

International  
Special Report

# Sovereign Review

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## Related Research

- [Global Economic Outlook \(June 2009\)](#)
- [Sovereign Data Comparator \(June 2009\)](#)
- [The Financial Crisis, Policy Response and Sovereign Credit Risk \(June 2009\)](#)
- [External Financing Risks in Central and Eastern Europe \(May 2009\)](#)
- [Latin American Sovereign Outlook \(March 2009\)](#)
- [High-Grade Sovereigns and the Global Financial Crisis \(March 2009\)](#)
- [Sovereign Implications of the Financial Crisis \(October 2008\)](#)

## Global Economy Has Stabilised – Public Finances Have Not

- The global economy has likely stopped contracting and is forecast by Fitch Ratings to stabilise in the second half of this year. But the recovery will be anaemic and unemployment will continue to rise well into next year and in this context, the world's major central banks are not expected to begin raising policy interest rates until the end of 2010 at the earliest.
- As economic recovery takes hold, the large 'AAA' sovereigns will need to re-orientate fiscal policy towards ensuring the sustainability of public finances over the medium term. Fitch does not expect fiscal deficits to begin to decline materially until 2011, but governments nevertheless must set out stronger medium-term fiscal consolidation plans during the course of next year to underpin confidence in their creditworthiness and commitment to low inflation.
- Without cuts in public spending and tax increases, government debt will reach 100% of GDP in the US and UK by 2012 and 2013 respectively, while government debt ratios in France and Germany will exceed 90% of GDP by the middle of the next decade when the fiscal costs of aging populations begin to be felt. While the capacity to fund large deficits and debt remains extremely strong and the interest burden remains modest by historical standards, public finances would be much more vulnerable to adverse 'shocks' and less able to pursue counter-cyclical fiscal policy, a key characteristic of 'AAA' sovereigns.
- The expansion of sovereign balance sheets in the largest 'AAA' sovereigns to support their economies has helped moderate the severity of the recession and hence the destruction of the tax base. But another feature of 'AAA' sovereigns is that fiscal policy over the medium term is consistent with sustainable public finances and Fitch expects that governments will articulate over the course of next year stronger fiscal consolidation programmes.

## Emerging Markets - Buffeted But Not Broken

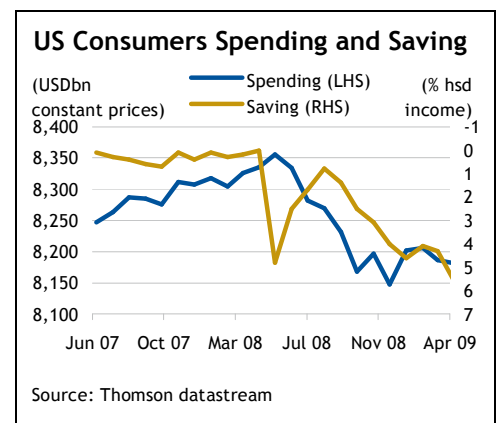
- In contrast to so-called 'advanced' economy sovereigns, a rising public debt burden has not so far been the principal risk to the creditworthiness and ratings of most 'emerging market' sovereigns. Rather the sharp decline in private capital flows and especially cross-border bank flows continue to pressure balance of payments and financial stability, especially in central and eastern Europe. Moreover, the very weak economic environment, reduced availability and higher cost of financing is pressurising non-sovereign credit quality, with around one third of emerging market corporate and banks with international ratings from Fitch (some 700 worldwide) currently on Negative Outlook/Watch and only 2% on Positive Outlook.
- Emerging market sovereign credit quality in broad terms has proved resilient in the face of the most severe global financial crisis and economic recession in decades. The benefits of much stronger sovereign balance sheets and policy frameworks built over the last several years have come to the fore during the current crisis. That said, several emerging market sovereigns have had their ratings downgraded and further downgrades are likely. But the risk of a systemic 'emerging market' crisis has diminished, in part because of the impressive international policy response coordinated by the G20.

The trough of the recession has been reached and the global economy will begin to slowly recover in the third quarter of this year.

### Global Economic Update

The world economy appears to be close to the trough of the deepest recession since WW2. The last three months have seen the emergence of significant signs of stabilisation, most notably in the banking sector and in a widespread recovery in financial markets, but also in business and consumer sentiment. This reflects growing recognition that massive and co-ordinated macro-economic and financial sector policy responses should gain traction in mitigating the severity of the de-leveraging process and drive a return to positive growth rates in the second half of 2009.

While Fitch’s latest forecasts for world growth in 2009 as a whole have been revised down slightly since the March “*Global Economic Outlook*” (GEO), this primarily reflects weaker than expected GDP in 09Q1. More significantly, the downside risks surrounding Fitch’s (unchanged) forecast of positive growth in 2010 have diminished in the last three months. One of the most significant ‘green shoots’ has been the increasing ability of banks in recent weeks to access term funding without sovereign guarantees, a development which points to declining fears of counterparty risk among banks as reflected in the narrowing of spreads between three-month inter-bank lending rates and policy rates to below ‘pre-Lehman’ levels. This has been accompanied by a widespread rally in major credit and equity markets since February, an increase in corporate bond issuance, a narrowing of emerging market sovereign bond spreads and a decline in risk aversion indicators (such as the VIX index). Business sentiment surveys have also picked up since the start of the year, although optimism balances remain below levels reported in the first half of 2008. Consumer confidence has also recovered with the notable exception of Germany.



However, while leading indicators have improved, ‘green shoots’ have not yet been matched in terms of hard economic data. With the exception of Japan – where the output collapse at the turn of the year was precipitous – industrial production continued declining through April and May in most major economies. World trade volumes have only stabilised following the collapse at the end of 2008.

Perhaps most significantly, there are as yet no clear signs of a pick-up in US consumer spending as the boost to income from tax cuts has been offset by a rising saving ratio. Nevertheless a return to growth is expected to take place later this year. In the very near term the improvement in sentiment should help to stem the sharp declines in inventory levels that were seen in late 2008 and early 2009. A stabilisation in inventory levels (or an easing in the rate of de-stocking) would have a temporary but strong positive impact on growth. A more sustained impact is likely to come from macro policy easing. Fiscal stimulus measures worth around 1.5% of GDP are being implemented in the advanced economies in 2009, compounded by ‘automatic stabilisers’ of around 2.5% of GDP. Sharp interest rate reductions from late 2008 are helping to ease household debt service burdens, particularly in

The strong external balance sheet of major emerging market economies has allowed counter-cyclical policies.

countries (such as the UK and Spain) where a sizeable share of mortgages pay interest at floating rates. The impact of unconventional monetary easing measures is harder to track but they are likely helping contribute to financial market recovery.

Policy easing has not been the sole purview of advanced economies. The external strengths of major emerging economies, such as Brazil, Russia, China, India and Saudi Arabia, have allowed greater domestic policy flexibility than in previous global downturns. This has been used, most notably in China, where a massive fiscal stimulus programme announced in November 2008 is proving effective in supporting the economy through the boosting of infrastructure investment. Growth is expected to be

6.5% in 2009 – upwardly revised from 5.6% in the March GEO – despite exports running a quarter lower than in 2008. While China still runs a current account surplus, its continued growth dynamism is supportive for the world economy.

The upturn is, however, expected to be anaemic by historical standards. Unemployment is expected to continue rising well into throughout 2010 in both the US and the euro area which will weigh on consumer spending even where household debt levels are low. While stabilised, the global banking system is still under significant stress. Official support has been aimed partly at ensuring that banks can lend into recovery once private credit demand picks up but doubts remain about their ability and willingness to do this. Disintermediation through capital market borrowing may be an option for larger companies but is less viable for small and medium sized enterprises, while the cost of capital is likely to remain high. The Euro area may be more exposed to lender de-leveraging given the predominant role of banks in corporate funding, while its direct economic exposure to economies suffering deep recessions in emerging Europe is high. Meanwhile housing and construction related activity remains depressed across the board. Growth in the advanced countries will be just 0.6% in 2010 and while it will pick up further in 2011 it is projected to remain somewhat below trend. This adds up to strong disinflationary forces remaining for the foreseeable future as excess capacity reduces firms' pricing power and rising labour market slack bears down on wages. Outsize responses from global central banks have reduced the risk of deflation but core inflation is likely to continue falling to very low rates. It seems unlikely in this context that monetary tightening will take place before late 2010.

### Fiscal Policy in 'AAA' Sovereigns – Beyond the Crisis

The global financial crisis and recession and the associated macroeconomic and financial sector policy responses are taking a heavy toll on the health of the public finances of highly-rated sovereigns. The average government debt to GDP ratio for 'AAA'-rated countries is projected to rise to 63% by end 2010, up from 44% at end-2007. Moreover four 'AAA'-rated sovereigns – the US, UK, France and Germany – are expected to see debt rise above 80% of GDP by 2010 which has been the upper end of the range typically associated with sovereigns rated 'AAA' by Fitch since the mid 1990s.<sup>1</sup> For the UK and US this reflects a particularly rapid pace of increase in

Large 'AAA' sovereigns are unique - no other borrowers enjoy the degree of funding flexibility that they have.

### Main Projections

(Annual average)	2008	2009f	2010f	2011f
<b>Growth (%)</b>				
USA	1.1	-3.1	1.3	1.7
Euro Area	0.6	-4.6	-0.3	1.9
Japan	-0.7	-6.9	0.9	1.5
Emerging Asia	6.2	2.6	5.9	6.6
Emerging Europe	3.8	-4.6	1.5	3.2
Middle East and Africa	4.7	1.1	3.6	4.1
Latin America	3.8	-2.5	1.9	2.8
World	1.7	-3.3	1.4	2.5
<b>Memo</b>				
BRICs	7.4	3.3	6.2	7.0
All emerging markets	5.0	-0.1	3.9	4.8
<b>Interest rates (%)</b>				
US Federal Funds	2.08	0.25	0.25	0.75
ECB Refinancing	3.89	1.12	0.50	1.50
Bank of Japan Rate	0.46	0.10	0.10	0.14
Bank of England Repo	4.67	0.65	0.50	2.00
Oil (Brent USD/pb)	97	55	65	70

Note: Regional growth aggregates weighted at market exchange rates  
Source: Fitch

<sup>1</sup> See "Sovereign Implications of the Financial Crisis" October 2008

indebtedness as they are at the epicentre of the crisis, whereas for France and Germany it reflects a high starting point for debt at end-2007. Debt is also expected to rise to high levels in Austria and Spain but to remain below 80% in 2010. Ireland's gross government debt ratio is rising at the fastest pace among high-grade sovereigns and is set to exceed 100% of GDP by end 2010 from 25% in 2007. Ireland was downgraded from 'AAA' to 'AA+' in April and remains on Negative Outlook.

### Policy Flexibility is Being Used to Good Effect

That the four largest 'AAA'-rated sovereigns are those where debt is projected to rise above 80% of GDP within the next two years is significant. As discussed in recent Fitch research, large 'AAA' sovereigns with deep and liquid government bond markets and reserve currency status benefit from an exceptionally high degree of near term funding flexibility.<sup>2</sup> For large 'AAA' sovereigns in particular, market depth substantially reduces the risk that the near term rise in borrowing will destabilise bond and currency markets and allows them to rapidly expand their balance sheets to respond to the crisis and recession. Policy flexibility is a key 'AAA' characteristic and these large 'AAA' sovereigns have greater headroom than those with weaker near-term funding flexibility to take measures – including running large budget deficits, offering balance sheet support to banks and expanding the money supply – in order to protect the economy and the tax base.

Large 'AAA' sovereigns are unique - no other borrowers enjoy the degree of funding flexibility that they have.

