany	1.0	1.5	1.8	-0.5	7.4	3.2	0.7	1.3	1.3	0.3	1.4	0.0	0.0	4.8	2.6
Greece	-6.0	-0.6	0.7	-12	-2.8	3.2	-4.1	-2.1	-1.4	-7.7	-0.3	1.0	-3.6	1.5	2.5
Ireland	-1.1	1.1	1.7	4.9	11.2	4.5	-0.6	0.4	0.8	0.2	3.2	2.2	-1.9	2.1	2.4
Italy	-2.6	0.2	0.7	-4.6	0.5	0.6	-0.8	-0.2	0.1	-3.3	-1.1	-0.5	-2.9	0.6	1.2
Japan	1.9	0.9	-0.1	2.7	4.5	1.7	2.2	0.7	-0.4	0.6	-0.1	1.0	-0.6	5.5	4.2
Luxembourg	2.0	2.6	2.5	2.9	10.1	4.1	1.8	2.5	2.0	10.9	7.3	0.1	-2.5	6.5	3.1
Netherlands	-2.1	0.0	1.2	-4.8	7.1	2.3	-0.2	0.0	1.6	-4.5	-1.0	0.5	0.6	0.2	1.5
New Zealand	3.4	3.1	2.9	9.4	8.9	7.8	0.9	1.1	0.6	2.4	2.8	3.2	0.9	3.3	2.6
Norway	2.1	1.3	2.3	8.8	0.8	0.5	1.6	1.9	2.2	0.1	0.5	0.9	-4.9	2.3	2.3
Portugal	-1.7	0.6	0.7	-6.6	2.8	1.3	-1.7	-0.2	0.6	-2.6	0.8	1.3	0.7	1.9	2.3
Spain	-2.1	1.0	1.3	-5.1	0.9	0.8	-2.3	-3.1	-1.3	-3.7	0.5	0.8	-1.6	1.8	1.3
Sweden	2.0	2.1	2.0	-1.2	2.6	3.9	1.9	1.6	1.5	2.1	2.4	2.0	-4.7	4.2	2.6
Switzerland	2.3	1.9	1.7	1.8	5.6	4.6	3.0	1.8	1.0	0.9	1.6	1.7	0.8	5.2	3.5
United Kingdom	2.2	2.4	2.7	-0.6	8.1	6.2	0.7	0.4	-0.1	0.0	1.7	2.3	-0.3	2.8	2.8
United States	2.0	2.4	3.0	2.9	4.6	7.8	-2.0	-0.6	0.2	2.8	0.7	2.3	2.9	3.1	3.4
Eurozone	-0.6	0.8	1.3	-2.7	3.2	2.2	0.2	0.3	0.7	-	-	-	-0.8	2.2	1.9
European Union	0.0	1.2	1.7	-2.2	3.7	3.0	0.5	0.4	0.6	-	-	-	-0.6	2.5	2.3

Source: IHS Global Insight

Note: IHS Global Insight forecasts for 2014 and 2015 (Data edge 2013 Q4). Date of forecast, 29 April 2014. These forecast values are provided as an indication of direction, representative of one vendor's view only. The values in the table may therefore differ from the Consensus values quoted throughout the report.

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Table A3: Macroeconomic headline figures - Emerging markets

