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Sovereigns

Special Report

Sovereign Review and Outlook

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Related Research

- *Sovereign Data Comparator (June 2010)*
- *Sovereign Review and Outlook (December 2009)*
- *Sovereign Credit Crisis (June 2010)*
- *European Senior Fixed Income Investor Survey Q210 (May 2010)*
- *Sovereign Rating Methodology (October 2009)*

Global Recovery on Track, But Downside Risks Intensify

The outlook for the global economy and sovereign credit is at a critical and uncertain juncture. Economic data show a strengthening in the global recovery, which would support a gradual exit from unsustainably loose fiscal and monetary policy settings. However, concerns over sovereign debt sustainability in some euro area countries and renewed market volatility raise the risk of a double-dip recession.

The global recovery has strong momentum, and Fitch Ratings' base case is that world GDP grows by 3.1% in 2010 (up from 2.3% in its December 2009 "*Sovereign Review and Outlook*" — see *Related Research*), after contracting by 2.5% in 2009, helped by a rebound in world trade, a turn in the inventory cycle and accommodative fiscal and monetary policies. Emerging market (EM) economies are providing the main growth impetus, along with a gradual recovery in US consumption. But activity in the euro area remains sluggish. Extended loose monetary policy should keep growth robust to the fiscal consolidation plans currently mapped out by major advanced countries (MAEs). However, the degree of macroeconomic uncertainty is highlighted by the presence of both inflation and deflation risks, and the scope for policy mistakes is high.

Market fears about the solvency of some European governments and the future of the euro zone itself cast a shadow over the base case. A widespread loss of confidence in sovereign debt could force governments into abrupt fiscal tightening before private sector demand has gained sufficient traction, leading to a double-dip recession, feeding back on bank asset quality and public debt dynamics. The crisis of confidence in the euro area reflects the severity of macroeconomic imbalances within the region; scepticism over the ability of economies to adjust in the absence of exchange rate flexibility; and doubts over the strength of political commitment to the euro zone, given the initially hesitant support given to Greece. Nonetheless, Fitch believes the risk of a break-up of the euro zone in the medium term is low.

Emerging Markets: Resilient but Not Immune from Crisis Scenario

Most EM economies have had a "good" crisis in terms of their resilience to the initial shock, containing the impact on their sovereign balance sheets and preserving favourable growth prospects. Nevertheless, although they have outperformed advanced countries (and prior expectations), they have not de-coupled.

Fitch forecasts EM GDP growth to bounce back strongly to 5.8% in 2010 and 5.6% in 2011, up from 0.9% in 2009, driven by the recovery in global trade, supportive global and domestic fiscal and monetary policy stimulus, higher commodity prices and favourable base effects. Asia is expected to set the pace, while growth will be weaker in emerging Europe, where pre-crisis imbalances were greater and trade and banking sector exposure to the euro area is material.

Monetary policy that is looser for longer in MAEs will add to risks of inflation and overheating in EMs, unless they are willing to tolerate greater exchange rate appreciation. Despite coming back into fashion, EM capital controls do not appear to be the answer to EM monetary and exchange rate regimes or global imbalances.

EM and advanced country sovereign ratings are continuing to converge. In H110, four EM countries were upgraded including Indonesia and Lebanon, plus both

Azerbaijan and Panama to investment grade, while only Jamaica was downgraded. In contrast, Greece (by another two notches), Portugal and Spain suffered downgrades.

Global Economic Update

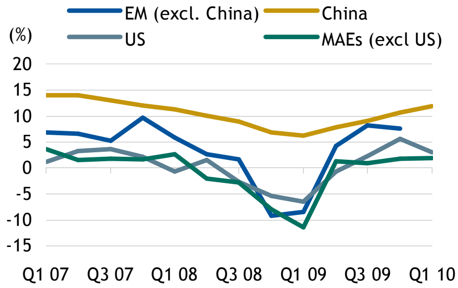
Recent macroeconomic data outturns have surprised on the upside, and forward-looking surveys point to a strong global recovery underway. However, growth performance in Q110 was uneven across countries and regions. EMs have provided much of the impetus, with GDP in China accelerating to 11.9% in Q110 (yoy), the fastest pace of growth in almost three years. In contrast, GDP in MAEs increased by 1.9% in Q110 yoy.

Sequential MAE GDP growth slowed somewhat to 0.6% in Q110, from 0.8% in Q409, reflecting growth of 0.8% in the US (down from 1.4% in Q409), and stable but weak growth in the euro area and the UK, of 0.2% and 0.3% respectively. The stronger cyclical upturn in Japan, which accelerated to 1.1% in Q409, continued in Q110 with higher-than-expected GDP growth of 1.2%.

A number of factors shaped the global picture in Q110. The recovery in world trade gathered momentum, particularly vis-à-vis the Asian economies, Russia and Brazil. Both exports and imports came in significantly higher than previously projected for a number of major economies, including a 4.9% upward adjustment of export growth in Japan, and a 4% upward adjustment of import growth in Germany. The upturn in the inventory cycle was another major growth driver, as firms are beginning to re-stock following almost two years of inventory draw-downs. A number of major EMs, including Brazil, China and India have benefited from stronger-than-expected domestic demand. Monetary and fiscal policies continued to be exceptionally accommodative.

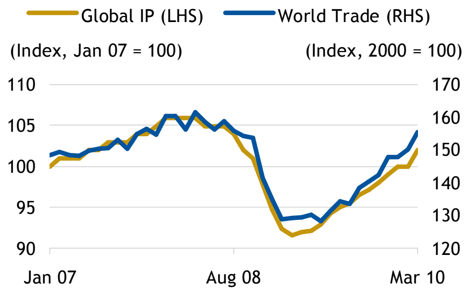
For 2010 as a whole, Fitch forecast world GDP to grow by 3.1%, after a contraction of 2.5% in 2009. This represents an upward revision of 0.3% compared with the March 2010 "*Global Economic Outlook*" and 0.8% compared with the December 2009 "*Sovereign Review and Outlook*". To a large extent this reflects continuing positive growth data surprises, particularly in Japan and the BRIC economies (Brazil, Russia, India and China), as well as generally healthy readings from forward-looking surveys. Private-sector deleveraging will continue to weigh on the advance economies. Fitch forecasts the US economy to expand by 3% in 2010, matched by Japan, which would be its fastest pace of growth for 10 years. Growth in the euro area and UK are expected to be more subdued at 1.0% and 1.3% respectively. In contrast, Fitch forecasts the BRICs to grow at an above trend 8.1% in 2010, up from 4.4% in 2009.

Recession and Recovery



Source: Fitch estimates

World Trade and Output



Source: Netherlands Bureau for Economic Policy Analysis and World Bank GEM

Several euro area governments, including Germany, have announced large headline fiscal tightening measures. Nonetheless, with the exception of some so-called "peripheral" euro area economies in southern Europe, these are of moderate size in

2010 and will then take time to feed through to demand. However, the announced fiscal measures will exert a more significant drag on growth from 2011, while higher risk premiums on some sovereign debt will add to headwinds.

Main Projections

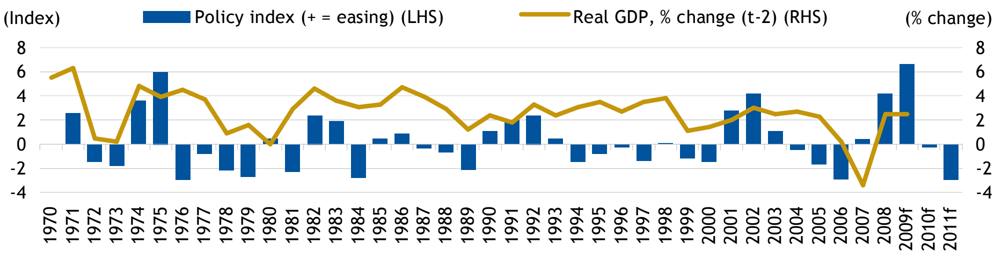
Annual averages)	2009	2010f	2011f	2012f
Growth (%)				
USA	-2.4	3.0	2.7	3.3
Euro area	-4.1	1.0	1.6	2.0
Japan	-5.3	3.0	1.6	1.7
Emerging Asia	5.1	7.6	7.4	7.1
Emerging Europe	-5.5	3.6	3.7	4.1
Middle East and Africa	1.5	4.1	4.7	4.7
Latin America	-2.5	4.6	3.8	4.1
World	-2.5	3.1	2.9	3.3
Memo				
BRICs	4.4	8.1	7.5	7.3
All emerging markets	0.9	5.8	5.6	5.6
Interest rates				
US federal funds	0.25	0.31	1.00	3.00
ECB refinancing	1.28	1.00	1.25	1.50
Bank of Japan repo	0.11	0.10	0.11	0.11
Bank of England repo	0.63	0.50	1.50	3.25
Oil (Brent USDpb)	**64.0**	**80.0**	**85.0**	**85.0**

Regional growth aggregates weighted at market exchange rates
Source: Fitch

In its central forecast, Fitch expects world GDP growth to flatten off at 2.9% in 2011 (unchanged from the December 2009 "*Sovereign Review and Outlook*"). The dispersion of global growth is expected to remain uneven, underpinned by dynamic growth in emerging economies and a gradual recovery in consumption in the US. Growth is expected to ease closer to the long-term trend growth of 1.6% in Japan as the impact of the export recovery fades and domestic demand remains subdued. Fiscal tightening and unsettled consumer sentiment will continue to weigh on the euro area, although Fitch expects GDP growth to strengthen slightly to 1.6%. A similar story is unfolding in the UK where, despite fiscal tightening, Fitch expects output growth to increase to 2.1%, boosted by net trade and some firming in private sector demand.