While it is early days, there are some clear signs that policy responses are helping. Specifically, fiscal deficits are offsetting the impact of higher private savings and lower investment on aggregate demand as governments absorb some of the decline in incomes through lower taxes and increased public expenditure. The orientation of fiscal policy to macroeconomic stabilisation in large 'AAA' sovereigns has been an appropriate response to the crisis from a credit perspective. One of the key lessons from the Great Depression was that macroeconomic and financial sector policies were not sufficiently supportive of the economy.<sup>3</sup> Uncertainties over the transmission mechanism of monetary policy amidst financial system stress further underlines the importance of fiscal policy as a tool in macroeconomic stabilisation.

Unsustainable public finances undermine confidence in policy-makers commitment to low inflation.

However with deflationary risks appearing to diminish and some signs of economic stabilisation emerging, the point is approaching where large 'AAA' sovereigns will need to re-orientate fiscal policy towards ensuring the sustainability of public finances over the medium term. Absent fiscal consolidation, public debt ratios would continue to rise sharply over the medium term, reducing creditworthiness and potentially undermining monetary policy frameworks if the private sector begins to fear that governments – whose liabilities at the 'AAA' level are typically dominated by long-term fixed rate securities – might seek higher inflation to ease their debt burden. Moreover, ongoing increases in government debt towards the middle of the next decade would set a difficult backdrop for dealing with the costs of ageing populations which are set to become significant by 2015.

### Post-Crisis Consolidation - How Much and How Soon?

The scale of fiscal adjustment that will be required to stabilize and reduce debt is highly uncertain and will depend on the future path of growth and interest rates and the extent to which economic recovery delivers 'automatic' improvements in fiscal balances. In addition the success which governments have in recovering outlays associated with financial sector support measures will influence debt dynamics (as would other asset sales), although this has to be set against the risk that further fiscal outlays may be needed before the crisis is over.

However it is very clear that there are unlikely to be major signs of improvement until 2011. The Fiscal Forecasts and Medium-Term Adjustment Scenarios table (page 6) sets out Fitch's latest fiscal forecasts to 2011. These are based on the

<sup>2</sup> See "High Grade Sovereigns and the Global Financial Crisis" March 2009

<sup>3</sup> See "The Financial Crisis, Policy Response and Sovereign Credit Risk" June 2009

The interest service burden remains relatively low by historical standards, limiting the near-term impact on creditworthiness, but policy actions are still required to tackle rising government debt over the medium-term.

agency's latest economic forecasts and incorporate recent official budget announcements from France and Germany. They also incorporate further outlays for financial support in Germany and France where support packages announced have not to date been fully utilised or funded. Little significant improvement in debt dynamics is expected until 2011. This reflects the lagged impact of this year's steep recession on fiscal balances in 2010, Fitch's view that growth will remain well below trend next year and the fact that discretionary fiscal easing measures stretch into 2010 in the US, France and Germany.

Deficits are expected to decline in 2011 as growth recovers and discretionary easing measures expire but are expected to remain large, particularly in the US and UK. The forecast narrowing of deficits in 2011 is far from sufficient to achieve debt stabilisation. On the basis of the medium-term economic assumptions described below, debt would rise to around 110% of GDP in the US and the UK by 2015, to around 95% in France and over 90% in Germany if there was no further decline in the primary deficit after 2011.

In order to illustrate the scale of the medium term adjustment challenges faced by the major 'AAA' sovereigns, Fitch has constructed a set of medium-term adjustment scenarios for 2012-2015 based on stylised economic projections. These assume higher GDP growth in the UK and the US from 2012 than in France and Germany reflecting higher potential growth rates and greater economic flexibility which should more easily facilitate above trend growth rates as output converges towards its potential level. The scenarios assume that half of the gross up-front outlays for financial sector support committed in the crisis to date are recovered over the period. For the UK it is also assumed that the government has to absorb losses of around 20-25% on assets covered by the Asset Protection Scheme (APS).

A key question in the analysis of the 'required' fiscal adjustment is the precise definition of debt 'stabilisation and reduction'. A weak definition would be simply based on stabilising the debt ratio around its 2011 peak. Even on this basis governments would need to enact very substantial fiscal adjustments. Debt stabilisation would require primary surpluses of 0.2% in the US and UK, 0.4% in France and 1% in Germany from 2012, implying fiscal tightening beyond 2011 of 4.3%, 5.7%, 2.3% and 1.9% in the US, UK, France and Germany respectively.

The fiscal tightening post-2011 required to place debt to GDP on a firm downward path is equivalent to 7.6 percentage points of GDP for the US, 9.1pps for the UK and 5.3pps and 4.4pps for France and Germany.

However this would still leave debt at very elevated levels relative to historical 'AAA' parameters implying a high vulnerability to further shocks. Fitch judges a more appropriate definition is the adjustment necessary to set the debt ratio on a firmly declining path at a rate of around 2pps to 3pps per year after 2011. This would bring debt ratios to within recent 'AAA' ranges by 2015. As the table shows, the required fiscal adjustment on this basis would entail primary fiscal surpluses rising to 3.5% by the end of the period, a significant post-2011 tightening.

A recovery in economic growth should help deliver these further required adjustments to some extent. To help illustrate this, the second table attempts to identify how much of the fiscal deterioration between 2007 and 2009 can be explained by the 'automatic stabiliser' effects of the recession, fiscal stimulus measures and other factors. There are very large uncertainties surrounding these numbers which are based on the average historical correlation between the public finances and the economic cycle. In addition it is far from clear how much of the residual 'other' category reflects a permanent deterioration in the structural deficit (for example due to the reliance of revenues on unsustainable asset price levels in the boom), cyclical factors not captured in the historical correlations or one-off shocks to the deficit associated with the crisis. The latter could be particularly important in the US where a greater share of financial sector support measures are recorded 'above the line' in the fiscal deficit.

Nevertheless, it is clear that a substantial portion of the deterioration in fiscal deficits between 2007 and 2009 can be accounted for by 'automatic stabilisers'.

The reversal of these cyclical effects as economies recover will last beyond 2011. However, the majority of the adjustment will need to come from discretionary policy tightening. To the extent that fiscal stimulus measures announced to combat the recession are temporary, their expiration could play an important part in this discretionary tightening. However many of the announced stimulus measures have focussed on infrastructure spending which may be hard to reign back. The UK seems to be something of an exception here as a relatively high proportion of the measures are time-limited or self reversing (e.g. the temporary VAT cut).

### Fiscal Forecasts and Medium-Term Adjustment Scenarios

(% GDP) or (%)		Forecasts				Illustrative adjustment scenarios			
		2008	2009	2010	2011	2012	2013	2014	2015
<b>Debt</b>	US	65.1	83.0	92.2	97.8	98.2	95.0	90.5	87.1
	UK	52.0	68.6	81.2	90.2	91.6	88.7	84.3	80.9
	Germany	66.0	77.3	83.4	85.4	85.8	84.1	80.9	78.5
	France	68.1	77.9	83.6	85.9	87.0	85.5	82.2	79.2
<b>Deficit</b>	US	5.9	13.2	11.0	7.9	6.3	2.9	1.2	1.0
	UK	5.5	12.7	12.3	9.3	6.3	2.4	0.7	0.5
	Germany	0.1	5.3	6.6	4.3	3.3	1.3	-0.2	-0.3
	France	3.4	7.5	7.4	5.3	4.4	2.1	0.2	0.1
<b>Primary</b>	US	3.0	10.5	7.8	4.1	1.5	-2.0	-3.5	-3.5
<b>Deficit<sup>a</sup></b>	UK	3.2	10.0	9.0	5.6	2.0	-2.0	-3.5	-3.5
	Germany	-2.6	2.3	3.7	0.9	0.0	-2.0	-3.5	-3.5
	France	0.6	4.4	4.0	1.8	0.7	-1.7	-3.5	-3.5
<b>GDP</b>	US	1.1	-3.1	1.3	1.7	3.0	3.0	3.0	3.0
<b>Growth (%)</b>	UK	0.7	-3.7	0.3	2.1	2.8	2.8	2.8	2.8
	Germany	1.0	-6.3	-0.3	2.0	1.6	1.6	1.6	1.6
	France	0.4	-2.9	0.3	2.2	1.8	1.8	1.8	1.8
<b>Inflation (%)</b>	US	2.2	-0.2	0.4	0.8	2.0	2.0	2.0	2.0
	UK	2.3	2.0	0.8	2.0	2.0	2.0	2.0	2.0
	Germany	1.5	1.5	0.9	0.8	1.0	1.0	1.0	1.0
	France	2.4	1.6	1.5	1.2	2.0	2.0	2.0	2.0
<b>Interest</b>	US	5.2	4.0	4.0	4.3	5.2	5.2	5.2	5.2
<b>Rates (%)<sup>b</sup></b>	UK	5.4	5.0	4.8	4.8	5.0	5.0	5.0	5.0
	Germany	4.3	4.3	3.7	4.0	4.0	4.0	4.0	4.0
	France	4.5	4.5	4.4	4.2	4.5	4.5	4.5	4.5

<sup>a</sup> Deficit excluding interest payments

<sup>b</sup> Effective interest rate on government debt

Source: Fitch

A key uncertainty relevant for sovereign rating analysis as well fiscal policies is the extent that fiscal deficits reflect 'structural' rather than temporary cyclical weakness.

While the figuring is highly uncertain, this analysis suggest that roughly two thirds of the 'required' further fiscal improvements beyond 2012 in the US and UK would need to come from discretionary tightening measures over and above the reversal of recent stimulus measures and 'automatic' cyclical improvements in the public finances. For France and Germany these ratios are around half and a fifth respectively. This translates into a need for 'underlying' discretionary fiscal policy tightening of around 5% to 6% of GDP in the UK and the US, around 3% of GDP in France and 1% in Germany.

### Decomposition of Change in Fiscal Deficit 2007-2009

(% GDP)	Automatic stabilisers <sup>a</sup>	Discretionary easing	Other	Total change	Memo temporary discretionary measures (2009)
US	-2.2	-2.0	-6.1	-10.3	n.a.
UK	-3.2	-1.5	-5.3	-10.0	-0.9
Germany	-4.3	-1.6	0.8	-5.1	-0.2
France	-3.1	-0.7	-1.0	-4.8	-0.2

<sup>a</sup> Calculated as change in output gap since 2007 times elasticity of budget deficit with respect to the output gap  
Source: IMF, CBO, EC, Bruegel, Fitch

The much larger fiscal effort required in the US and UK reflects their greater exposure to the crisis and the bigger debt shock to be unwound, reflected in a larger rise in the debt interest burden between 2007 and 2011 relative to France and Germany. However it is important to set this in a relative historical context. In the relatively recent past, both the US and the UK have both experienced episodes where primary surpluses have exceeded 4% of GDP and the debt to GDP ratio has fallen sharply on a sustained basis. This contrasts with France and Germany where adverse fiscal shocks have had more lasting effects on debt ratios.

With regard to timing there is no doubt that medium-term fiscal sustainability has moved upwards on the agenda of policy makers of the major economies in recent months as signs of economic stabilisation have emerged. However at this stage most still seem firmly committed to staying the course with fiscal stimulus policies in the presence of still significant economic risks and fears of snuffing out a nascent recovery. Moreover while medium term fiscal projections have been set out that incorporate declining deficits after 2010, they typically do not project policy adjustments on the scale suggested by the foregoing analysis.

### Credit and Rating Implications

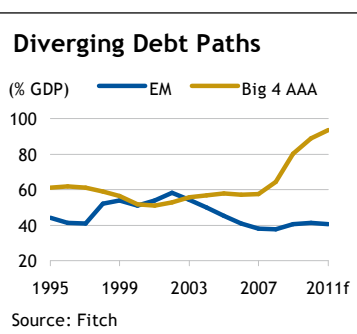
As noted earlier, aggressive fiscal easing is an appropriate macroeconomic policy response to the financial crisis and even from a narrow sovereign credit perspective it is also positive over the medium-term if it helps prevent excessive destruction of economic capacity and hence the tax base. However, given the sheer scale of the fiscal deterioration currently underway it will be important from a credit perspective to see a re-orientation of fiscal policy intentions in the course of 2010 even if the economic news remains patchy. Further significant stimulus measures in the presence of a stagnant economy would exacerbate fears about public debt dynamics which could, in turn, limit the effectiveness of such measures and undermine confidence in long-run fiscal solvency and commitment to low inflation.