	GDP growth (%)			Inflation (%)			Current account (% of GDP)			Private cons. (%)			Export growth (%)		
	2013	2014	2015	2013	2014	2015	2013	2014	2015	2013	2014	2015	2013	2014	2015
Asia Pacific*	5.8	5.9	6.2	3.8	3.2	3.5	1.4	1.5	1.4	5.3	5.7	6.1	4.5	5.5	6.6
ASEAN	5.1	4.7	5.2	4.4	4.2	3.9	2.1	2.7	3.0	4.5	4.6	5.0	3.7	4.9	6.1
China	7.7	7.5	7.6	2.6	2.0	2.7	1.9	2.1	2.2	8.2	8.2	8.3	3.6	4.8	5.7
Hong Kong	2.9	3.6	4.1	4.3	3.9	3.7	2.7	3.2	4.1	4.2	4.0	4.4	6.5	6.1	7.3
Taiwan	2.1	3.4	4.0	0.8	1.3	1.6	11.3	11.7	10.7	1.8	2.7	2.7	3.8	5.0	7.2
India	4.6	5.3	6.0	10.1	7.7	7.4	-2.4	-2.9	-3.6	4.0	5.1	6.1	7.9	8.0	8.6
Singapore	4.1	3.4	4.1	2.4	2.6	3.2	17.9	18.9	18.6	2.4	3.5	3.9	3.6	4.9	6.3
Latin America	2.9	2.1	2.9	8.2	10.6	9.0	-2.8	-3.0	-3.1	3.2	2.7	3.2	1.6	2.8	3.7
Argentina	3.0	-0.3	-0.9	10.6	32.5	40.7	-0.9	-2.4	-4.1	5.6	1.6	0.8	-4.5	-1.4	-1.6
Brazil	2.3	1.9	2.9	6.2	6.3	5.4	-3.6	-3.5	-3.5	1.9	2.2	2.9	2.5	3.8	4.8
Mexico	1.1	3.1	4.2	3.8	3.8	3.7	-1.4	-1.1	-1.0	2.5	2.7	4.0	1.4	3.9	3.7
CIS	2.0	1.4	2.4	6.4	6.6	6.1	0.9	0.9	0.5	6.6	2.5	3.2	1.2	4.2	4.1
Czech republic	-0.9	2.1	2.7	1.4	0.8	2.3	-1.4	-1.3	-1.7	0.1	0.9	2.6	0.2	4.3	6.4
Hungary	1.2	2.3	2.9	1.7	1.4	4.3	3.0	3.2	2.7	0.0	0.2	1.2	5.3	3.3	3.3
Poland	1.6	2.9	3.4	0.9	1.2	2.6	-1.3	-1.6	-1.9	0.8	2.5	3.4	4.6	4.5	5.4
Russia	1.3	1.0	1.7	6.8	6.4	5.8	1.6	1.0	0.6	4.7	1.8	2.7	4.2	2.1	3.9
Turkey	4.0	2.8	3.9	7.5	8.2	4.9	-7.9	-6.7	-6.4	4.9	1.8	3.2	0.1	3.8	4.7
Africa	3.2	4.1	5.5	6.8	7.2	6.9	-3.1	-3.6	-3.6	3.8	4.1	4.2	2.5	5.0	6.5
South Africa	1.9	2.8	3.8	5.8	6.2	6.0	-5.8	-6.3	-6.5	2.6	2.6	3.8	4.2	5.7	5.6
MENA	2.3	3.1	4.4	7.9	5.7	5.5	10.2	8.1	6.2	2.4	3.9	4.4	1.0	3.9	5.3
BRIC	5.6	5.6	6.0	4.7	3.9	4.0	0.5	0.6	0.5	5.5	5.5	6.1	4.2	4.7	5.8
World	2.5	3.0	3.5	3.0	3.1	3.0	-	-	-	2.4	2.7	3.2	2.5	4.4	5.1

Source: IHS Global Insight

Note: * Excluding Japan

Note: IHS Global Insight forecasts for 2014 and 2015 (Data edge 2013 Q4). Date of forecast, 29 April 2014. These forecast values are provided as an indication of direction, representative of one vendor's view only. The values in the table may therefore differ from the Consensus values quoted throughout the report.

Appendix II: Country risk

Country risk

Companies that do business internationally rely on the stability of the business environment in the foreign country. Profits and investments are vulnerable to adverse developments in this environment. These risks are broadly termed 'country risk'. The level and change in country risk is therefore an important strategic and operational indicator for international companies.

Country risk covers a wide range of factors such as political developments, the risk of (armed) conflict and sovereign financial situation. These factors relate, for example, to regulatory changes, the risk of confiscation, civil unrest, war, currency controls and devaluations. Country risk takes into account a sovereign's willingness and ability to pay and the impact of this on the ability of public or private entities to meet their cross-border payment obligations. Under its political risk contract, Atradius provides cover against a subset of events that are labelled 'country risk'. This protection allows for companies to safely make transactions across borders.

The STAR rating

STAR is Atradius' in-house political risk rating. STAR stands for Sovereign Transfer and Arbitrary Risk and represents a rating system for assessing country risk. The STAR rating is designed as a summary measure of political risk relevant under the Atradius insurance contract and explicitly targets the impact on public or private entities with cross-border payment obligations.

The STAR rating runs on a scale from 1 to 10, where 1 represents the lowest risk and 10 the highest risk. In addition to the 10-point scale, there are rating modifiers associated with scale steps: 'POSITIVE', 'STABLE', and 'NEGATIVE'. These rating modifiers are referred to as 'notches' and allow further granularity and differentiate more finely between countries in terms of risk.