As governments eventually rein back fiscal stimulus measures, the burden of countering the risk of a double-dip recession and deflation in MAEs and soothing market concerns will fall even more squarely on central banks. Against this backdrop, Fitch expects monetary policy in the MAEs to remain looser for longer, and be a vital support for the global economy and financial system. It has adjusted downward its forecast for ECB refinancing rate to 1.25% for 2011 (annual average), from 1.5% (in the March 2010 "*Global Economic Outlook*"), while forecasts for US and UK policy interest rates are unchanged at 1% and 1.5% respectively.

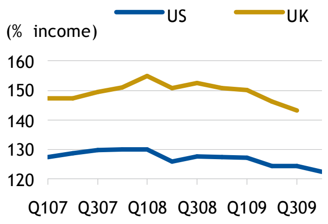
Eventual Easing of Policy Stimulus Casts Shadow Over Growth Outlook
Index of policy stimulus and growth in advanced econmies



Based on change in fiscal deficits and changes in real interest rates in US, Japan, UK and euro area (Ger pre-1995)
Source: Fitch

However, at this juncture, there are even greater than usual uncertainties around this essentially benign global base case forecast, highlighted by the presence of risks of both inflation and deflation. First and foremost is how fears about the sustainability of some European countries' sovereign debt will play out, including whether the market will impose a more abrupt fiscal retrenchment than governments are currently planning, and what impact it will have on EU and global activity. It is also uncertain how heavily household deleveraging will weigh on growth in MAEs and whether the private sector can take up the baton of growth as

Household Gross Debt Ratio



Source: Fitch

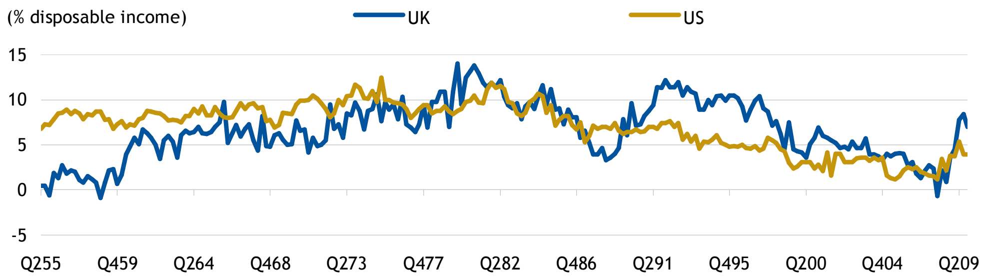
governments eventually have to tighten fiscal policy to protect their credit profiles. In addition, risk of a sharper than anticipated policy tightening and financial risk in China and other EMs cannot be discounted. Finally, all these uncertainties mean the scope for policy mistakes is high.

US Household De-Leveraging to Weigh on Growth

The deleveraging process underway in the US household sector is a key influence on the global economic outlook. Encouragingly, US households have already made significant inroads into debt reduction with the ratio of gross and net debt to income down by about 10% from its peak. This has been achieved by a large swing into financial surplus as savings have risen and residential investment rates fallen since 2007. The position is similar in the UK, where the household savings rate increased to 7.7% of disposable income in H209 from 0.8% in H108.

Retrenchment Clearly Visible in Consumer Behaviour

Household savings ratio



Source: Datastream and Fitch

A number of factors suggest that the full peak to trough decline in the US gross debt-to-income ratio could be as much as 30% — ie, fully reversing the run-up in the ratio seen over 2002 to 2007[1]. A further 20% fall in the debt ratio could be achieved by 2015 if the household sector sustains a net saving ratio of 6% over the next five years on plausible growth and other assumptions (see the Outlook for US Household Finances table). This saving ratio would be higher than the rate of 4.3% in 2009, but lower than the rates seen before the 1990s and below the long-run average.

Outlook for US Household Finances: Savings, Investment and Debt

				Illustrative Projections					
% disposable income	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**
Saving ratio[a]	1.7	2.7	4.3	6.0	6.0	6.0	6.0	6.0	6.0
Gross saving	4.4	5.3	6.9	8.6	8.6	8.6	8.6	8.6	8.6
Fixed investment	6.2	4.7	3.6	3.5	3.5	3.5	3.5	3.5	3.5
Financial surplus[b]	1.4	6.8	4.5	5.6	5.6	5.6	5.6	5.6	5.6
Net credit inflow[c]	-2.5	-5.9	1.3	-2.6	-2.6	-2.6	-2.6	-2.6	-2.6
Net debt	27.0	20.9	18.7	15.6	12.5	9.3	6.3	3.4	0.6
Gross debt	137.6	131.4	128.1	124.9	121.9	118.7	115.7	112.8	110.0
Memo									
Net equity purchases	-1.1	0.8	5.8	3.0	3.0	3.0	3.0	3.0	3.0
Income growth	4.9	3.9	1.1	3.0	3.0	4.5	4.5	4.5	4.5
Statistical discrepancy	-3.3	-6.2	-1.2	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5

[a] Net, excludes consumer durables; [b] Gross savings minus fixed investment minus statistical discrepancy; [c] Financial surplus net of non-debt creating (ie equity) flows = net borrowing minus net lending
Source: Federal Reserve and Fitch

[1] For example: in its "*Debt and Deleveraging*" report in January 2010, McKinsey found, based on 45 historical episodes since 1930, that deleveraging on average lasted six to seven years and saw a reduction in ratio of debt to GDP of 25%. The San Francisco Federal Reserve concluded that: "Japanese experience…of deleveraging is useful as a benchmark [for US household sector]. Japanese firms reduced debt ratio from 125% of GDP to 95% of GDP between 1991 and 2001", FRBSF Newsletter May 2009

Overall, this suggests that the household deleveraging process is probably less than half complete, and this will continue to prevent above trend growth over the medium term. Nevertheless, once the household savings ratio reaches 6% - which could happen this year as consumption is expected to grow less rapidly than GDP - it will not need to increase further to secure a typical pattern of balance sheet improvement by 2015. Consumer spending can then grow in line with GDP from 2011 (provided the labour share and household tax rates are broadly constant) while still allowing balance sheets to improve. Hence household deleveraging should not preclude a return to trend growth from 2011.

High-Grade Sovereigns: Crisis of Confidence in Euro Area

Developments in financial markets in the first half of 2010 were primarily driven by mounting concerns over the fiscal sustainability of some euro zone governments. The catalyst for these concerns was the deterioration in the fiscal and financing situation of Greece. The "contagion" from the Greek crisis to other peripheral euro zone sovereigns, notably Portugal, Spain, Ireland and to a lesser degree Italy, in Fitch's opinion reflected not only market concerns regarding their underlying budgetary position but also weak medium-term economic prospects in the absence of monetary and exchange rate flexibility and the emergence of some market doubts about political commitment to the euro zone in the aftermath of initially hesitant and reluctant support given to Greece. In this respect, the volatility in sovereign debt and other markets is as much a crisis of confidence in the long-run viability of the euro zone as it is about the fiscal solvency of some member states.

Table 1: Key Financials, 2009

(% GDP)	Euro zone	US	UK	Japan
Government budget	-6.3	-11.4	-10.9	-8.8
Government debt	78.7	71.3	70.8	201.7
Private debt (excl. FIs)	151.4	145.6	224.8	160.9[a]
Real GDP growth (%)				
Peak to trough	-5.2	-3.5	-6.2	-8.4
2010 forecast	0.9	3.0	1.2	1.8
Unemployment (%)	9.4	9.3	7.8	5.7
Inflation (%)	0.3	-0.3	2.1	-1.4
Current account	-0.3	-2.9	-1.3	2.8
Net IIP	-16.3	-24.0[a]	-13.1	-50.8[a]

[a] 2008 data
Source: Fitch

A Crisis of Confidence

At first glance, it is not evident why the euro zone is the centre of market concerns regarding fiscal solvency given that overall levels of government indebtedness are broadly comparable with other high-grade sovereigns and the budget deficit, in aggregate, is almost half the level of the UK and US. Moreover, the euro zone as a whole is largely "self-financing" in the sense that its external current account position is broadly balanced and net foreign debt is moderate. Certainly, the extent of contagion within the euro zone is hard to understand on the basis of fiscal comparisons with Greece, where public debt and debt service levels, fiscal policy credibility and transparency is far weaker than in other peripheral euro zone states. In Fitch's opinion, the focus on other euro zone sovereigns reflects concerns over the long-run viability of the euro because of:

- fiscal and other macroeconomic imbalances within the euro zone and the weaknesses of the economic policy framework and institutions that allowed such imbalances to arise;
- scepticism over the ability of economies within the euro zone to adjust in the absence of monetary and exchange rate flexibility;
- concerns about fiscal solvency given large fiscal deficits and weak economic growth prospects; and

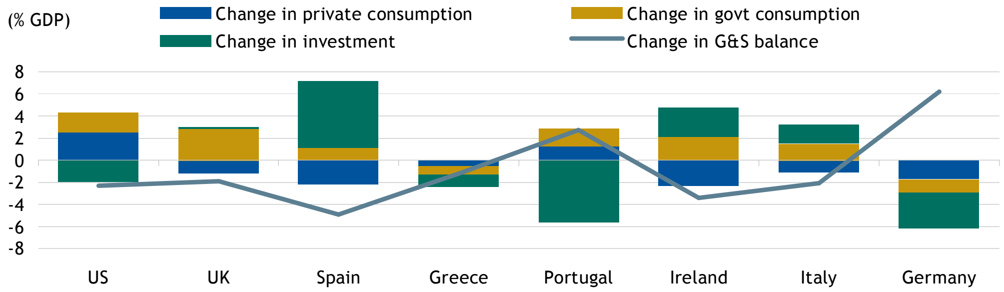
- doubts over the political commitment to the euro zone in the aftermath of the initially hesitant and reluctant support given to Greece.