The operational 'rule of thumb' currently used for Fitch sovereign rating Outlooks is that there must be a 'better than even chance' that credit fundamentals will materially change over the next 12-24 months to warrant a change in the rating

While sovereign credit quality has been eroded by the financial crisis and severity of the global recession, it remains within 'AAA' tolerances. Moreover, the unmatched funding flexibility enjoyed by the largest 'AAA's means that they can sustain a higher level of public debt consistent with retaining their 'AAA' status than the 'typical' 'AAA' sovereign (as was the case of Japan that did not get downgraded until government debt was approaching 130% of GDP and rising). Nonetheless, a key credit support for retaining 'AAA' status is confidence that, over the medium-term, government debt levels will be brought down from the elevated levels forecast. Fitch is sufficiently confident that such an adjustment will take place to support the current Stable Outlooks on all its 'AAA' ratings. But as the foregoing analysis has highlighted, the scale of the fiscal adjustment required is growing ever more challenging and as a minimum governments will need to start articulating plans to bring budget deficits down during the course of next year.

### Emerging Market Overview

In the aftermath of the collapse of Lehman's Brothers and the intensification of the global financial crisis, the immediate focus of attention was on those emerging market economies most reliant on cross-border bank flows to finance large current account deficits and foreign currency borrowing by the private sector. This remains a key risk factor in the credit profile of several emerging market economies, especially in Emerging Europe as the on-going travails of Latvia ('BB+' / Negative Outlook) highlight. However, for Latin America and Asia, the risks to economic and credit fundamentals arose from the unprecedented severity and breadth of the decline in economic activity and world trade and the associated fall in commodity prices. While in Emerging Europe the financial sector has been under the greatest pressure, in Latin America and Asia where banks are generally less reliant on foreign funding and better capitalised, it is the corporate sector that has suffered most directly from the collapse in export demand and domestic activity.



**Emerging Markets**

Key indicators

(USDbn)	2008	2009f
Real GDP growth (%)	5.0	-0.1
Inflation (%)	7.9	4.1
Gov bal (% of GDP)	-0.2	-4.5
Gov debt (% of GDP)	34.7	38.2
Current acc balance	568	315
% of GDP	3.1	1.8
Debt services	737	715
% of CXR <sup>a</sup>	9.5	11.4
Net external debt	-2,950	-3,269
% of CXR <sup>a</sup>	-38.0	-52.1
Net public ext debt	-3,890	-3,981
% of CXR <sup>a</sup>	-50.1	-63.4
Reserves incl gold	4,752	4,952

<sup>a</sup> Current external receipts  
Source: Fitch

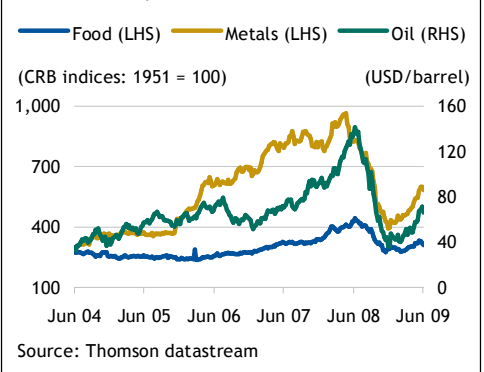
**Growth Outlook**

The sudden drop in world trade reflected not only the decline in final demand but also disruptions to the provision of finance for working capital, including trade finance, prompting several sovereigns, such as Brazil ('BBB-'/Stable Outlook), to directly provide trade financing and guarantees. The stabilisation of the global financial sector does appear to have eased the pressures on the availability and cost of trade finance. However, elevated risk aversion and 'home bias' has reduced cross-border financial flows. According to the latest World Bank projections, net private debt and equity flows to emerging and developing economies in 2009 will be equivalent to around 2% of GDP compared to almost 9% in the peak year of 2007, while the IMF forecasts that net private capital flows will be negative this year and flat in 2010 (note that IMF and World Bank estimates are not directly comparable). And for the first time in several years, many emerging markets are also contending with a significant deterioration in their terms of trade after several years of improvement. Despite the recent rally, commodities prices remain substantially below the highs reached in the middle of last year and metals are at 2005 levels.

The combination of the dramatic decline in private capital flows, worsening terms of trade and recession in the major advanced economies (MAEs) are powerful headwinds for emerging market economies. For the first time ever, Fitch's 'bottom-up' forecasts for all 74 emerging and developing economies with Fitch rated sovereigns suggests zero growth in aggregate, underscoring the severity and global nature of the economic downturn, and just 4% growth in 2010 compared to an average annual rate of almost 7% over the five years to 2007. A 'top-down' estimate from a simple model of EME growth based on net private capital flows (as a percent of GDP), change in terms of trade and growth in the MAEs, also implies zero growth in 2009 and a similarly subdued rebound in 2010.

Emerging Europe and Latin America are forecast to contract by 4.6% and 2.5% respectively this year, while Middle East and Africa and Emerging Asia remain in positive territory. Given the weakness of the recovery forecast for the MAEs and limited inflows of private capital, emerging market economies are expected to grow at a rate below potential in 2010 and into 2011, implying continuing upward pressure on unemployment and stagnant household incomes, potentially pressuring social and political stability.

**Commodity Prices**

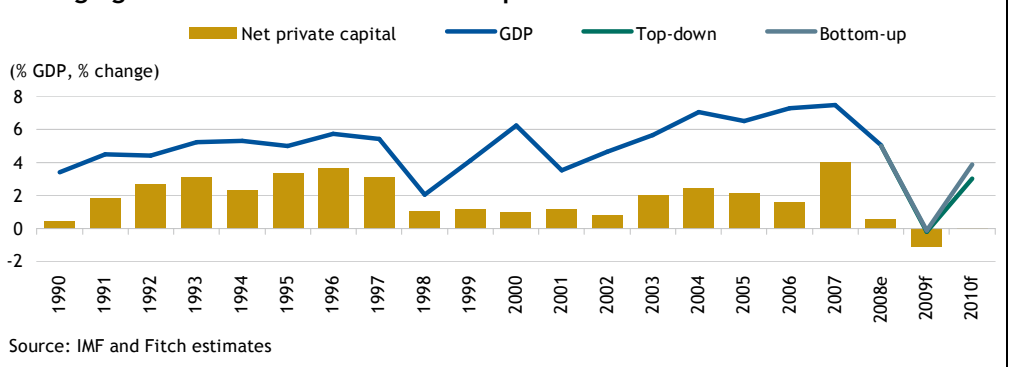


**Forthcoming Elections**

Country	Type	Scheduled date
Bulgaria	Parliament	5 Jul 09
Mexico	Legislature	5 Jul 09
Indonesia	President, 1st round	8 Jul 09
Indonesia	President, 2nd round	8 Sep 09
Uruguay	President & parliament	28 Oct 09
Chile	President & legislative	11 Dec 09
Romania	President	12 Dec 09
Ukraine	President	Jan 2010
Colombia	Congress	Mar 2010
Hungary	Parliament	By Apr-10
Colombia	President	May 2010
Philippines	President & legislative	May 2010
Poland	President	Oct 2010
Brazil	President & parliament	3 Oct 2010
Venezuela	Congress	Dec 2010

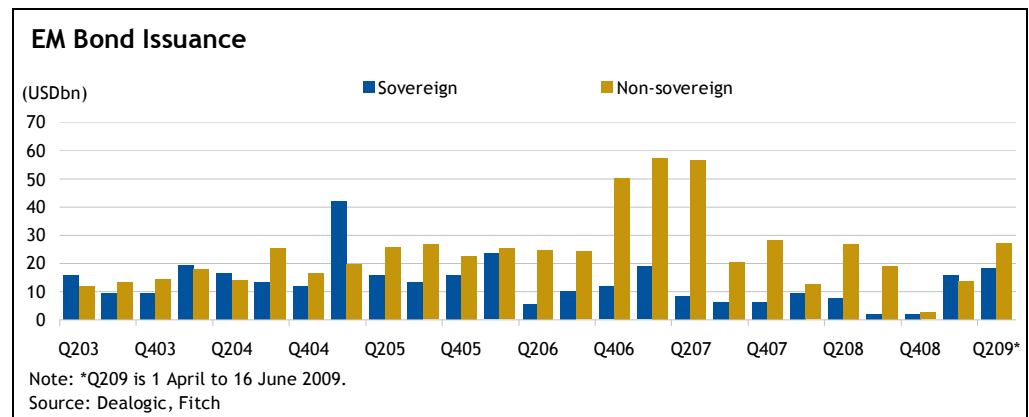
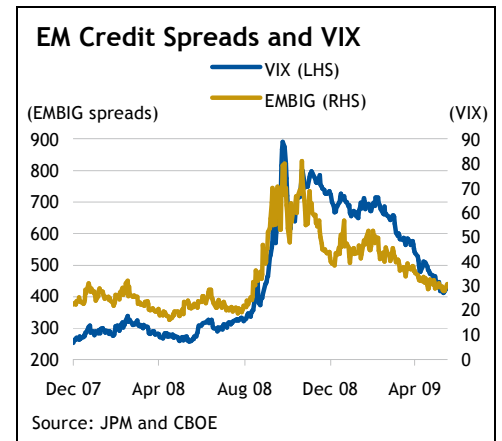
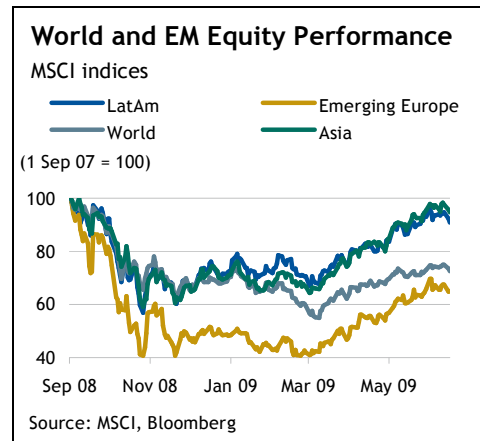
Source: National sources

**Emerging Market Growth and Private Capital Flows**



**Capital Flows and External Financing**

The recent rally in asset prices, including emerging market equities, currencies and credit, reflects a general improvement in risk appetite as the fear of a ‘great depression’ has receded and investors have become more optimistic about the prospects for global economic recovery. Nonetheless, while emerging market assets have generally ‘out-performed’ their ‘mature economy’ counterparts during the recent global rally, the recovery in Emerging European asset prices has been more muted in comparison with Latin America and Emerging Asia.

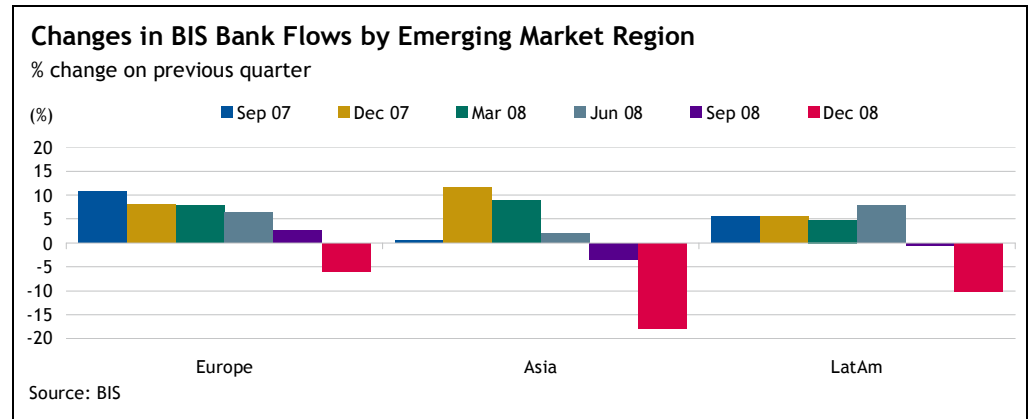


The worst fears of an indiscriminate and prolonged exclusion of EM borrowers from international capital markets have not been realised

In as much as the recent rally in asset prices reflects greater risk appetite, it has allowed a broader range of EM issuers to access international capital markets. In the fourth quarter of last year and early 2009, very few EM companies and banks were able to access the market (unless perceived as ‘quasi-sovereign’ due to state-ownership and ‘strategic’ importance). However in the latter part of the first quarter and through the second quarter, non-sovereign international bond issuance has recovered to ‘pre-Lehman’ levels, albeit still substantially lower than during the height of the credit boom in 2007. The level of non-sovereign bond issuance in the first half of this year is estimated to be around USD41bn, compared to total bond maturities in 2009 of around USD63bn.<sup>4</sup> Similarly, sovereign bond issuance in the first half of the year was USD35bn – already exceeding the forecast in the December 2008 edition of the Sovereign Review for the year as a whole. Greater than expected international bond issuance by sovereigns reflects the need to replenish foreign exchange reserves as well as increased budget borrowing requirements, but still remain very small in comparison with overall external financing needs.