Table A4 The STAR rating scale

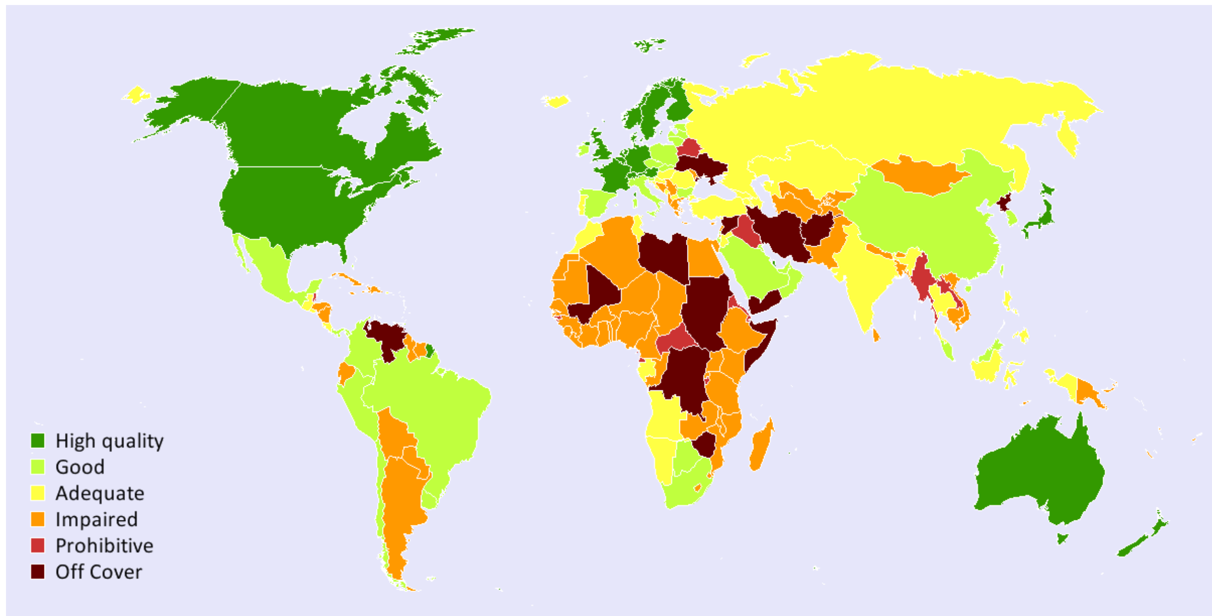
Credit type	Grade	STAR rating	Sovereign type
'Investment grade'	High quality	1	AAA
		2 POSITIVE	AA+
		2 STABLE	AA
		2 NEGATIVE	AA-
	Good	3 POSITIVE	A+
		3 STABLE	A
		3 NEGATIVE	A-
		4 POSITIVE	BBB+
		4 STABLE	BBB
		4 NEGATIVE	BBB-
'Speculative grade'	Adequate	5 POSITIVE	BB+
		5 STABLE	BB
		5 NEGATIVE	BB-
	Impaired	6 POSITIVE	B+
		6 STABLE	B
		6 NEGATIVE	B-
		7 POSITIVE	CCC+
		7 STABLE	CCC
		7 NEGATIVE	CCC-
	Prohibitive conditions	8	CC / C
		9	SD / D
	Off cover	10	

The principal features of the STAR rating scale are demonstrated in Table A4. The 10 rating steps are aggregated into five broad categories to allow their interpretation in terms of credit quality. Starting from the most benign part of the quality spectrum, these categories range from 'High Quality', 'Good', 'Adequate', 'Impaired' to 'Prohibitive Conditions', with a separate grade reserved for 'Off Cover'.

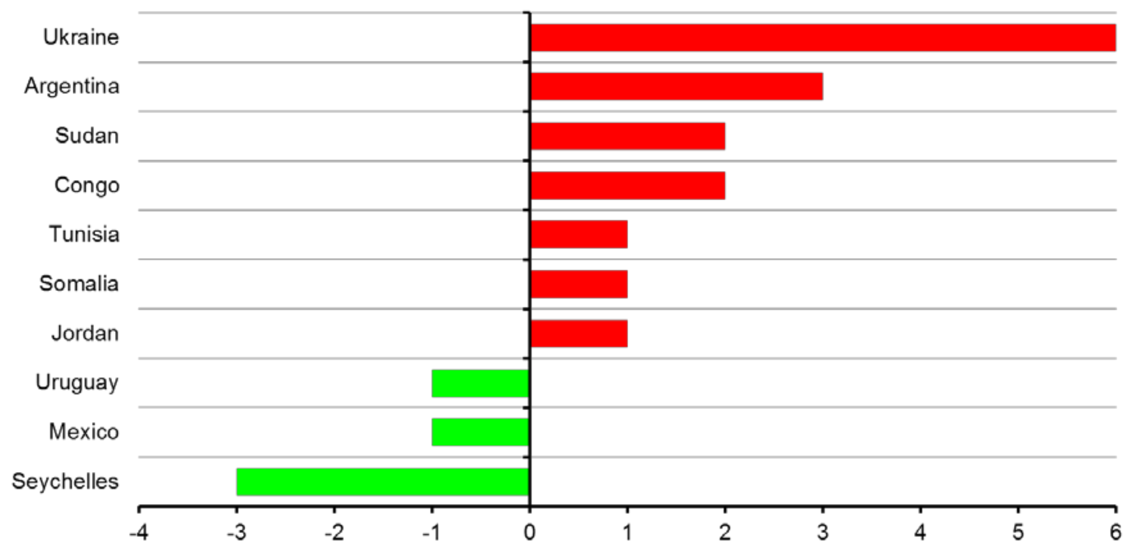
Recent developments

On the next page we summarise country risk conditions across the globe as measured through the STAR rating: Upper panel - Overview in the shape of a risk map; Lower panel - STAR rating changes taking place between 2013Q3 and 2014Q2.

Atradius political risk map 2014



Source: Atradius Economic Research (May 2014)



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