However, in Fitch's opinion, these concerns and their implications for sovereign creditworthiness, though warranted, are over-stated and that the risk of a "break-up" of the euro zone is exaggerated. Nonetheless, from a broadly balanced position at its inception, sizeable trade and current account imbalances within the region have arisen and rendered the euro zone economy and the public finances of some member states more vulnerable to the global crisis and economic downturn. Germany's current account surplus peaked at more than 8% of GDP in 2007, the counterpart of which in the euro zone were large deficits in Ireland, Portugal and most notably Spain which had a current account deficit of 10% of GDP in 2007.

But while sizeable current account deficits and increasing net financial liabilities have been a common feature of the "peripheral" economies, with the notable exception of Italy, there have been key differences in underlying economic, fiscal and sovereign credit fundamentals. These differences imply that excessive real exchange rate appreciation and fiscal "indiscipline" offer only a partial explanation of the imbalances within the euro zone. In particular there is a striking contrast between persistent "twin (fiscal and current account) deficits" in Greece since 1999 — whereby external capital inflows were effectively helping to fund persistent large fiscal deficits — and the patterns seen elsewhere.

Notably, the increase in the Spanish (and Irish) trade deficit of five percentage points of GDP between 1999 and 2007 was driven by an investment boom rather than a decline in savings and fiscal indiscipline. Over the same period, the Greek goods and services deficit actually shrunk marginally to 11% of GDP as a result of an increase in private savings, while Portugal's trade deficit shrunk because of a decline in investment. In contrast, the counterpart of the more than six-percentage-point rise in Germany's trade surplus over the period was a decline in domestic public and private consumption as well as investment demand.

Drivers of External Imbalances, 1999-2007 [a]

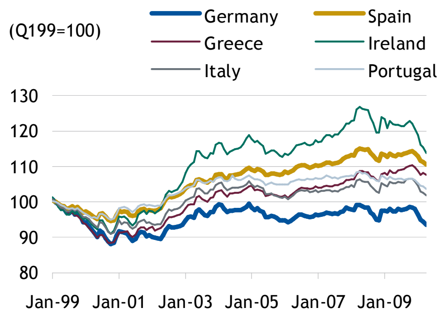


[a] Goods and services trade balances; 2000-2007 for Greece
Source: Eurostat and Fitch

Moreover, there is weak correlation between the evolution of real exchange rates and export market shares as the charts below illustrate. Ireland has experienced gains in its export market share despite having the most significant real appreciation of its exchange rate, while Italy experienced the greatest decline in market share, although it did not lose price competitiveness significantly over the period and its current account deficit is moderate. Finally, the countries that have suffered the greatest deterioration in their public finances — globally as well as within the euro zone — are those that had a private credit fuelled domestic boom that was typically associated with increasing external imbalances.

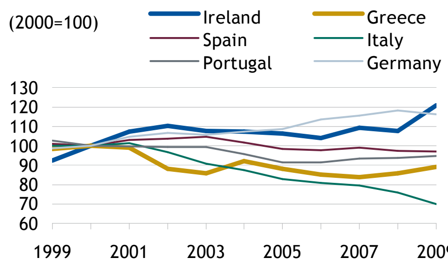
Thus the imbalances within the euro zone are much more than a simple story of the "super-competitiveness" of Germany and "chronic un-competitiveness" of the peripheral economies. Part of the story is also about relative domestic demand, credit growth and asset and housing booms, in part because of the common interest rate across the euro zone, as well as the fiscal stance. Though this still implies a downward adjustment in deficit countries real exchange rates, it is only one element of the broader rebalancing of the economy, as is an increase in private and national (ie, including government) savings. This implies that economies like Spain do not necessarily have to deflate massively in order to restore competitiveness, even though the process of re-balancing their economy and private sector de-leveraging does imply a period of prolonged low growth. If it is indeed the case that a prolonged economic slump and deflation is neither necessary nor unavoidable, the medium-term fiscal outlook for the peripheral economies is much less unfavourable than currently assumed.

Real Exchange Rates (CPI based)



Source: ECB

Export Market Shares [a]



[a] Exports (goods + services) relative to imports in main trading partners
Source: EC AMECO

Weaknesses in the Euro Policy Framework

Nonetheless, the crisis has revealed weaknesses in economic policy framework and institutions, which failed to prevent the emergence of severe fiscal and other macroeconomic imbalances, failed to enhance fiscal discipline in Greece and rendered the euro zone vulnerable to the global financial crisis and downturn. Even in the absence of further integration and political and fiscal “union” — that is to say, a move towards a “United States of Europe” with a federal government — some dilution of sovereignty over national economic and fiscal policies will be necessary to secure the success of European monetary union. The Stability and Growth Pact (SGP) was materially weakened as a mechanism for imposing fiscal discipline and debt sustainability when France and Germany escaped sanction despite failing to adhere to the 3% of GDP limit on budget deficits for three consecutive years in 2004. Moreover, the current framework for economic policy coordination was too weak to prevent the emergence of large external imbalances within the euro zone.

The current debate among European policymakers on how to reinforce economic policy coordination within the EU and euro zone appears to be framed around the following principles.

- Greater focus on the sustainability of public finances, with a shift in emphasis from the annual 3% deficit limit in the SGP towards medium-term debt sustainability, including requiring more concerted effort by those member states to reduce public debt in line with the Maastricht 60% debt to GDP criterion.
- Strengthening mechanisms for the surveillance and enforcement of the SGP and realisation of medium-term budgetary objectives and debt sustainability and putting in place credible mechanisms to sanction member states that persistently breach the SGP ranging from the suspension of EU budgetary lending and voting rights to, in extremis, expulsion from the euro area.
- Greater peer review and possible amendment of national budgets before they are submitted and approved by national parliaments and enshrining in national

legal and constitutional frameworks medium-term compliance with the SGP and the 60% debt to GDP limit.

- Broader and strengthened surveillance of intra-euro area macroeconomic developments with a particular attention to addressing persistent external imbalances and divergences in competitiveness. The European Council could potentially have the authority to recommend structural as well as specific tax and spending measures that it believes are necessary at the national level to address and reduce such imbalances.
- Establishing permanent mechanisms for the provision of financial support to euro area member states in financial distress where such stress poses a risk to the financial stability of the euro area as a whole. However, to mitigate potential moral hazard risks, a mechanism for "orderly" sovereign debt restructuring has also been advocated.

The incorporation of some restraints on national budgetary freedom in national law as a means to strengthening fiscal discipline and debt sustainability within the euro area is a key feature of the governance discussions underway. The vulnerability of the euro area to the global financial crisis and economic downturn has revealed that at least some degree of fiscal sovereignty will have to be surrendered to ensure the success of European monetary union. Nonetheless, it will be very politically challenging for member states to reach agreement on specific and credible measures that would materially strengthen economic and fiscal policy coordination and surveillance but also dilute fiscal sovereignty. Although formal proposals will not be made until the autumn, the European Commission has recently outlined a "toolbox" for enhanced governance. This includes greater ex ante input from EU peers to national budget policies, explicit peer surveillance of external imbalances and, most importantly, stronger sanctions for non-compliance including the imposition of interest bearing deposits and the possible suspension or even cancellation of EU budget transfers.

Fitch believes that the risk of a break-up of the euro area in the medium term remains low, despite the macroeconomic imbalances and financial stress that the peripheral economies are currently facing, not least because of the policy response initiated in early May (see the following section). Moreover, the legal, financial and political obstacles to a break-up of the euro area are formidable — see Fitch's "*Sovereign Credit Crisis: Crisis of Confidence in the Euro Zone*" report, dated 21 June 2010, in *Related Research*. Nonetheless, it is also evident that far-reaching changes in the conduct of economic and fiscal policy at the national and euro area level will be required to dispel doubts over the long-run viability and success of European economic and monetary union.

Euro Policy Response

By the end of April, Greece had effectively lost access to capital markets as a result of the deteriorating fiscal and economic outlook for the country as well as the lack of policy credibility of the government. On 2 May, the IMF/EU/ECB announced a EUR110bn package of policy conditional financial support for Greece in the form of EUR80bn of bilateral loans from other euro area member states and EUR30bn from the IMF that would be disbursed together in accordance with an IMF stand-by arrangement. Despite ring-fencing Greece, at least in the short-term, contagion to other peripheral states, notably Portugal and Spain continued to escalate.

Over the weekend of 8-9 May, the EU, IMF and ECB announced a further series of policy actions in an effort to stabilise financial markets. The EU announced the creation of a temporary EUR500bn European Stabilisation Mechanism (ESM). The existing EU balance of payment facility available for non-euro area members of the EU was made accessible to euro area member states and expanded by EUR60bn funded out of the existing EU Budget. A new European Financial Stabilisation Facility (EFSF) was also announced that would access capital markets on the back of sovereign guarantees from all member states and lend as much as EUR440bn to those countries facing financing distress, which could be supplemented by as much as EUR220bn from the IMF, in addition to the EUR30bn already committed to Greece.

The ECB also announced that it would intervene in the euro area public and private debt securities markets. The ECB emphasised that purchases under its Securities Markets Programme did not imply the adoption of quantitative easing — the purchase of government securities funded by the creation of base money in an effort to expand the money supply. ECB purchases would be in those segments described as "dysfunctional" and any purchases would be "sterilised"; that is to say, the monetary impact would be offset by operations to withdraw liquidity elsewhere. In addition, the ECB re-activated measures to supply unlimited three- and six-month liquidity to banks and extended bilateral arrangements with the US Federal Reserve to provide USD liquidity to European banking markets.

In addition to the commitment to strengthen the euro area economic and fiscal policy framework, the Portuguese and Spanish governments announced that they would introduce further measures to strengthen their fiscal consolidation programmes as did Italy shortly thereafter. France and Germany have also detailed initiatives to strengthen the credibility of their fiscal consolidation programmes.