<sup>4</sup> These estimates are based on final maturity for bonds in the Dealogic database

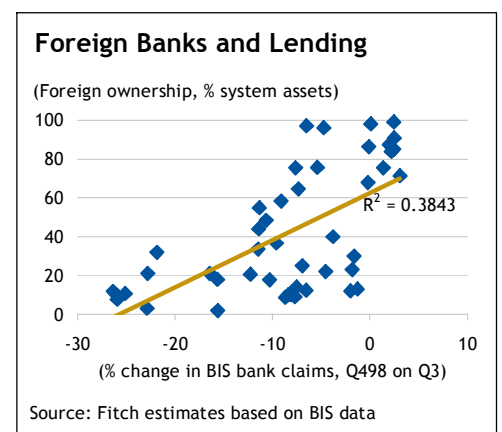
While recent issuers may not necessarily be those borrowers that have substantial refinancing needs, for emerging markets as whole, the international bond market is currently not a source of a refinancing and ‘credit squeeze’. As in ‘mature’ economies where corporate borrowers, especially those rated investment-grade, have been raising record funds from the bond markets, it is the availability and cost of bank financing that is the primary concern. In terms of external bank financing for emerging markets, the picture is more mixed (in part because of the paucity of reliable and up-to-date data).



Foreign banks invested in emerging markets have not yet significantly cut-back lending to their foreign subsidiaries.

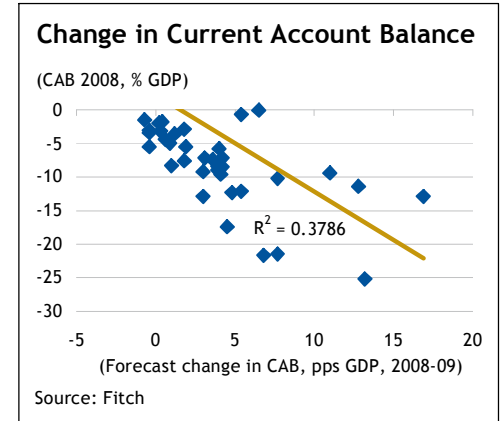
According to the latest BIS data, banks reduced their exposure to emerging markets by 10% (USD282bn) in the fourth quarter of 2008, though outstanding lending by international bank local offices remained broadly stable. Cross-border bank claims on the Asia-Pacific region declined the most with short-term US dollar denominated lending to Chinese and South Korean entities curtailed. Emerging Europe suffered the smallest decline despite being the region most reliant on cross-border bank financing and the BIS estimate that taking account of exchange rate movements and lending by local offices of foreign banks, international bank claims on the region may even have marginally increased in the fourth quarter. Within Emerging Europe, outflows were concentrated in Russia (more than half), Turkey and Poland. Though the latest BIS data is only for the fourth quarter, the pattern of international bank flows it reveals suggests that foreign bank parent to subsidiary flows are relatively more stable and that local offices are more likely to maintain lending to residents, especially if locally funded. While international banks arguably bare some responsibility for the excessive private credit growth in Emerging Europe that contributed to the emergence of serious macroeconomic imbalances, the region is also now benefiting from the continued commitment of the banks to their operations in the region. This was highlighted by the ‘Vienna Initiative’ earlier this year whereby regional banks committed to maintain funding to the region and the IFIs offered financial support, including USD25bn to support the recapitalisation and lending of CEE banks. Syndicated bank lending to emerging markets is however substantially down on previous levels, though there has been an increase in bilateral bank loans such as the USD15bn and USD10bn loans from China Development Bank to Russia’s Rosneft (‘BBB-’/Negative Outlook) and Transneft respectively in February.

The most important and stable source of external financing for emerging markets over the last decade has been foreign direct investment (FDI). But Fitch ‘bottom-up’ forecasts imply that after several years of strong growth, FDI will more than halve this year from an



Emerging markets with large current account deficits are being forced to reduce these deficits quickly.

estimated USD384bn in 2008. Projections of private capital flows are inevitably subject to a wide margin of error, but it is evident that net private capital flows to emerging markets will be substantially below the levels of recent years. Nonetheless, the surge in outflows of private capital as well as the ‘sudden stop’ of inflows during the final quarter of last year and which was partially funded by the run-down of official international reserve assets (as well as private sector foreign assets) has proved temporary. Many EM borrowers are still able to obtain international market and bank financing, albeit at much less favourable terms than previously. However, for economies with current account deficits, simply rolling over existing external debt is not enough - the economy must attract net additional capital inflows. Given the decline in net private capital flows, the larger the current account deficit, the greater the real economic adjustment required. Official sector flows and increased IFI support to the most severely affected countries are helping to moderate this adjustment.



### The Role of International Financial Institutions

The International Financial Institutions (IFIs) and especially the IMF were placed at the centre of the international policy response to the global crisis by the G20 at the Heads of State Summit in London on 2 April. The G20 commitments included a ‘tripling’ of the IMF’s lending capacity to USD750bn as well as injections of capital into multilateral development banks (MDBs), such as the Inter-American Development Bank (IADB), to increase their lending capacity. So far USD220bn of additional funding for the IMF has been secured.<sup>5</sup> It is intended to raise the remainder through the issue of notes by the IMF that can be purchased by member governments and central banks (Russia and Brazil have said they will purchase USD10bn each and China a further USD50bn); an expansion of the New Arrangements to Borrow (NAB) facility from USD50bn to USD250bn; and a general SDR (Special Drawing Right) allocation of USD250bn. The latter two initiatives are expected to be concluded before the next G20 Heads of State Summit in Pittsburgh, US, on 24-25 September 2009.

The strengthening the IMF’s financial position is necessary given the increase in the number and size of IMF programmes. The previous ‘access limit’ on the amount that can be borrowed under the IMF’s ‘Stand-By Arrangement’ (SBA), the primary facility for extending credit to member countries, has been doubled to 600% of a country’s ‘quota’ and a major new credit facility, the ‘Flexible Credit Line’ (FCL) created.<sup>6</sup> The latter provides those member countries with what the IMF describes as ‘very strong economic fundamentals’ with the option to draw on a renewable 6-12 month credit line without any policy strings attached. Some USD78 billion of financing under the FCL has already been approved for Colombia (‘BB+’/Stable Outlook), Mexico (‘BBB+’/Negative Outlook) and Poland (‘A-’/Stable Outlook).

Including the commitments under the FCL, since November 2008 the IMF has committed around USD150bn to 19 countries, most in Emerging Europe, of which around USD35bn has been disbursed. Based on the IMF’s current resources (including confirmed commitments), it has the capacity to extend a further

<sup>5</sup> Bilateral loans from Japan (USD100bn), Canada (USD10bn) and Switzerland (USD10bn) have been announced and agreed and the US Congress also recently approved USD100bn loan to the IMF.

<sup>6</sup> For more detail on ‘SBAs’, ‘quotas’ and ‘access limits’, see page 7 of the December 2008 edition of the Sovereign Review

USD200bn which is substantial, though could be quickly exhausted if several additional countries decided to avail themselves of the FCL.

Financing from MDBs is also increasing in the form of lending to the private sector as well as loans to governments. The International Bank for Reconstruction and Development (IBRD – part of the World Bank Group) plans to triple annual lending to some USD35bn in FY 2008-2009 (USD100bn over three years), though a capital increase has not yet been decided. For the major regional MDBs, large capital increases have been already agreed to allow a significant increase in lending without potentially jeopardizing their ‘AAA’ ratings.

**Responding to the Crisis - Additional Financial Support From MDBs  
2009-2011**

Institution	Lending	Equity investment	Trade finance		Political risk insurance	Total
			Guarantee	Liquidity facility		
AsDB	5.7		0.9			6.6
AfDB				1.0		1.0
EBRD	1.4		1.0			2.4
IADB	6.0		1.0	6.0		13.0
World Bank Group	60.0	1.0	2.0	1.0	1.0	65.0
IBRD	60.0					60.0
IFC		1.0	2.0	1.0		4.0
MIGA					1.0	1.0
<b>Total MDBs</b>	<b>73.1</b>	<b>1.0</b>	<b>4.9</b>	<b>8.0</b>	<b>1.0</b>	<b>88.0</b>

Source: Global development finance report, 2009

Emerging Europe is currently the largest recipient of official sector financing, including balance of payments support under the European Union’s Medium-Term Financial Assistance programme. A total of USD14.6bn has been committed by the EU in support of Hungary (EUR6.5bn), Romania (EUR5bn) and Latvia (EURD3.1bn), of which EUR5bn has already been disbursed. The region will also benefit from increased commitments from the European Investment Bank (EIB), which has increased lending in this region by 31% in the first five months of 2009 and has approved an envelope of EUR5.7bn for SME lending over 2009-2010 and from the European Bank for Reconstruction and Development (EBRD), which expects to increase lending by some EUR2bn in 2009 compared to 2008.

Finally, the currency swap agreements between the US Federal Reserve and ECB with several emerging market central banks are also major sources of foreign currency liquidity for emerging markets. From an emerging market perspective, the most notable are the US Fed USD30bn swap lines with the central banks of Brazil, Korea and Mexico and the EUR10bn and EUR5bn foreign currency swap facilities provided by the ECB to Poland and Hungary respectively.

While the increase in official sector financing to emerging markets will not offset the decline in private capital flows, such flows do moderate the severity of adjustment in the real economy and reduce the risk of ‘liquidity’ crisis and the risk of contagion and systemic crisis arising from country-specific difficulties.

The response of the international financial community - including the US Federal Reserve, ECB and EU as well as the IMF and other IFIs - has materially reduced the risk of a systemic crisis

**Potential Candidates for FLC**

(USDbn)	Quota	FLC <sup>a</sup>
Brazil	4.7	46.7
Chile	1.3	13.2
Czech Rep.	1.3	12.6
Indonesia	3.2	32.0
Israel	1.4	14.3
Korea	4.5	45.0
S Africa	2.9	28.7
Philippines	1.4	13.5
Malaysia	2.3	22.9
Thailand	1.7	16.6
Peru	1.0	9.8

<sup>a</sup> Assumed that FLC would be equal to 10 times quota  
Source: IMF and Fitch

**Eligibility for the IMF's Flexible Credit Line**

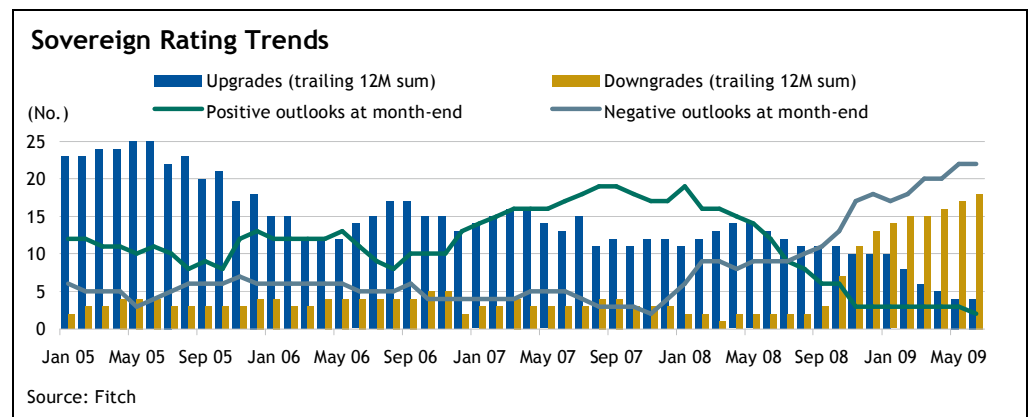
The IMF has published the following criteria for eligibility to the FCL:

1. a sustainable external position;
2. a capital account position dominated by private flows;
3. a track record of steady sovereign access to international capital markets at favorable terms;
4. a reserve position that is relatively comfortable when the FCL is requested on a precautionary basis;
5. sound public finances, including a sustainable public debt position;
6. low and stable inflation, in the context of a sound monetary and exchange rate policy framework;
7. the absence of bank solvency problems that pose an immediate threat of a systemic banking crisis;
8. effective financial sector supervision; and
9. data transparency and integrity.