European Financial Stability Facility

The stated objective of the EFSF is to "collect funds and provide loans in conjunction with the IMF to cover the financing needs of euro area member states in difficulty, subject to strict policy conditionality". The EFSF is incorporated in Luxembourg and the shareholding of each member state will correspond to its respective share in the paid-up capital of the ECB. The implied weighted average rating of the shareholders is 'AA'. On a pro-rata basis, each participating member state will provide guarantees of up to 120% of its shareholding of the debt issued by the EFSF, while a cash reserve will also be created to further enhance the credit profile of the EFSF, with the objective of ensuring the best possible credit rating for EFSF's debt instruments.

Implied Shareholding and Guarantees Commitment to the EFSF

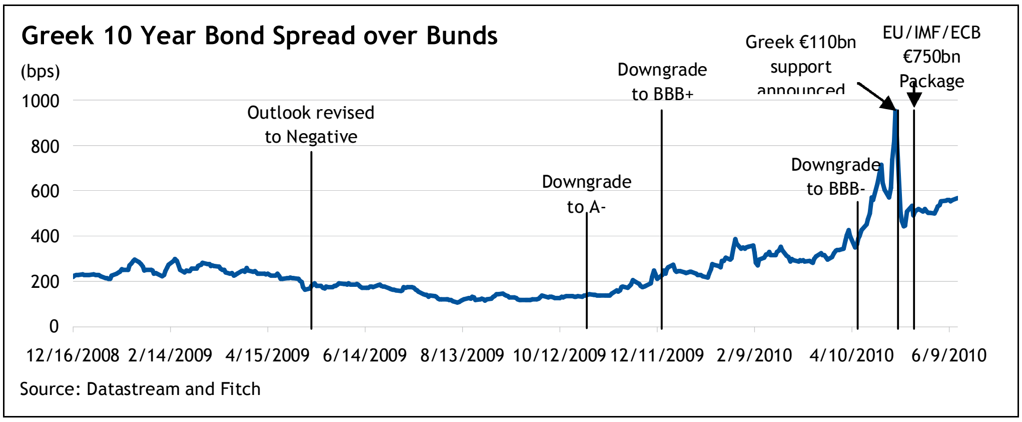
	ECB Capital key	% of ECB paid % capital	Pro-rata share of EUR440bn guarantee	Rating
Germany	18.9	27.1	119	AAA
France	14.2	20.4	90	AAA
Italy	12.5	17.9	79	AA-
Spain	8.3	11.9	52	AA+
Netherlands	4	5.7	25	AAA
Belgium	2.4	3.5	15	AA+
Greece	2	2.8	12	BBB-
Austria	1.9	2.8	12	AAA
Portugal	1.8	2.5	11	AA-
Finland	1.3	1.8	8	AAA
Ireland	1.1	1.6	7	AA-
Slovakia	0.7	1	4	A+
Slovenia	0.3	0.5	2	AA
Luxembourg	0.2	0.3	1	AAA
Cyprus	0.1	0.2	1	AA-
Malta	0.1	0.1	0	A+
	69.8	100	440	

Source: ECB and Fitch

The board of the EFSF will consist of the members of the Eurogroup Working Group and Mr Klaus Regling has been appointed as the chief executive officer. The EIB ('AAA') will provide treasury management services and operation support. The policy conditions attached to any loans provided by the EFSF will be negotiated by the European Commission in liaison with the ECB. At the time of writing, the terms of any lending have not been disclosed, though they are likely to be similar to those extended to Greece under its EU/IMF EUR100bn package — ie, three years and 300bp over three-month euribor (plus 50bps in charges). The EFSF is intended to be a temporary facility.

Why is Greece Still Investment Grade?

Prior to the downgrades to its ratings by Fitch commencing last October, Greece was rated 'A', the lowest rating by some margin of any euro zone economy. EMU membership, high GDP per capita — at USD31,900 in 2008 compared with a 'A' median of USD17,700 and a 'BBB' median of USD8300 — and low and stable inflation compared to peers were important supports to its rating (and remain so), offset by clearly identified weaknesses in public finances and a low national savings rate.



Fitch first warned of the deteriorating credit profile of Greece, in May 2009 when it revised the rating Outlook on the then 'A' rating from Stable to Negative. Following a near doubling of the expected budget deficit for 2009 to 12.5% of GDP (the latest estimate is 13.6% of GDP) and upward revisions in government debt, Fitch downgraded Greece to 'A-' with a Negative Outlook and again in December after review of the 2010 draft Budget by the new government. On the 9 April 2010, Greece was downgraded to 'BBB-' and the Negative Outlook maintained as the fiscal and economic outlook worsened, pressures on the banking system intensified and uncertainty over the fiscal and external financing strategy.

The EU/IMF EUR110bn financial support package announced for Greece at the beginning of May dramatically reduced the near-term liquidity and sovereign credit risk of Greece. The first EUR20bn disbursement (EUR14.5bn in bilateral loans from other euro member states and EUR5.5bn from the IMF) in mid-May allowed Greece to repay its remaining major EUR9bn bond maturity in 2010 on 19 May. Although the Greek government is still issuing small volumes of treasury bills to local banks, Greece is no longer reliant on the market for fiscal funding and its actual cost of funding is around 5% for loans with a three- to five-year grace period, followed by a three-year amortisation profile.

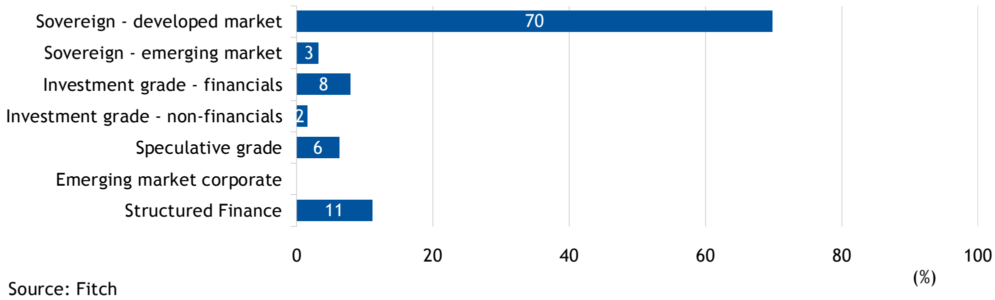
Following the announcement of the EU/IMF aid for Greece, Fitch stated that in the absence of material news, it would not actively review Greece's sovereign ratings until Q410 and retained the Negative Outlook indicating a greater than even probability of further rating downgrades. Given the greatly reduced near-term credit risk, Fitch judged that it would be best placed to add value with its research and rating opinions by conducting a substantive review of the risks to fiscal solvency and debt repayment over the short to medium term in the light of some months of performance under the EU/IMF programme. Current indications are that Greece is fully compliant with its IMF programme and the fiscal deficit is falling in line with target and the economy performing broadly as expected.

Fitch fully recognises that in the secondary bond and CDS markets Greek sovereign assets do not trade in a manner consistent with investment grade and Greece has lost access to market financing, reducing a key element of financing flexibility associated with investment grade status. Nonetheless, in the absence of news, it remains Fitch's judgement that deferring an active review of the rating for a few months until it is better placed to assess the performance and prospects for the Greek economy as well as the political will and capacity to sustain fiscal austerity and structural reform is more appropriate than taking an immediate action to reflect current market circumstances and sentiment.

Investors Concerned

Concerns about the euro area were underscored by Fitch's Q210 Investor Survey of European Senior Fixed Income (see the agency's "*European Senior Fixed Income Investor Survey Q210*" Special Report, dated 25 May 2010 in *Related Research*), in which 70% of investors identified developed-market sovereigns as facing the greatest refinancing challenge over the next 12 months out of any broad asset class, compared with only 3% for EM sovereigns.[2] Moreover, the proportion of investors expecting "significant" credit deterioration over the next 12 months nearly doubled to 19% compared with the Q110 survey. A total of 74% of respondents anticipated some degree of deterioration, remaining in the 70%-80% range which has prevailed since early 2009, while worries about most other asset classes have declined since Q110. Some 90% of investors saw contagion from developed-market sovereigns as posing the greatest risk to European credit markets over the next 12 months.

Fitch European Investor Survey: Q210
Greatest Refinancing Challenge Over the Next 12 Months Will be Faced by:



Source: Fitch

[2] This survey features 70 responses from the top 100 investing institutions in Europe, obtained during April 2010. See "*European Senior Fixed Income Investor Survey Q210,*" available under *Related Research* on front page

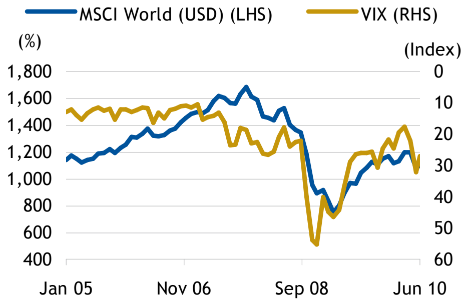
Downside Scenario: Could the World Sink Back into Crisis?

Global Markets Take Fright

Notwithstanding some firming towards the end of June 2010, global financial markets have witnessed a marked and broad-based sell-off since mid-April, primarily reflecting fears over euro area sovereign debt and a double-dip recession, as well as perhaps the pricing-in of tail risks such as the break-up of the euro area. The combination of the high level of uncertainty over the global economic and financial outlook, the severe if unlikely downside risks and the incentive to stay invested in risky assets given low bond yields means that periodic bouts of financial market volatility may be part of the landscape for the foreseeable future.

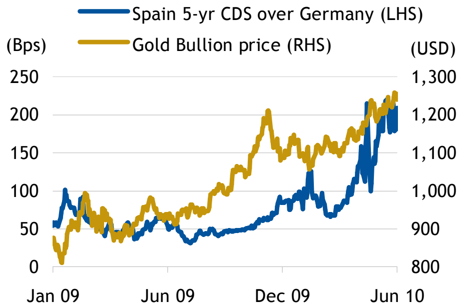
The Chicago Board Options Exchange (CBOE) Volatility Index (VIX) "fear gauge" spiked to 27 as of 22 June (after touching 35 earlier in the month) from an average of 17.6 in March 2010. The MSCI Global equity index has dropped 9% (16% in early June) since its recent high in mid-April, while traditional "risk on" assets, including some currencies, commodities and other markets have retraced some of their gains in the rally from Q109 lows. As in the post-Lehman period of "flight to quality", the US dollar and US Treasuries remain the world's pre-eminent "safe haven" assets, while the Swiss Franc, Bunds, UK Gilts and gold have seen price gains. Nevertheless the recent deterioration in markets and in confidence indicators has been far less pronounced than in late 2008.

Financial Markets Take Fright
Global equities and volatility index



Source: Morgan Stanley, CBOE and Datastream

Financial Markets Take Fright (2)
Sovereign debt and gold



Source: CMA, LME and Datastream

Downside Scenarios

A double-dip recession is not Fitch's base case, but risks are rising. While a full blown European sovereign debt crisis or break-up of the euro is a low probability event, it cannot be wholly discounted. This section fleshes out some of the issues.

Double-Dip Recession

As described in the sections above, robust growth momentum and extended accommodative monetary policy mean the global economy should be able to cope with the fiscal consolidation currently being mapped out by MAEs. However, a deepening loss of market confidence in euro area sovereign debt (or the fear that it could occur) could force governments into abrupt fiscal tightening before robust private sector demand has gained sufficient traction, leading to a double-dip recession in MAEs and double-dip slowdown in EMs.

A double-dip recession would create a negative feedback loop to public finances, bank asset quality and, in turn, financial market confidence. Political and social instability in relation to austerity measures or heterodox policy actions could compound risks. EMs would suffer a sharp slowdown in growth and macro-financial and sovereign credit risks would increase in the more vulnerable countries, particularly those in emerging Europe with strong ties to the euro area.

Full-Blown Sovereign Debt Crisis

A full-blown sovereign debt crisis or break-up of the euro zone would represent a crisis of a different magnitude. Advanced country sovereign defaults are without precedent in the modern era, let alone a default on or disappearance of one of the world global reserve currency assets in the form of the euro and euro area government bonds. This would likely spark extreme financial volatility. It would also impair the value and liquidity of some EM foreign exchange reserves — one of their main assets and credit strengths, as well as precipitating severe distress in dollarised banking systems that would leave few countries, if any, unscathed.

Potential Contagion From the Euro Area

To what extent could the euro area crisis trigger contagion to other countries in the event of the downside materialising? Contagion is normally considered to take place through three main channels: trade and growth, financial sector linkages and confidence.

Impact on Trade and Growth

Greek GDP is only 2% of total EU GDP and not, therefore, of economic significance on its own; while together the GDP of Greece, Ireland, Italy, Portugal and Spain add up to 35% of the euro area total and 27% of EU GDP. However, if the Greek sovereign debt crisis were to spread to the rest of the EU through financial sector exposures, forced fiscal tightening and a collapse in confidence, it would clearly have a major impact on other regions.

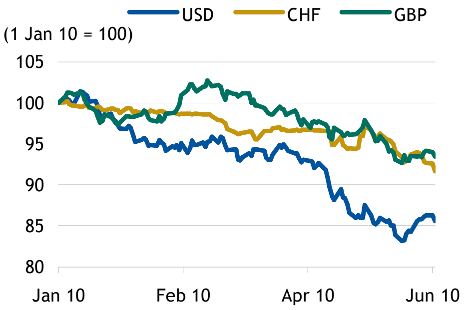
Not surprisingly, emerging Europe is the EM region most exposed to a slump in exports to the EU, as well as lower FDI inflows. The EU is the destination for some 60% of its merchandise exports. Within emerging Europe, Macedonia and Bulgaria are the two most exposed countries to Greece in terms of percentage of exports, at 13% and 9% respectively, although this is not of a systemic scale.

Exports to the EU

2009	% total goods
EM Europe	60
Switzerland	58
UK	55
Africa	33
US	21
EM Asia	18
LatAm	13
Middle East	13
Japan	12

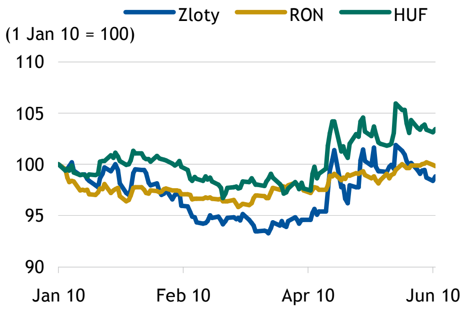
Source: IMF DOTS

Euro Depreciates Against USD



Source: Datastream

Euro Rises Against EM Europe



Source: Datastream

A loss of competitiveness against the euro — which has depreciated 14% against the USD and 7% against the Swiss franc since the beginning of the year — could compound the impact on trade, not just within the EU but also in third markets. The Swiss National Bank's revelation that its FX reserves (excluding gold) had increased by a staggering 49% in May 2010, from USD160bn to USD239bn, underlined its concern about the impact of the CHF appreciation. In contrast, countries in emerging Europe with flexible exchange rates have depreciated against the euro.

Banking and Financial Sector Linkages

A second channel for potential contagion is through common linkages in financial sectors, whereby credit losses or funding pressures leads to forced selling, balance sheet retrenchment or adverse confidence effects such as deposit flight, and spills over to other asset classes or regions. The Greek, Portuguese and Spanish Bank Claims table provides a summary of their claims on different regions and countries as one measure of exposure, in that funding pressures at these European banks could lead them to seek to cut credit to entities in those other countries.

Greek, Portuguese and Spanish Bank Claims

% GDP of region or country	Greek	Portuguese	Spanish
Regions			
Middle East and Africa	0.1%	0.5%	0.2%
Latin America	0.0%	0.2%	10.0%
Emerging Europe	2.6%	0.5%	0.3%
Emerging Asia	0.0%	0.0%	0.1%
Developed Europe	0.4%	0.7%	4.5%
Selected countries			
Angola	0.0%	4.5%	0.4%
Argentina	0.0%	0.1%	4.5%
Brazil	0.0%	0.5%	9.3%
Bulgaria	36.7%	0.0%	0.2%
Cape Verde	0.0%	46.8%	0.8%
Chile	0.0%	0.1%	32.9%
Cyprus	44.6%	0.8%	0.4%
Luxembourg	27.9%	6.8%	23.0%
Macedonia, FYR	19.8%	0.0%	0.0%
Mexico	0.0%	0.0%	14.8%
Mozambique	0.0%	25.3%	0.1%
Romania	15.6%	0.4%	0.2%
Serbia	16.4%	0.0%	0.0%
United States	0.0%	0.1%	1.4%
United Kingdom	0.8%	0.5%	18.8%

BIS foreign claims of reporting banks, December 2009. Data on a consolidated basis, (Table 9B) i.e. contractual lending by head office and all its branches and subsidiaries on a worldwide consolidated basis, net of inter-office accounts, not purely cross-border lending.

Source: BIS and Fitch

Few countries in emerging Europe have significant exposure to Greek, Portuguese or Spanish banks. The main exception is the exposure of Bulgaria and to a lesser extent Macedonia, Serbia and Romania to Greek banks. This largely reflects the operations of local (legally separate) subsidiaries of Greek parent banks. Even though loan-to-deposit ratios are well over 100% in Bulgaria, Serbia and Romania, it would be difficult for parent banks to rapidly cut exposure as loans cannot be quickly recalled and local regulators would step in to prevent a destabilising withdrawal of funding or capital. Furthermore, these operations remain profitable.

The other noteworthy numbers are the exposure of Chile, Mexico and Brazil to Spanish banks. However, these Latin America operations are important parts of parent banks' global diversification strategies, provide important profits streams and are self-funded operations that operate primarily in local currency, with minimal funding flows from their parents.

Another potential source of contagion is an abrupt exit of "hot money" that can cause stress on local securities markets, exchange rates and FX reserves. Hungary and Poland, and to a lesser extent Turkey, are countries where European-based non-resident investors hold a significant proportion of domestic government debt.

Confidence

An escalation of the euro area sovereign debt crisis would likely intensify market sensitivity to and scrutiny of public finances. Countries with large budget deficits, high public debt levels or large financing requirements could come under heightened pressure. Overall, EM countries have lower budget deficits and debt ratios than advanced countries, but there are important exceptions (see *Public Finances: EMs Versus "Advanced Countries"*).

Major financial turbulence and currency volatility could expose countries with substantial external financing needs and foreign-currency exposures in domestic banking systems and only moderate levels of FX reserves, as post-Lehman.

Weaker global activity and flight out of risky assets would likely trigger a plunge in commodity prices, with adverse implications for major producers that are dependent on commodities for budget and export revenues.

Public Finances: EMs Versus "Advanced Countries"

EM economies generally have lower government deficits and debt ratios than mature economies, providing support to their sovereign creditworthiness. In addition, their stronger growth prospects make debt dynamics more favourable.