However, the IMF state that qualification for the FCL does not require that a country meet all these criteria if 'corrective policy measures' are in place and it is judged that the country has 'very strong economic fundamentals and institutional policy frameworks', as well as a 'sustained track record' of implementing 'strong policies' and remains 'committed' to maintaining such policies. The IMF has not published a list of members that 'qualify' for the FCL, but the countries in the table in the left-hand margin could be potential candidates (although others may also be eligible and none of the countries listed have indicated that they are seeking to access the FCL). Though the amount that can be committed by the IMF under the FCL is not capped, the FLCs for Mexico, Poland and Colombia were equivalent to 10x their IMF quota.

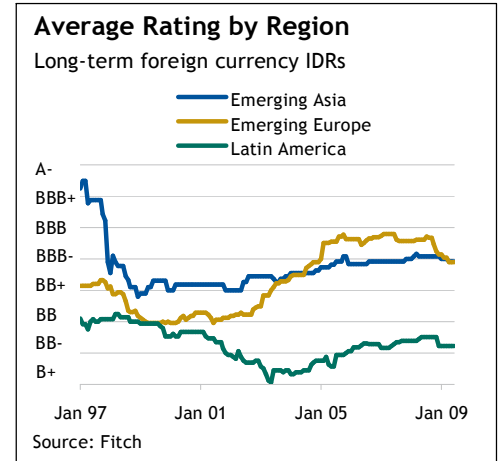
**Credit and Rating Outlook**

The intensification and broadening of the financial crisis and the dramatic worsening in the outlook for the global economy in September 2008 had an almost immediate impact on the credit profile of emerging markets, which until then had been relatively sheltered from turmoil that characterised the financial markets of the so-called 'advanced' economies over the previous 12 months. This was reflected in an increase in the number of sovereign rating downgrades and Negative Outlooks since September.



Since the bankruptcy of Lehman Bros., Fitch has downgraded the (Foreign- and/or Local-Currency) Issuer Default Ratings (IDRs) of 19 sovereigns, 11 of which have been in Europe (including Ireland and Iceland). Only the Emerging European sovereigns of Lithuania, Estonia, Latvia, Romania and Ukraine (as well as Iceland)

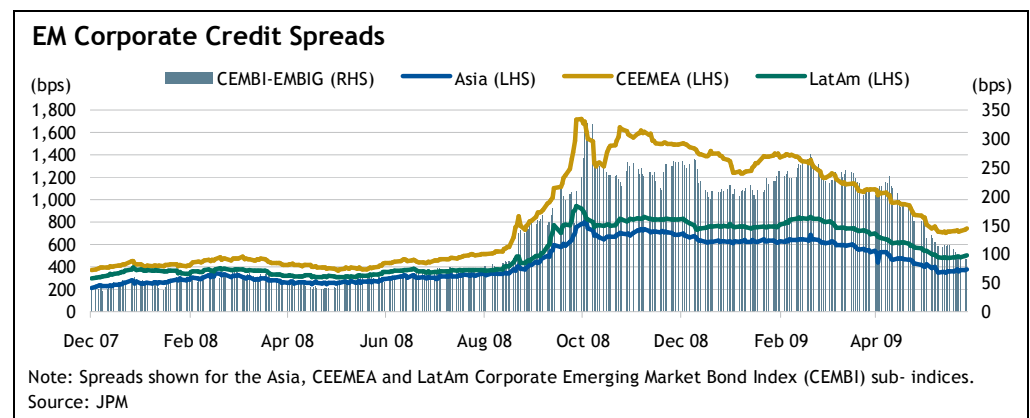
have been subject to multi-notch downgrades as the severe macroeconomic imbalances and financial vulnerabilities that were evident before September (and reflected in previous downgrades and/or Negative Outlooks, except for Ukraine) were exposed. The remaining eight sovereign downgrades have been broadly split between Latin America (Argentina, Ecuador, El Salvador, Jamaica and Venezuela) and Asia (Mongolia, Thailand, Vietnam and Malaysia).



The majority of the 22 ratings of Emerging Europe sovereigns (including Iceland) are currently on Negative Outlook or Watch, with none on Positive Outlook/Watch, suggesting that further downgrades in the region are likely. However, most of the Negative Outlooks are on sovereign ratings that have already been downgraded and despite the severity of the European recession, the rating Outlook for the three largest economies in the region after Russia – Turkey, Poland and Czech Republic – remains Stable. In terms of the other emerging regions, Asia has proportionally the most Negative Outlooks – Korea, Mongolia, Sri Lanka, Taiwan and India – with either their Foreign-Currency and/or Local-Currency sovereign ratings on Negative Outlook, while there are three Negative Outlooks currently outstanding in Latin America (Mexico, Jamaica and El Salvador) and only two in Middle East and Africa (South Africa and Ghana).

Emerging market sovereign credit quality has so far proved resilient in the face of the most severe global financial crisis and recession in decades.

Despite recent rating downgrades and the prospect of more given the number of Negative Outlooks/Watches, Ecuador has been the ‘only’ sovereign to default on its obligations so far during this crisis (see box, ‘Ecuador’s Debt Restructuring’) and the risk of other sovereign defaults remains relatively low with Ukraine and Argentina judged to be the most risky over the short to medium term. However, as in the ‘advanced’ economies, failures and defaults by banks and companies domiciled in emerging markets are on the rise. According to JP Morgan, the total number of EM corporate and bank defaults (excluding distressed debt exchanges) in the first five months of 2009 was fifteen for a combined amount of USD13.2bn or 6.1% of the EM corporate high yield debt stock, mostly Russia/CIS and Latin American issuers. Around one third of emerging market corporate and banks with international ratings from Fitch (some 700 worldwide) are currently on Negative Outlook/Watch. Given the very weak economic environment and the reduced availability and higher cost of financing, it is likely that the number of corporate defaults will continue to rise.



Distress in the corporate and banking sectors often impinges on sovereign creditworthiness. As in the ‘advanced’ economies, intervention in support of banks

and major companies can substantially increase the direct and contingent liabilities of the sovereign and erode creditworthiness over the medium-term if corrective fiscal policy action is not taken. But for the creditworthiness of emerging market sovereigns in particular, the greater near-term risk is posed by the potential for balance of payments and currency crises triggered by 'sudden stops' of inflows of foreign capital and balance of payments and currency crises that devastate the local economy. Emerging market sovereigns are less able than their advanced country counterparts to dramatically expand their balance sheet without threatening financial stability and confidence in the government's solvency. Consequently, EM policymakers must more quickly confront the trade-off between supporting distressed sectors of the economy and maintaining macroeconomic stability and confidence in sovereign creditworthiness. This was most recently illustrated by the decision of the Kazak authorities to allow a restructuring of two of its four largest banks foreign debts, despite their earlier nationalisation. From a sovereign credit perspective, the clear delineation of the banks and sovereign's liabilities while maintaining domestic financial stability was a positive development and the RatingWatch Negative on Kazakhstan's sovereign ratings were lifted, though its 'BBB-' ratings remain on Negative Outlook.

### **Ecuador's Debt Restructuring**

On 15 November 2008, Ecuador's government failed to pay USD30m coupon payment on USD510m of outstanding Global bonds maturing in 2012 ('Global 2012') and subsequently announced that it would also not make payments on the USD2.7bn outstanding on the Global 2030. Fitch downgraded Ecuador to 'RD' ('Restricted Default') on 15 December 2008 on the expiration of the grace period on the Global 2012.

The unilateral decision of the government of President Rafael Correa to suspend payments on its global bonds was justified on the basis that the Global 2012 and 2030s were 'illegitimate and illegal', though such a judgement appeared to be politically rather than legally motivated. The Global 2015 (USD650m) was not identified by the authorities as 'illegitimate' (it had been issued when President Correa was the then finance minister) and continues to be serviced (though the December coupon was delayed). In a 'tender offer' for the Global 2012s and 2030s, 91% of the combined outstanding stock of USD3.2bn was bought back by the government at a price of 35 cents in the dollar. The government did not recognise past due interest and had threatened to block any collective action by bondholders through the transfer of the repurchased bonds to a third party.

In Fitch's view, Ecuador's repurchase of a portion of its outstanding debt at a deep discount highlights the sovereign's long-standing fundamental credit weaknesses, notably a very low level of 'debt tolerance' in terms of its 'willingness' as well as capacity to service public debt (Ecuador has never been rated above 'B-' since Fitch first rated it in 2002). There are concerns that the unwillingness of Ecuador, like Argentina in 2005, to enter 'good faith' negotiations with creditors and the unilateral imposition of restructuring terms (despite which some multilateral financial institutions continue to extend new loans to the government) is setting a precedent that other sovereigns could follow and will reduce the flow of private capital to 'emerging market' sovereigns. Fitch's own assessment is that the impact on lending to emerging market sovereigns more generally will be marginal given Ecuador's history of debt default and restructuring. Moreover, like Argentina, the failure to act in 'good faith' does have repercussions in terms of access to international capital markets and that the benefits of negotiation with creditors, even when in severe distress, will for most sovereigns outweigh the benefits of unilateral restructuring. Nonetheless, the Ecuador episode does highlight that sovereign actions are not necessarily driven by an assessment of the long-run economic costs and benefits of particular policy actions.

Europe is the most vulnerable of the emerging market regions to reduced private capital and cross-border bank flows.

## Emerging Europe

Macroeconomic trends and creditworthiness in Emerging Europe (EE) remain under strong downward pressure as it struggles to cope with the fallout from the reduction in global capital flows and the global recession. It is the most vulnerable of the emerging market regions owing to the characteristics of many of the countries with large current account deficits (CADs), sizeable maturing external debt payments, the unwinding of previous strong bank credit booms, the presence of significant foreign-currency debt on balance sheets, relative trade and financial openness and, in the case of many countries in the CIS and Balkans, exposure to lower commodity prices and workers remittances.

The reduction in global leverage, risk appetite and cross-border capital flows make a correction of excessive CADs and a severe recession inevitable in most countries. Encouragingly, rapid adjustment is underway. For example Latvia and Lithuania's current accounts swung back to balance in Q109, from deficits of 16.8% of GDP and 18.7%, respectively in Q108. However, the synchronised global recession makes export-led growth very difficult – particularly for countries with exchange rate pegs that have seen trade partners and competitors depreciate their currencies – so that rebalancing is coming through the compression of domestic demand and GDP.