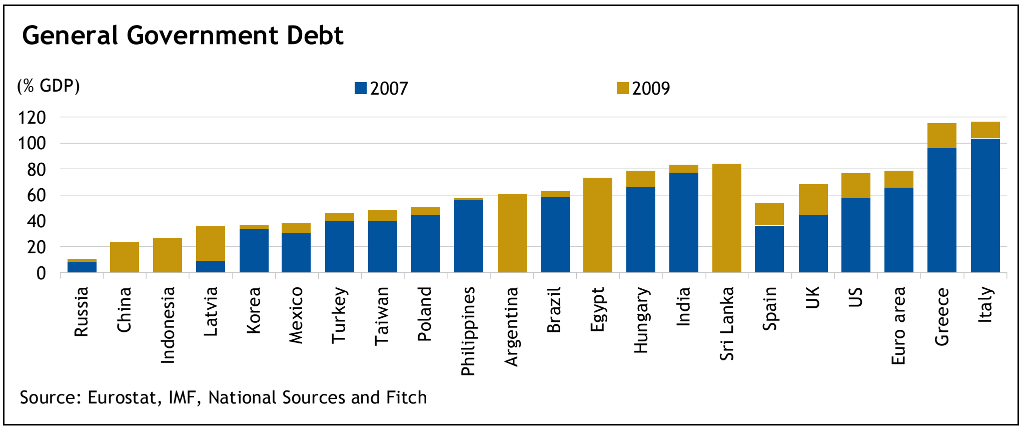
Public Finances in Emerging Markets

% GDP	General Govt debt (end-2009)	General Govt debt % Revenue (end-2009)	Govt balance (2009)	Govt balance (2010f)	Debt maturities (2010)
EM Total	37.6	143	-4.4	-3.5	n.a.
Largest 10					
China	23.7	114	-2.9	-2.5	1.6
Brazil	62.8	165	-3.4	-2.8	8.1
India	83.0	400	-10.1	-10.3	6.5
Russia	10.6	31	-6.2	-4.5	0.9
Mexico	38.3	212	-2.7	-3.0	6.0
Korea	36.9	154	-1.7	-1.0	3.7
Turkey	45.7	213	-6.7	-4.7	14.1
Indonesia	26.6	172	-1.5	-2.1	2.0
Poland	51.0	137	-7.1	-6.5	9.0
Taiwan	47.9	310	-5.8	-3.8	7.0
Selected other					
Lebanon	148.0	606	-9.1	-8.4	35.4
Sri Lanka	83.9	549	-9.5	-8.7	18.4
Israel	79.4	211	-6.5	-5.6	8.4
Hungary	78.3	171	-4	-4.2	12.5
Egypt	73.2	263	-7	-8.2	11
Argentina	60.8	177	-0.7	-1.1	5
Philippines	57.3	392	-3.9	-3.9	12.8
Malaysia	53.7	228	-6.2	-5.9	4.7
Latvia	36.1	107	-9.0	-8.5	2.7
South Africa	33.1	103	-7.5	-6.4	3.2
Memo					
US	76.4	289	-11.1	-8.5	20.2
Euro area	78.7	177	-6.3	n.a.	n.a.
UK	68.1	167	-11.2	-10.1	8.0
Germany	73.2	165	-3.3	-5.5	7.8
France	77.6	161	-7.5	-8.1	10.3
Italy	115.8	248	-5.3	-5.0	21.5
Spain	53.2	153	-11.2	-9.4	6.0
Greece	115.2	313	-13.6	-8.1	22.7
Japan	201.0	634	-8.8	-9.0	52.3

Source: Eurostat, IMF, National sources and Fitch

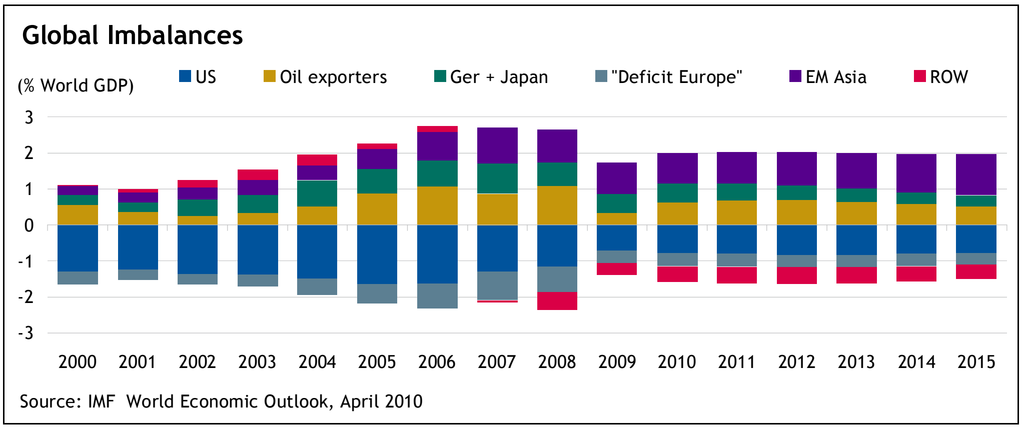
Nevertheless, weak public finances are not the exclusive preserve of developed countries: Lebanon, Jamaica and the Seychelles had general government debt ratios of over 100% of GDP at end-2009 (debt restructuring will reduce it in the Seychelles); while in Sri Lanka, India, Hungary and Egypt, it exceeded 70%. Jamaica, Sri Lanka, India, Ghana, Georgia, Lebanon, Angola, Latvia, Lithuania, Vietnam, Ukraine and Romania all had general government deficits above 8% of GDP in 2009.

Moreover, the difference between EM and mature economies is far less clear cut in terms of government debt-to-revenue ratios rather than government debt-to-GDP ratios. In addition, many EMs have economies and public finances that are more susceptible to shocks and have lower "debt tolerance" than developed countries. In terms of public finances, many have a higher proportion of government debt in foreign currency, shallower local debt markets and more limited financing options (and lack benchmark borrower and reserve currency status), and some have more recent default histories. In broader terms, they generally have poorer and less diversified economies and tax bases, weaker institutions and governance, greater risk of political shocks, and higher inflation and macroeconomic volatility[3].



Global Imbalances

Part of the origin of the global financial crisis was the savings glut in current account (CA) surplus countries (primarily China, EM Asia, Japan, Germany and oil exporters) combined with large-scale exchange rate intervention that recycled "excessive" capital to countries with CA deficits (primarily the US plus much of southern and eastern Europe, and the UK) bidding down the cost of capital and fuelling risk appetite and asset price bubbles. The confidence and willingness of savers to acquire claims on the borrowers was heightened by the fact that the main CA deficit countries had global reserve currencies — mainly the US, but also southern European countries in the euro area, and the UK. To what extent are global imbalances being unwound and is this compatible with global economic recovery?



The world cannot both grow faster and reduce CA imbalance without an increase in domestic demand and a reduction in the net savings rate in countries running CA surpluses. The emerging evidence of a re-orientation of the Chinese economy towards greater domestic demand, including consumption, and away from net exports is an encouraging trend. China's CA surplus fell from 10.8% of GDP in 2007 to 6.1% in 2009 and, Fitch forecasts, 5.5% in 2010. The People's Bank of China's recent announcement that it "has decided to proceed further with reform of the CNY exchange rate regime and to enhance the CNY exchange rate flexibility" is also encouraging, although Fitch expects only a moderate and gradual appreciation against the USD of around 3% by the end of the year. Fitch expects ongoing Chinese

[3] See "*Sovereign Rating Methodology*" in *Related Research*

efforts to stimulate domestic consumption by permitting faster wage growth to make a more significant contribution to rebalancing.

Currency adjustment may also be part of the equation of reducing CA deficits in Europe, including the UK. Southern European euro area members may not be able to depreciate against Germany, but the fall in the euro may be a "second-best" solution to a lack of competitiveness and sluggish growth, although ironically Germany with its export-orientated economy may be the chief beneficiary. The reduction in cross-border capital flows between developed countries has been greater than from developed countries to EMs, which is adding to adjustment pressures in developed countries with large CA deficits.

Nevertheless, Fitch expects CA imbalances to persist, albeit not on the same scale as seen in 2005-2008. Of course, CA deficits and surpluses can be rational for different countries at different times, depending on investment opportunities and demographics. However, it is not obvious why fast-growing emerging markets with relatively young populations and already high stocks of precautionary savings should be exporting capital to slower growing developed countries.

Could the IMF Run Out of Fire Power?

The inclusion of a contribution of EUR250bn (EUR220bn on top of the commitment to Greece) from the IMF in the headline figure of EUR750bn in the 10 May announcement on the European Stabilisation Mechanism has again raised questions about how much capacity the IMF has left to act as lender of last resort to crisis-hit sovereigns. The G20 Heads of State Summit on 2 April 2009 announced a tripling in the IMF's lending capacity to USD750bn[4]. However, this headroom has been rapidly eroded by commitments to sizeable stand-by arrangements (SBAs) to numerous crisis-hit emerging markets (mainly in emerging Europe) as well as precautionary flexible credit lines (FCLs) available without policy conditions for countries with strong economic fundamentals.

IMF Financial Resources and Liquidity Position

End-May 2010	(USDbn)
Usable resources	455
O/w committed	116
Uncommitted	339
Plus repurchases one-year forward (ie repayments)	4
Less Prudential balance	104
One-year forward commitment capacity	**238**
Memo: EU stabilisation mechanism "contribution"	272

Source: IMF and Fitch

The IMF's headline measure of its capacity to lend is its one-year ahead forward commitment capacity (FCC), which stood at USD238bn at end-May 2010 (see side table). However, if the EUR220bn is included as a commitment equivalent to undrawn balances under General Resource Account (GRA) arrangements (ie, amounts committed but not yet disbursed in IMF programmes) then the IMF would have a shortfall in its FCC (which also sets aside a large prudential balance to safeguard the liquidity of its creditors' claims).

However, the EUR250bn allocation to the EU appears unlikely to be drawn in its entirety and certainly not within 12 months. John Lipsky, first deputy managing director of the IMF, described the amount as "a hypothetical or theoretical number" and "as opposed to the creation of the [European Stabilisation] Mechanism that has a very specific amount that will be created through the special-purpose vehicle… our participation would be determined on a case-by-case basis and at the request of our member countries" and "we have never said 250, per se" and "I cannot conceive that the IMF would be unable to fulfil its responsibilities because of a shortage of funding"[5]. Although these elucidations provide some reassurance about the amount of ammunition the IMF retains in its locker, it casts a somewhat

[4] The exact mechanism of the expansion in resources was fleshed out and evolved through intermediate steps. It comprises a general Special Drawing Right allocation of USD250bn and an expansion of the New Arrangement to Borrow (NAB) from around USD50bn to USD550bn. The proposal for the expanded and more flexible NAB was approved by the IMF Board on 12 April 2010 though is yet to be ratified by domestic legislative bodies in all participating countries. As an intermediate step the IMF tapped bilateral loans including Japan (USD100bn), various EU countries (USD100bn) Canada (USD10bn), Norway USD4.5bn and Switzerland (USD10bn); and issued new IMF notes to governments or central banks, including China (USD50bn, Brazil (USD10bn), India (USD10bn) and Russia (USD10bn).

[5] "*Transcript of a Press Briefing by the IMF First Deputy Managing Director John Lipsky on the Euro Countries Stabilization Measures,*" IMF 10 May 2010

less favourable light over the amount of "real money" on the table out of the impressive headline EUR750bn announced in the EU financial package.

In any case, Fitch concurs that the IMF would be likely to be able to raise additional funding to support its operations if necessary, whether through the NAB, new general SDR allocation, bilateral loans or note issuance. One caveat, however, is that tensions over shareholdings and governance of the IMF between EM and developed countries could increase in the event of large disbursements with generous conditionality to EU counties (which have IMF shareholdings disproportionate to the size of their economies).

Emerging Market Overview

Macroeconomic Outlook

Most EM economies have had a "good" financial crisis (relative to MAEs) in terms of their resilience to the initial shock, containing the adverse impact on their sovereign balance sheets and preserving favourable growth prospects. In the process they have outperformed both advanced countries and prior expectations, accelerating the secular shift of global economic and political power away from developed countries (and the G7) to EMs (and the G20).

Emerging Markets
Key Indicators

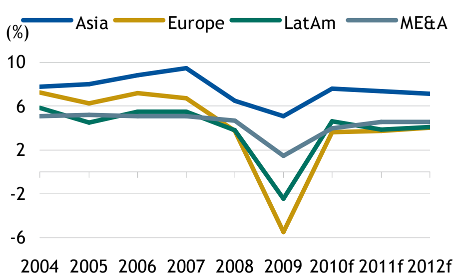
(USDbn)	2009	2010f
Real GDP growth (%)	0.9	5.8
Inflation (%)	4.0	5.1
Gov bal (% GDP)	-4.4	-3.5
Gov debt (% GDP)	37.6	37.9
Current account bal	435	421
% GDP	2.5	2.1
Ext debt service	714	781
% CXR[a]	11.4	11.0
Net external debt	-3,854	-4,367
% CXR	-61.7	-61.5
Net public ext debt	-4,623	-5,205
% CXR	-74.0	-73.3
FX reserves	5,950	6,604

[a] Current external receipts
Source: Fitch

As discussed in previous "*Sovereign Review and Outlook*" reports, the fortitude of most EMs to the severe external and financial shock owes much to the accumulation of large FX reserves by EM central banks, which allowed them to provide foreign-currency liquidity to domestic financial systems and to cut interest rates, without precipitating a collapse in exchange rates or macro-financial crises. In many cases, EM banking systems benefited from clean-ups following previous home-grown crises. In addition, the steady decline in public debt ratios in the boom years and reduced dependence on international capital markets provided the space for many EM governments to implement counter-cyclical fiscal policy to support growth.

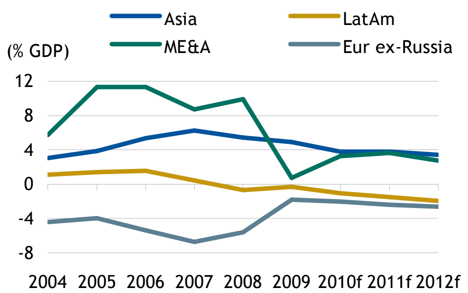
Fitch forecasts EM GDP growth to bounce back strongly to 5.8% in 2010 (up from 4.9% at the time of the December "*Sovereign Review and Outlook*") from 0.9% in 2009, driven by the recovery in global trade and GDP, supportive global and in many cases domestic fiscal and monetary policy stimulus, the increase in commodity prices, a positive contribution from inventories and favourable base effects from the quarterly path of 2009 GDP. It projects GDP growth at a similar rate of 5.6% in 2011 and 2012, as some temporary effects fade, but are offset by a strengthening in private-sector-led domestic demand.

EM Regional Growth Forecasts
% change in real GDP



Source: Fitch

EM Regional Current Accounts

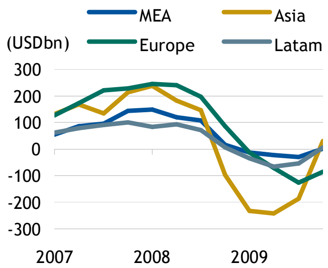


Source: Fitch

This would represent a largely benign resumption of trend growth to not far below pre-crisis rates. EM annual average GDP growth was 6.8% in the five years to 2007, during which many EMs started to overheat and grow above potential. Most EM regions have smaller banking systems and moderate levels of private sector debt and so are not so exposed to deleveraging as developed countries. Furthermore, most are running CA surpluses and are not, therefore, dependent on net external financing to fund investment and growth. Nevertheless, as EMs gain in economic weight, they will need to re-orientate to domestic consumption and away from exports to developed countries to maintain GDP growth rates. Overall, Fitch expects the reduction in CA imbalances achieved in 2009 to be broadly sustained, but for there to be little further improvement this year or thereafter.

However, it will be a multi-speed recovery. Asia will continue to set the pace, growing by some 7.6% in 2010, followed by Latin America at 4.6% and the Middle East and Africa at 4%. Fitch expects a more subdued recovery in most countries in emerging Europe, as they are more exposed to weak growth in the EU — their main export market — and can expect much lower levels of capital inflows (which mainly came from western Europe) and credit growth, which were key elements of its pre-crisis growth model. Nevertheless, Fitch forecasts GDP growth in the region to rebound to 3.6% in 2010 from -5.5% in 2009, helped by a stronger performance in Russia and Turkey, the two largest economies in the region.

BIS Banks' Claims by Region
Exchange rate adjusted, 4Q MA



Source: BIS and Fitch

Capital Flows and External Financing

EM economies as a whole are continuing to run large CA surpluses and attract more than enough capital inflows to meet debt amortisation and accumulate substantial volumes of foreign exchange reserves. Fitch projects EM economies to run a CA surplus of around USD421bn in 2010, and to increase FX reserves by another USD654bn to some USD7274bn. However, the aggregate numbers conceal important regional and country-specific differences. Emerging Europe remains the region with the largest external financing needs, which Fitch projects at round USD269bn in 2010 (CA deficit plus medium- and long-term amortisation, excluding countries with negative financing needs), and the most vulnerable to renewed financial market distress and reduction in cross-border capital flows.

Emerging Markets External Financing Requirement

(USDbn)	2008	2009	2010f	2011f	2012f
Current account balance	555.4	435.1	420.6	451.6	395.2
O/w Asia	446	427	380	439	452
Europe	-45	10	25	8	-19
LatAm	-27.9	-13.6	-46.6	-73.0	-101.0
ME&A	182.9	11.5	62.2	77.5	63.4
MLT amortisation	496.8	520.4	577.2	571.7	533.2
O/w Asia	107.7	121.6	161.0	163.9	158.7
Europe	259.2	264.8	282.2	282.8	247.1
LatAm	95.9	97.7	97.8	88.8	87.1
ME&A	34.5	36.8	36.7	36.8	41.0
Financing needs[a]	648.9	489.1	588.2	624.7	669.1
% of reserves	37.9	26.2	24.1	27.5	27.6
O/w Asia	90.2	43.9	104.1	99.4	118.8
Europe	342.3	261.7	269.1	288.6	281.1
LatAm	155.6	120.1	155.9	174.4	197.5
ME&A	60.8	63.4	59.2	62.3	71.7
Net equity FDI	350.2	165.2	187.1	192.8	198.5
Short term debt	1,481	1,447	1,503	1,564	1,641
Stock of FX reserves, including gold	5,193	5,950	6,604	7,274	7,893

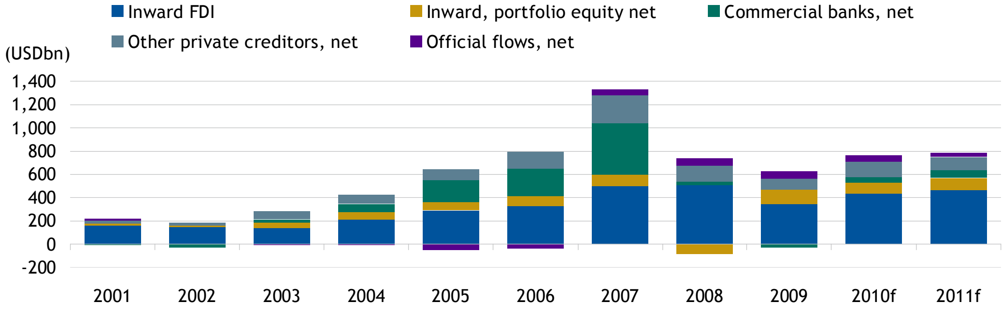
Source: Fitch

2010 Sovereign International Bond Issues

(USDbn)	YTD	Total, forecast
LatAm o/w	6.6	17.6
Brazil	0.8	4.0
Chile	0.0	1.5
Colombia	0.8	1.3
Dom. Rep.	0.8	0.8
El Salvador	0.0	0.8
Mexico	3.0	3.0
Panama	0.0	0.5
Peru	1.3	1.3
Uruguay	0.0	0.5
Venezuela	0.0	4.0
Asia o/w	5.3	8.3
Indonesia	2.0	2.8
Malaysia	1.3	1.3
Mongolia	0.0	0.5
Philippines	1.1	2.0
Sri Lanka	0.0	0.8
Vietnam	1.0	1.0
EMEA o/w	30.3	40.5
Russia	5.5	5.5
Turkey	5	5.5
Poland	6.4	8.4
Hungary	2	2
Czech Rep	0	1.28
Lithuania	2	3.5
Romania	1.4	2.5
Croatia	0	1.28
Kazakhstan	0	1
Lebanon	1.2	1.2
South Africa	2	2
Israel	2	2
Egypt	1.5	1.5
Bahrain	1.3	1.3
Angola	0	1
Nigeria	0	0.5
Total	42.3	66.3