Moreover, countries in EE not only need to attract net capital inflows to finance CADs, but also to roll-over sizeable maturing external debts falling due. Fitch estimates the region faces an aggregate adjusted gross external financing requirement of some USD300bn in 2009 (and USD720bn if short-term debt is included) and USD274bn in 2010. This is by far the highest of any EM region and there is significant uncertainty over how financing requirements are going to be filled<sup>7</sup>. The vast majority of external debt is owed by the private sector and it is notable that despite difficult market conditions a number of sovereigns in the region have issued Eurobonds this year: Croatia (EUR0.75bn), the Czech Republic (EUR1.5bn), Lithuania (EUR0.5bn), Poland (EUR1bn), Slovakia (EUR2bn) and Turkey (EUR2.5bn).

### Emerging Europe: Key Indicators

(USDbn)	2008	2009f	2010f	2011f
Real GDP growth (%)	3.8	-4.6	1.5	3.2
Inflation (%)	10.8	7.3	6.0	5.5
Gov balance (% of GDP)	0.3	-6.0	-4.3	-2.8
Gov debt (% of GDP)	24.4	28.4	29.3	28.8
Current acc balance	-57	-27	-5	2
% of GDP	-1.3	-0.8	-0.1	0.0
Debt service	370	364	356	352
% of CXR <sup>a</sup>	19.2	23.4	21.7	20.1
Gross financing need <sup>b</sup>	366	300	274	267
% of reserves	89.7	40.5	35.4	31.9
Net external debt	327	374	338	278
% of CXR <sup>a</sup>	16.9	24.1	20.6	15.8
Net public external debt	-511	-340	-331	-394
% of CXR <sup>a</sup>	-26.5	-21.9	-20.2	-22.5
Reserves incl gold	842	740	774	848

<sup>a</sup> Current external receipts

<sup>b</sup> Current account balance, plus amortisation payments on medium- and long-term debt. Aggregate calculation excludes countries with no demonstrable financing need

Source: Fitch

<sup>7</sup> "External Financing Risks in Central and Eastern Europe" 14 May 2009 available at [www.fitchresearch.com](http://www.fitchresearch.com)

For many countries currency depreciation has been part of the necessary adjustment process. But this has added to pressures on countries with fixed exchange rates and can add to risks to financial stability for countries with substantial FX debt on balance sheets. Armenia, Hungary, Latvia, Romania, Serbia and Ukraine have all secured IMF-led programmes and substantial financial assistance. Fitch would not be surprised if a number of other countries decide to follow suit to help meet potential financing gaps and give more of a breathing space for macroeconomic adjustment to take place.

Fitch forecasts real GDP in EE to contract by 4.6% this year, a severe recession after growth of 3.8% in 2008 and an average 6.8% in the five years to 2007. The slump in GDP will be the first since the Russian crisis in 1998, when output fell by 0.5% (based on 2007 GDP weights) and the steepest since the collapse of the Communist planned economic system in the early 1990s. The aggregate masks considerable divergence in prospects from 0% in Poland to projected double-digit declines in the Baltic States and Ukraine. The deepest recessions are expected in countries with the greatest external imbalances, trade openness and exposure to commodity prices and workers remittances<sup>8</sup>. Moreover, Fitch expects only an anaemic recovery of 1.5% in 2010 and 3.2% in 2011.

The sudden and severe economic downturn is adding to other pressure points. Bank asset quality is worsening rapidly and public finances are deteriorating, while fiscal financing is more challenging. Russia and Kazakhstan's sovereign wealth funds are allowing them to implement counter-cyclical fiscal policy and support their banking systems. However, many countries have to implement austerity measures to prevent budget deficits increasing too greatly, which is exacerbating recessions and adding to political risks. Governments in all three Baltic States and Hungary have fallen this year, in part related to budget expenditure cuts and the economic situation.

In February, Fitch downgraded the sovereign ratings of Russia to 'BBB'/Negative Outlook from 'BBB+' /Negative, owing to the severe impact of the drop in commodity prices and reversal of net capital inflows on the economy and sovereign balance sheet. The completion of the RUB devaluation process and the rebound in oil prices has reduced risks somewhat, but Fitch believes these remain weighted to the downside owing to uncertainty over the depth of the recession (GDP fell 9.8% in Q109 yoy), the scale of impaired loans in the banking sector, capital flight and the capacity of the private sector to refinance its external debts. Fitch also downgraded Ukraine's rating again in February to 'B' /Negative from 'B+' /Negative.

The other downgrades this year, in April, were another round of reduction for the Baltic States: Estonia to 'BBB+' /Negative Outlook, Latvia to 'BB+' /Negative Outlook and Lithuania to 'BBB' /Negative Outlook. This reflected the deepening recessions - Fitch expects GDP to contract this year by 13%, 18% and 16% respectively - which are leading to rising unemployment and impaired loans in the banking sectors, pressures on budget deficits and on macroeconomic policy frameworks. The risk of devaluation in Latvia has risen further this year. The government agreed a further round of budget cuts in June, which should unlock the next EUR1.4bn tranche of IMF and EU money necessary to support the currency peg in the near term. However, the pain of restoring competitiveness and growth through domestic wage and income deflation will test the political resolve of policy makers to stay the course, and public jitters could lead to substitution out of the Lat adding to financial pressures. Devaluation in Latvia would ratchet up the pressure on the currency boards in Estonia and Lithuania owing to strong trade links, common ownership of the banking sectors and the risk of residents switching into foreign currency.

Forced devaluation of the Lat would exacerbate pressures on other fixed exchange rate regimes in the region.

<sup>8</sup> "Emerging Europe Growth Outlook" 1 April 2009 available at [www.fitchresearch.com](http://www.fitchresearch.com)

A poll of market participants at a recent Fitch conference on the region found that more than 10% believe that a systemic region-wide financial crisis is likely.

Notwithstanding severe macroeconomic and financial challenges facing specific countries and the general negative regional trends, Fitch believes there is a relatively low risk of a severe systemic region-wide financial crisis involving multiple sovereign defaults. The global economic and financial situation will clearly be important, as well as the extent of psychological contagion in the market in the event of a crisis in a specific country. In addition to consideration of the standalone credit fundamentals countries in the region, there are a number of factors arguing against such a systemic crisis.

- The increased firepower and activity of the IMF is providing substantial financial assistance, supported by other international IFIs (including the EUR25bn EBRD/EIB and World Bank banking sector support initiative), the EUR50bn EU financial support lending facility, ECB and other central bank swaps and bilateral loans.
- A large proportion of external debt is owed to foreign parent companies and banks arguing for a high roll-over rate rather than a 'sudden stop' to capital inflows. Furthermore, the EU has agreed that home country (and ECB liquidity) support for western European banks should not be prevented from reaching their eastern European subsidiaries, and the IFIs are co-ordinating action to 'bail-in' parent banks to support programmes.
- The amount of financing required looks manageable in a European context. Last year the CADs of the 10 EU member states in eastern Europe plus Croatia, Macedonia and Serbia were only equivalent to 0.7% of EU27 GDP and their GDP only 8% of EU27 GDP.
- Some of the countries most exposed to the global crisis such as the Baltic and Balkan states are relatively small. In contrast, Poland and the Czech Republic, the largest of the above 13 economies are in relatively good shape and, together with euro area members Slovenia and Slovakia, account for 58% of their GDP. Fitch has affirmed the rating of all four countries with Stable Outlooks through the crisis, together with Turkey (the second-largest in EE as a whole after Russia).

Since the onset of the credit crunch in summer 2007, Fitch has downgraded the ratings of 10 countries in the region by a total of 18 notches. It now has 13 countries (excluding Iceland) on Negative Outlooks or Watches and none on Positive Outlooks or Watches. Nonetheless, Fitch has affirmed the ratings of half the countries in the region and it is important to recognise the differences between countries, amid the sometimes indiscriminate gloomy narrative for the region.

### Latin America

While the 'green shoots' of recovery are evident in Latin financial markets, the economic recession will be the worst since the early 1990s.

The green shoots of financial recovery are evident in Latin America. Since early 2009, Latin America's stock markets have rallied, external debt spreads have tightened and the major regional currencies have strengthened. The rally in currencies corrected some of the 'over shooting' observed since September 2008 and occurred despite aggressive monetary easing and reduced fx intervention by central banks. In addition to benefiting from the broader recovery in financial assets and risk appetite, Latin America has also benefited from the rise in commodity prices from recent lows. Sentiment has also been boosted by the extent of multilateral support for the region highlighted by the extension of IMF's new 'Flexible Credit Facility' to Mexico and Colombia as well as the unwinding of the short USD positions of some of the Latin corporates in Mexico and Brazil which had exacerbated fx pressures and eroded investor confidence in Q408.

Despite the recovery in financial markets, 'real economy' weakness persists as countries cope with weaker external demand, lower average commodity prices and reduced capital inflows while rising unemployment and depressed confidence indicators continue to weigh on domestic demand. Currently, Fitch expects the

**Latin America: Key Indicators**

(USDbn)	2008	2009f	2010f	2011f
Real GDP growth (%)	3.8	-2.5	1.9	2.8
Inflation (%)	7.5	6.8	5.8	5.9
Gov balance (% of GDP)	-1.3	-2.9	-3.0	-3.0
Gov debt (% of GDP)	45.8	47.8	48.7	48.3
Current acc balance	-27	-68	-73	-80
% of GDP	-0.6	-1.9	-1.9	-2.0
Debt service	157	151	155	152
% of CXR <sup>a</sup>	14.4	17.3	16.9	15.8
Gross financing need <sup>b</sup>	163	160	165	167
% of reserves	37.2	36.5	38.8	39.2
Net external debt	-65	-38	-17	-3
% of CXR <sup>a</sup>	-5.9	-4.3	-1.9	-0.3
Net public external debt	-148	-77	-49	-33
% of CXR <sup>a</sup>	-13.6	-8.8	-5.4	-3.4
Reserves incl gold	494	447	435	436

<sup>a</sup> Current external receipts

<sup>b</sup> Current account balance, plus amortisation payments on medium- and long-term debt. Aggregate calculation excludes countries with no demonstrable financing need

Source: Fitch

region's real GDP to contract by 2.5% in 2009, after a growth of 3.8% in 2008. The regional aggregates will be heavily influenced by the real GDP contraction in Mexico (-5.5%), Brazil (-1%) and Argentina (-1.9%). Currently, Fitch expects real GDP to contract in 13 of the 18 countries with Fitch rated sovereigns and only three countries including Bolivia, Panama and Peru are expected to record modest growth. Barring Mexico, other countries in the region are expected to experience shallower recessions compared with some of the other emerging markets. Limited financial distress in Latin America and the Caribbean due to healthier banking sectors as well as greater flexibility of central banks to front-load interest rate cuts and allow currencies to adjust to the new economic realities have prevented a sharper economic contraction. While on aggregate the region's external accounts are deteriorating, most countries are running modest current account deficits making them comparatively less vulnerable to the reduction in capital inflows. Moreover, despite the expected decline in the region's external liquidity, Fitch estimates that international reserves would stand at a hefty USD447bn at the end of 2009 and several sovereigns including Brazil, Chile, Peru and Mexico will remain net sovereign external creditors.

Growth performance during the first quarter of 2009 has differed across countries, with Mexico's real GDP contracting by 8% (yoy), Brazil's 1.8%, Chile's 2.1% while Peru and Panama displayed greater resilience with growth of 1.8% and 2.5% respectively. Overall, Fitch believes that a gradual recovery should be evident later in the year as the rebound in financial markets and commodity prices feeds through the regional economies, the inventory cycle runs its course, the aggressive monetary stimulus kicks in and the effects of counter-cyclical fiscal policies implemented by some countries gain traction. On the positive side, inflation has been declining across Latin America as the decline in commodity prices (from 2008 levels) and weaker domestic demand have more than counter-balanced the pass-through effects from weaker currencies. Fitch expects most inflation-targeting central banks in the region to meet targets in 2009.

Public finances will deteriorate in 2009 as several countries will face negative revenue shocks and continued spending pressures due to weaker economic performance. Moreover, some countries such as Chile, Mexico and Peru are in the process of executing their counter-cyclical fiscal packages. Fitch expects the weighted average general government balance to increase to 2.9% of GDP in 2009 from 1.3% in 2008. For most countries, higher deficits should not pose financing

Fiscal deficits are being comfortably financed by a combination of asset draw-downs, multilateral funding and continued access to domestic and international capital markets.

problems due to higher multilateral disbursements, increased local (and in some cases international) market issuance and manageable amortisation profiles. Notably, Chile will draw down the resources in its Stabilization Fund to finance its wider fiscal deficit.

While Latin America has re-coupled with the developed world with lesser rigor than in the past, the region is likely to face the following challenges over the next year.

- A modest global and US recovery will weigh on the region's growth momentum, with Fitch projecting Latin America's growth at 1.9% in 2010. A muted recovery in the US will limit the growth upside in Mexico, and in most of the small and open economies of Central America and the Caribbean which depend heavily on the US for trade, tourism, remittances and capital inflows. Fitch also believes Argentina, Ecuador and Venezuela will face greater difficulty in recovering due to their over-dependence on commodities, inconsistent policy frameworks, and weakened investment prospects. On the other hand, Chile, Peru and Panama will be better positioned to recover due to greater fiscal flexibility, brighter investment prospects as well as monetary flexibility in the first two countries. Finally, Brazil's large domestic economy, relatively sound financial system and increased monetary flexibility will allow the economy to recover next year.
- The slow economic recovery will test the commitment of Latin governments to maintain fiscal prudence in the midst of an electoral cycle. Fiscal consolidation will become necessary as economic recovery takes hold in order to limit the fallout on debt dynamics. Chile and Peru are best placed in the region to provide a more sustained stimulus (if needed) due to their better fiscal balance sheets and greater fiscal cushions. On the other hand, Mexico would need a fiscal reform that expands its non-oil revenue base to prevent a sharper deterioration in public finances and debt dynamics. Brazil's fiscal credibility will be tested next year as the government will need to make good on its intention of returning to a higher primary surplus trajectory in 2010. Finally, Colombia could also face fiscal pressures if economic recovery is weak given its high level of budgetary rigidity. While fiscal accounts of Argentina, Ecuador and Venezuela will benefit somewhat from a modest recovery in commodity prices, these countries will need to curb spending growth to reduce financing pressures. Overall, Fitch projects the regional general government debt to reach 49% of GDP in 2010 compared with 46% in 2008.
- A below-potential growth in 2010 following economic contraction (or very modest growth) this year coupled with continued labor market slack could increase political and social risks in the region. Moreover, a slew of presidential and congressional elections over the next 12-18 months will add to political noise and deter governments from implementing significant structural reforms.
- While multilateral disbursements and sales of USD by regional central banks (to fund reduced trade finance and/or corporate rollovers) have helped cushion balance of payments in some countries, the private sector will need to obtain greater access to international capital markets in order to finance the economic recovery. Saving rates in Latin America remain low compared with other emerging market regions and an uptick in investment could increase 'crowding out' if sovereigns don't reduce their domestic borrowing.

Credit and sovereign rating trends are beginning to stabilise.

Since the beginning of this year, credit trends have stabilized in Latin America especially after a slew of negative rating actions observed during September-December 2008. Fitch affirmed the ratings of Brazil ('BBB-'), Peru ('BBB-') and Chile ('A') with Stable Outlooks in May. Panama's 'BB+' rating and Positive Outlook was also affirmed in February. On the other hand, Ecuador remains in RD, although its sovereign rating is likely to come out of default once the country concludes its debt restructuring. Mexico, Jamaica and El Salvador continue to remain on Negative outlook. El Salvador's sovereign ratings were recently downgraded due to the structural shift in the country's fiscal and growth trajectory.

Current and forecast oil prices remain above fiscal 'breakeven' levels for Gulf producers.

### Middle East and Africa

Oil exporters' vulnerability to lower oil prices are reflected in existing ratings which also build in some tolerance to a temporary fall in oil prices. No oil producer in the region has yet attracted negative rating action. Having reached a near-term low in December, oil prices now exceed USD70pb and even assuming a second half correction, Fitch's assumed average for the year of USD55pb is well above the fiscal breakeven price for all three major Gulf producers (Abu Dhabi and Kuwait 'AA'/Stable Outlook and Saudi Arabia 'AA-/Stable Outlook) as well as newly rated Libya ('BBB+' /Stable Outlook). Sovereign wealth funds suffered losses last year but these were offset by record surpluses due to record high oil prices.

OPEC quota cuts and lower oil prices will reduce oil sector GDP in 2009 – especially in Saudi Arabia – but although non-oil GDP growth will slow, reflecting lower private sector activity, it will remain positive. Kuwait will likely see the biggest non-oil GDP slowdown, due to ongoing political instability which hampers decision-making, as well as the travails of its financial sector. Both could ultimately take their toll on creditworthiness but Kuwait also has one of the lowest breakeven oil prices and is still forecast to enjoy 15%-20% fiscal and current account surpluses this year, providing strong underpinning to creditworthiness. Abu Dhabi is incurring growing contingent liabilities as sovereign related entities increase external borrowing to fund economic diversification. However, these remain well within the 'AA' tolerance, especially given an equally low breakeven price. Support for the UAE banking system and Dubai has so far been financed at the UAE federal level. Saudi Arabia will suffer the biggest deterioration in its fiscal and current account balances this year as it bears the brunt of OPEC production cuts. But the budget deficit will be only 1% of GDP and like the other highly rated oil producers, its large external assets allow it comfortably to weather a temporary oil price fall with its credit fundamentals essentially unharmed.

#### Middle-East and Africa: Key Indicators

(USDbn)	2008	2009f	2010f	2011f
Real GDP growth (%)	4.7	1.1	3.6	4.1
Inflation (%)	9.3	5.7	4.5	4.3
Gov balance (% of GDP)	9.6	-3.1	-0.4	0.5
Gov debt (% of GDP)	32.0	36.5	35.3	34.8
Current acc balance	210	-9	29	38
% of GDP	11.9	-0.6	1.7	1.9
Debt service	52	47	48	44
% of CXR <sup>a</sup>	5.2	6.6	6.1	5.1
Gross financing need <sup>b</sup>	62	61	61	63
% of reserves	33.8	26.3	30.9	32.4
Net external debt	-562	-557	-591	-630
% of CXR <sup>a</sup>	-56.1	-79.4	-75.0	-73.6
Net public external debt	-535	-537	-578	-624
% of CXR <sup>a</sup>	-53.4	-76.5	-73.4	-72.8
Reserves incl gold	374	383	411	434

<sup>a</sup> Current external receipts

<sup>b</sup> Current account balance, plus amortisation payments on medium- and long-term debt. Aggregate calculation excludes countries with no demonstrable financing need

Source: Fitch

Bahrain ('A'/Stable Outlook) is the only investment grade oil exporter that has made significant budget cutbacks, lacking the large external assets of its GCC neighbours. However, it has financing flexibility, with little net debt and the budget deficit forecast to be contained to 3% of GDP this year and the current account remaining in surplus. Bahrain's two largest wholesale (formerly offshore) banks made losses last year and others are affected by exposure to two troubled Saudi conglomerates, but no support from the Bahrain sovereign has been needed

or is expected for either wholesale or retail (domestic) banks. Bahrain's ratings were affirmed in June ahead of a USD750m sukuk issue.

Only Nigeria ('BB-/Stable Outlook) has suffered significant speculative outflows, though not on the scale that prompted rating downgrades in higher rated oil producers such as Russia and Kazakhstan. External finances have lately begun to stabilise with reserve losses slowing after the authorities engineered a 20% depreciation of the naira, albeit after resort to tighter administrative controls. Higher oil prices have now brought the first relaxation in controls. The authorities also acted swiftly to reduce the budgeted oil price to USD45pb, which dictates automatic cuts in federal and state spending. Fitch expects the former to comply but states will be under more pressure and could request increased funding from the ECA<sup>9</sup> later this year, especially with oil prices higher than budgeted. Oil output remains constrained by OPEC quotas and continuing attacks on oil facilities. However, Nigeria still has one of the strongest sovereign balance sheets in the 'BB' category and little external debt, providing strong underpinning to creditworthiness. Its 2009 fiscal and current account deficits are forecast to be contained around 2% and 1% of GDP respectively. Liquidity pressures and the fall out from last year's rapid lending growth and equity price bubble have taken their toll on the banks, but they entered the crisis well capitalised and sovereign fiscal support is not expected to be needed.

Among oil importers, the rating Outlook on Ghana's 'B+' ratings was revised from Stable to Negative in March as fiscal and current account deficits ballooned to 15% and 21% of GDP respectively. Although they should decline this year, they will remain near double digits and the new government must implement strong measures if further negative rating action is to be avoided. A new IMF programme is under negotiation.

South Africa ('BBB+/'Negative Outlook) remains on Negative Outlook due to its large current account deficit at a time of reduced global risk appetite. However, the Zuma administration shows no sign of radical policy change and political risk has eased. The depth of the recession and its impact on public finances are the main uncertainty. GDP may fall 1% this year – the first decline under the ANC. This will increase social pressures at a time when the budget deficit is already widening: weak revenues bring downside risks to the 3.9% of GDP deficit target – the highest in 15 years. However, years of prudent fiscal policy give room for counter-cyclical measures and the debt burden will rise only modestly. The current account deficit will narrow only slightly, to just below 6% of GDP. But portfolio inflows are responding to improved global risk appetite and the rand has risen by over 40% since its October low, with some intervention to take lumpy FDI flows into reserves.

Sharply lower South African imports will reduce the customs revenue pool shared with SACU neighbours Lesotho ('BB-/Stable Outlook) and Namibia ('BBB-/Stable Outlook).<sup>10</sup> This is a severe negative shock which could undermine creditworthiness if sustained and not effectively addressed. Another middle income country – Cape Verde ('B+/'Stable Outlook) – had its Outlook revised from Positive in June due to an increase in its already high debt burden.

East Africa is enjoying robust growth, helped by growing regional integration. Although growth will slow this year it will be around 6% in Rwanda ('B-/Positive Outlook) and Uganda ('B/'Stable Outlook) and although lower at 3% in Kenya ('B+/'Stable Outlook), this is faster than last year's 1.8% which was affected by political violence. Kenya's current account deficit will decline this year, due to lower oil prices, and financing will be eased by a new IMF programme. The Negative Outlook on Kenya's rating was changed to Stable in January.

<sup>9</sup> The Excess Crude Account – part of international reserves

<sup>10</sup> Other members of the South African Customs Union are Botswana and Swaziland

North Africa is also performing quite well. Egypt ('BB+' / Stable Outlook), Morocco ('BBB-' / Stable Outlook) and Tunisia ('BBB' / Stable Outlook) rely on Europe for exports and tourism and receive large remittances and FDI from the Gulf. All these income sources are under pressure and Egypt has also suffered a fall in Suez Canal receipts with weak world trade. Overall, Morocco has been the least affected and Egypt the most, but a discretionary fiscal boost should sustain Egypt's GDP growth at 3%-4% with little damage to fiscal ratios. A current account deficit has emerged but should remain covered by FDI.

### Asia-Pacific

The positive news for Emerging Asia is that the worst of the decline has likely passed.

Several Emerging Asian economies experienced severe GDP contractions at the end of 2008 and into 2009, coinciding with the dramatic drop in global trade flows. Countries that were hit hardest were those most open to trade and most concentrated in manufactured exports. Double-digit contractions in GDP (on a quarter-on-quarter basis, at annual rates) took place in South Korea, Malaysia, Singapore, Taiwan and Thailand. For the region as a whole, the decline in exports is already worse than 2001, when the "tech bubble" burst, and 1998, when the region was in the grips of its financial crisis.

The worst may be past – industrial production data across many countries have bounced back from their lows. Moreover, there is some evidence of an inventory adjustment in Asia, whereby production declined more than shipments at the depths of the downturn, suggesting an increase in production should be forthcoming as inventory levels are brought back to normal. Finally, with the notable exception of Korea, Emerging Asian economies are not undergoing a "de-leveraging" process, as banks tend to rely on deposits for funding.

Nevertheless, Fitch expects Emerging Asia's recovery to be modest, and vulnerable to reversals in several countries. Domestic demand will respond to fiscal and monetary policy easing, but the corporate sector in export-oriented economies is likely to adopt a wait-and-see approach before considering additional hiring or investment. In Fitch's view, this will limit consumption and investment growth, and prolong the period of below-trend growth in most countries, even if there is a pronounced jump in activity marking the end of the worst of the recessions.

### Asia-Pacific: Key Indicators

(USDbn)	2008	2009f	2010f	2011f
Real GDP growth (%)	6.2	2.6	5.9	6.6
Inflation (%)	6.4	1.1	2.8	3.6
Gov balance (% of GDP)	-2.0	-4.8	-3.6	-2.3
Gov debt (% of GDP)	35.1	38.3	38.9	37.0
Current acc balance	442	419	407	453
% of GDP	5.5	5.1	4.3	4.1
Debt service	158	153	152	194
% of CXR <sup>a</sup>	4.2	4.9	4.5	4.9
Gross financing need <sup>b</sup>	95.5	45.1	49.6	60.8
% of reserves	14.9	11.9	12.1	8.3
Net external debt	-2,650	-3,048	-3,412	-3,845
% of CXR <sup>a</sup>	-70.8	-96.8	-100.4	-98.2
Net public external debt	-2,696	-3,027	-3,436	-3,843
% of CXR <sup>a</sup>	-72.0	-96.1	-101.2	-98.1
Reserves incl gold	3.04	3,383	3,794	4,199

<sup>a</sup> Current external receipts

<sup>b</sup> Current account balance, plus amortisation payments on medium- and long-term debt. Aggregate calculation excludes countries with no demonstrable financing need

Source: Fitch

One of the lessons of the current economic cycle in Emerging Asia is that the region's growth prospects remain inextricably linked with those of the Advanced

The rapid rise in bank credit will be reflected in asset quality problems in the future - what is unknown is the size and severity of future NPLs.

Economies. It is not clear, for example, that China's massive CNY4trn stimulus package announced in November 2008 is having much effect on growth elsewhere, even though China has become the biggest export market for a number of countries across Emerging Asia. A decade of increasing intra-regional trade has not altered the fact that the final demand for much of Asia's exports is still in the US and EU.

In China, the effects of fiscal stimulus are strongly supportive of economic growth. Fixed asset investment is expanding by about 30% yoy, financed by a similar increase in bank credit that began to flow as soon as the fiscal initiative was announced last year. Fitch believes such an increase in bank credit will inevitably contribute to asset quality problems, but these will not be revealed in the short term, as corporate loans in China typically have "bullet" maturity structures, in which the principle is only due at maturity, and there is almost certainly a more relaxed approach to rolling over maturities in the current environment.

While China's short-term growth outlook remains comparatively favourable, Fitch notes that the current fiscal stimulus does not provide the basis for sustained growth in the medium term. Since a significant share of the stimulus is directed at infrastructure investment spending, the economy will continue to have an exceptionally high investment/GDP ratio and a low – and falling – consumption/GDP ratio. While policymakers have for some time acknowledged the importance of increasing domestic consumption as a means of rebalancing the economy, the policy response to the global downturn has been to revert to the proven approach of building up the capital stock – along with the economy's productive capacity – and relying on external demand to meet the increase domestic supply, in Fitch's view.

Just as China has undertaken a large-scale fiscal stimulus programme in 2009, so too has virtually every other sovereign in Emerging Asia. In fact, for most Emerging Asian sovereigns, the 2009 fiscal deterioration is larger than that of their respective peer group medians, at least as measured by the change in the headline balance this year versus 2008. This may be understandable given the preponderance of very open economies in Emerging Asia and the magnitude of the adjustment that has already taken place in the export sector. Even so, the cyclical weakening of public finances has underscored some structural fiscal vulnerabilities, prompting Fitch to take several rating actions specifically focused on public finance concerns. The Local Currency IDRs of India and Taiwan are on Negative Outlook, while both sovereigns' Foreign-Currency IDRs remain on Stable Outlook. In June, Malaysia's Local-Currency IDR was downgraded to 'A', and its Foreign-Currency IDR was affirmed at 'A-'. Public debt levels in India, Malaysia and Taiwan are higher than their respective peer group medians, and have been for some time.

In a surprise result, India's Congress Party emerged from parliamentary elections that concluded in mid-May with a decisive mandate (though still short of an absolute majority), perhaps allowing for more meaningful progress on both economic reforms to enhance India's competitiveness and improvements in public finances. The sustainability of public finances is a major sovereign rating concern. The previous two Indian governments had been coalitions, led by the Bharatiya Janata Party (1999-2004) and the Congress Party (2004-2009), leaving economic reforms exposed to the uncertainties of coalition politics. Fitch looks to the new government's FY10 budget, which will be released in the coming weeks, and the report of the 13<sup>th</sup> Finance Commission, which will be released at end-October, for insight into the government's immediate and longer term fiscal objectives.

**Long-Term Issuer Default Ratings as of 30 June 2009**

	LTFC	FC outlook	LTLC	LC outlook	Ceiling
<b>Western Europe &amp; North America</b>					
Austria	AAA	Stable	AAA	Stable	AAA
Belgium	AA+	Stable	AA+	Stable	AAA
Bermuda	AA+	Stable	AAA	Stable	AAA
Canada	AAA	Stable	AAA	Stable	AAA
Cyprus	AA-	Stable	AA-	Stable	AAA
Denmark	AAA	Stable	AAA	Stable	AAA
Finland	AAA	Stable	AAA	Stable	AAA
France	AAA	Stable	AAA	Stable	AAA
Germany	AAA	Stable	AAA	Stable	AAA
Greece	A	Negative	A	Negative	AAA
Iceland	BBB-	Rating watch negative	A-	Rating watch negative	BBB-
Ireland	AA+	Negative	AA+	Negative	AAA
Italy	AA-	Stable	AA-	Stable	AAA
Luxembourg	AAA	Stable	AAA	Stable	AAA
Malta	A+	Stable	A+	Stable	AAA
Netherlands	AAA	Stable	AAA	Stable	AAA
Norway	AAA	Stable	AAA	Stable	AAA
Portugal	AA	Stable	AA	Stable	AAA
San Marino	AA-	Rating watch negative	-	-	AAA
Spain	AAA	Stable	AAA	Stable	AAA
Sweden	AAA	Stable	AAA	Stable	AAA
Switzerland	AAA	Stable	AAA	Stable	AAA
United Kingdom	AAA	Stable	AAA	Stable	AAA
United States	AAA	Stable	AAA	Stable	AAA
<b>Central/Eastern Europe &amp; CIS</b>					
Armenia	BB	Stable	BB	Stable	BB+
Azerbaijan	BB+	Stable	BB+	Stable	BB+
Bulgaria	BBB-	Negative	BBB	Negative	BBB+
Croatia	BBB-	Negative	BBB	Negative	BBB+
Czech Republic	A+	Stable	AA-	Stable	AA+
Estonia	BBB+	Negative	A-	Negative	A+
Georgia	B+	Rating watch negative	B+	Rating watch negative	B+
Hungary	BBB	Negative	BBB+	Negative	A
Kazakhstan	BBB-	Negative	BBB	Negative	BBB
Latvia	BB+	Negative	BBB-	Negative	BBB
Lithuania	BBB	Negative	BBB+	Negative	A
Macedonia	BB+	Negative	BB+	Negative	BBB-
Moldova	B-	Stable	B	Stable	B-
Poland	A-	Stable	A	Stable	AA-
Romania	BB+	Negative	BBB-	Negative	BBB
Russia	BBB	Negative	BBB	Negative	BBB+
Serbia	BB-	Negative	BB-	Negative	BB-
Slovakia	A+	Stable	A+	Stable	AAA
Slovenia	AA	Stable	AA	Stable	AAA
Turkey	BB-	Stable	BB	Stable	BB
Ukraine	B	Negative	B	Negative	B
<b>Asia Pacific</b>					
Australia	AA+	Stable	AAA	Stable	AAA
China	A+	Stable	AA-	Stable	A+
Hong Kong	AA	Stable	AA+	Stable	AAA
India	BBB-	Stable	BBB-	Negative	BBB-
Indonesia	BB	Stable	BB	Stable	BB+
Japan	AA	Stable	AA-	Stable	AAA
Korea	A+	Negative	AA	Negative	AA
Malaysia	A-	Stable	A	Stable	A
Mongolia	B	Negative	B	Negative	B
New Zealand	AA+	Stable	AAA	Stable	AAA
Papua New Guinea	B+	Stable	B+	Stable	B+
Philippines	BB	Stable	BB+	Stable	BB+
Singapore	AAA	Stable	AAA	Stable	AAA
Sri Lanka	B+	Negative	B+	Negative	B+
Taiwan	A+	Stable	AA	Negative	AA
Thailand	BBB	Stable	A-	Stable	BBB+
Vietnam	BB-	Stable	BB-	Stable	BB-

Source: Fitch

**Long-Term Issuer Default Ratings as of 30 June 2009 (cont.)**

	LTFC	FC outlook	LTLC	LC outlook	Ceiling
<b>Middle East and Africa</b>					
Abu Dhabi	AA	Stable	AA	Stable	AA+
Bahrain	A	Stable	A+	Stable	A+
Benin	B	Stable	B	Stable	BBB-
Cameroon	B	Stable	B-	Stable	BBB-
Cape Verde	B+	Stable	BB-	Stable	BB-
Egypt	BB+	Stable	BBB-	Stable	BB+
Gabon	BB-	Stable	BB-	Stable	BBB-
Ghana	B+	Negative	B+	Negative	B+
Israel	A	Stable	A+	Stable	AA-
Kenya	B+	Stable	BB-	Stable	BB-
Kuwait	AA	Stable	AA	Stable	AA+
Lebanon	B-	Stable	B-	Stable	B-
Lesotho	BB-	Stable	BB	Stable	A
Libya	BBB+	Stable	BBB+	Stable	BBB+
Malawi	B-	Stable	B-	Stable	B-
Mali	B-	Stable	B-	Stable	BBB-
Morocco	BBB-	Stable	BBB	Stable	BBB
Mozambique	B	Stable	B+	Stable	B
Namibia	BBB-	Stable	BBB	Stable	A
Nigeria	BB-	Stable	BB	Stable	BB-
Ras Al Khaimah	A	Stable	A	Stable	AA+
Rwanda	B-	Positive	B-	Positive	B-
Saudi Arabia	AA-	Stable	AA-	Stable	AA
South Africa	BBB+	Negative	A	Negative	A
Tunisia	BBB	Stable	A-	Stable	BBB+
Uganda	B	Stable	B	Stable	B
<b>Latin America and Caribbean</b>					
Argentina	RD	-	B-	Stable	B
Aruba	BBB	Stable	BBB	Stable	A-
Bolivia	B-	Stable	B-	Stable	B-
Brazil	BBB-	Stable	BBB-	Stable	BBB
Chile	A	Stable	A+	Stable	AA
Colombia	BB+	Stable	BBB-	Stable	BBB-
Costa Rica	BB	Stable	BB+	Stable	BB+
Dominican Republic	B	Stable	B	Stable	B+
Ecuador	RD	-	-	-	B-
El Salvador	BB	Negative	BB	Negative	BBB-
Guatemala	BB+	Stable	BB+	Stable	BBB-
Jamaica	B	Negative	B	Negative	B+
Mexico	BBB+	Negative	A-	Negative	A
Panama	BB+	Positive	BB+	Positive	BBB+
Peru	BBB-	Stable	BBB	Stable	BBB
Suriname	B	Stable	B+	Stable	B
Uruguay	BB-	Stable	BB	Stable	BB+
Venezuela	B+	Stable	B+	Stable	B+

Source: Fitch

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