Source: Dealogic and Fitch

Capital Inflows to Emerging Markets

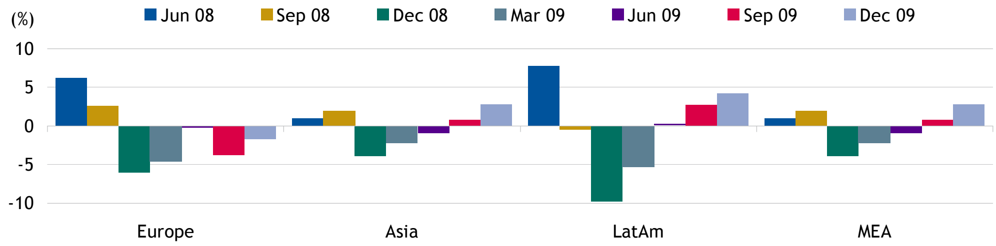


Source: IIF

Latest BIS data show a strengthening recovery in international banking flows to EM economies, with exchange rate adjusted inflows rising 3.1% in Q409 (qoq), after 0.2% in each of Q309 and Q209, following the precipitous drop of over 15% in Q408 to Q109. However, this data pre-date the return of global risk aversion. Emerging Europe was the only region to record declines in both Q309 and Q409. This probably reflects three factors: weaker near-term growth prospects; a counterpart to Q408 and Q109 when the region saw the shallowest percentage declines (in part owing to commitments by Western parent banks to maintain exposure); and on-going large net repayment of external debt by Russian banks (USD25.6bn in H209).

Changes in BIS Bank Flows by Emerging Market Region

% change on previous quarter

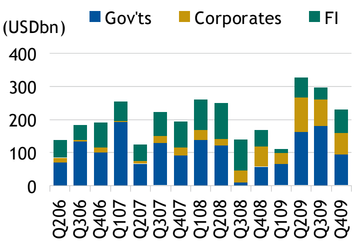


NB exchange rate adjusted change expressed as a percent of previous quarter stock of BIS banks' claims by region
Source: BIS

Banking sector de-leveraging and increased "home bias" means the international bond market has been an important source of funds for EM corporates, particularly from countries where domestic security markets remain relatively under-developed. Dealogic data, up to late-June, show strong year-to-date EM international bond issuance. Non-sovereign EM issuers have raised some USD73bn in H110, up from USD46bn in H109, albeit down from USD92bn in H209. However, weekly data show

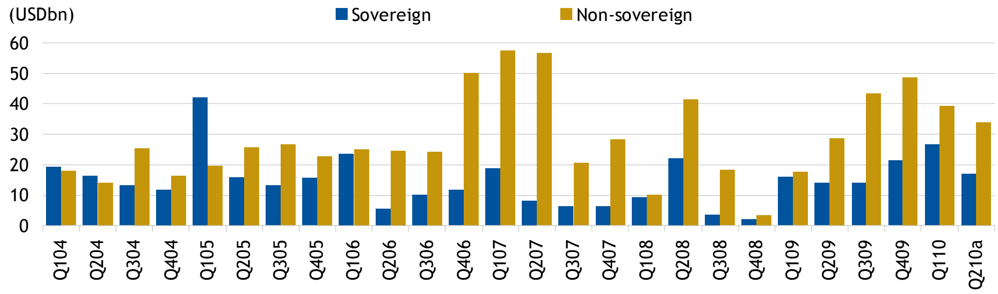
EM Domestic Debt Securities

Net issuance



Source: BIS

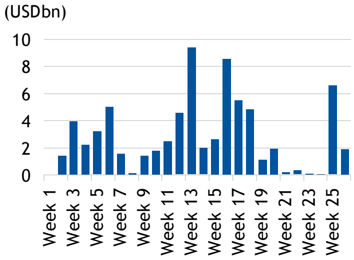
EM International Bond Issuance



Q210 is up to 15 June 2010
Source: Dealogic, Fitch

that market activity ground to a halt for several weeks in the wake of the financial market distress related to the euro area, before reviving in late June. If the market closes then it will starve companies of funds for investment needed to support real activity as well as debt service. This may be an early piece of evidence of how EM economies are far from immune from the ill health of developed countries.

EM Non-Sovereign Bonds
International issuance



Source: Dealogic

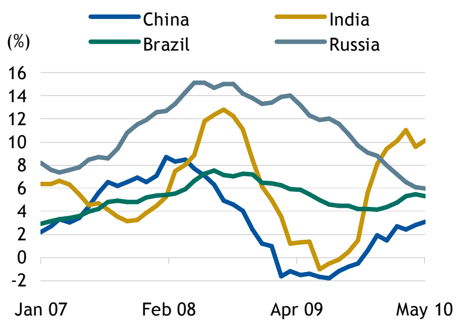
EM sovereigns have also been active in the global bond market, raising USD42bn in H110, up from USD30bn in H109 and USD36bn in H209. Fitch forecasts total 2010 EM sovereign global bond issuance of USD66bn, although some issuers in Latin America look to be behind the clock. The surge in issuance reflects the need to finance larger budget deficits, desire to lock-in low USD and EUR interest rates (and, in Q1, risk premiums) and to avoid crowding out the private sector from local markets.

EM corporates were able to expand their issuance of debt securities in domestic debt markets in Q209 to Q409, according to BIS data, without being crowded out by the increased weight of government borrowing. Nevertheless, local markets remain relatively small in most EMs so that non-sovereign borrowers are vulnerable to a persistence dislocation in international capital markets.

Inflation Risk Lurks for Emerging Markets

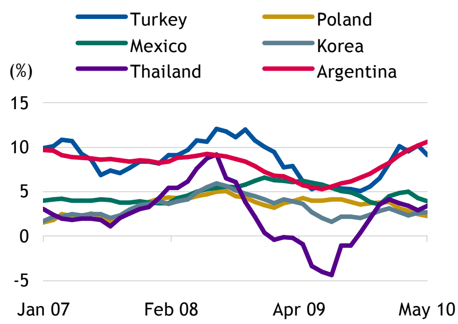
Strong domestic demand growth in EMs should help the world economy to grow and rebalance. However, in several countries in Asia and Latin America, there are signs of overheating that may require some tightening in macroeconomic policy in the near term, from current exceptionally accommodative settings, to avoid inflation re-emerging and sowing the seeds of the next asset bubble. Fitch forecasts Asia's annual average inflation rate to increase to 4.2% in 2010, from 1.1% in 2009. Some EM policy makers appear to be holding back from exiting stimulus mode on lingering fears over the strength of the global recovery. Moreover, slower and shallower global monetary policy tightening in MAEs will add to risks of inflation in EMs, unless they are willing to implement more independent monetary policies and tolerate greater exchange rate appreciation.

Inflation: BRICs



Source: Datastream

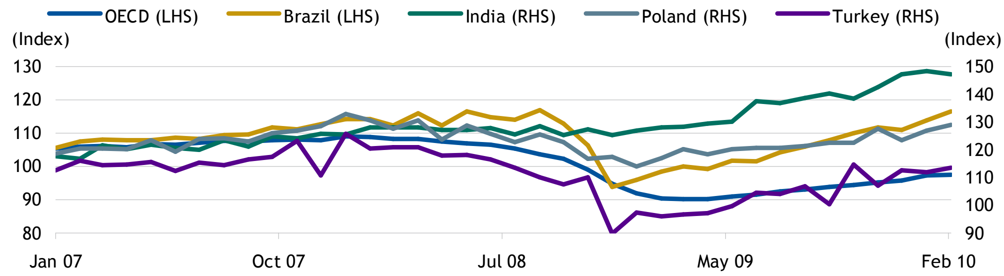
Inflation: Selected EMs



Source: Datastream

Moreover, major EMs joined MAEs in implementing large fiscal stimulus programmes, cuts in bank reserve requirements and other "anti-crisis" measures to prevent a second Great Depression. Yet in most EMs, annual GDP did not contract at all but merely suffered a temporary slowdown in growth. As a result, output gaps are much smaller and downward pressure on inflation is much less than in MAEs.

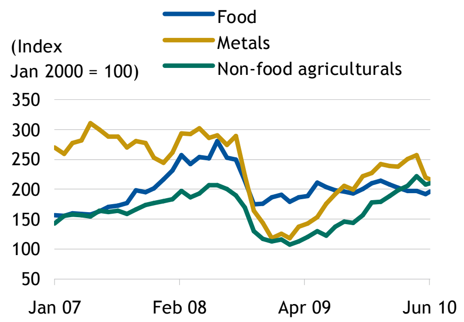
Industrial Production: Emerging Markets and OECD
Index 2005=100, seasonally adjusted, excluding construction



Source: OECD

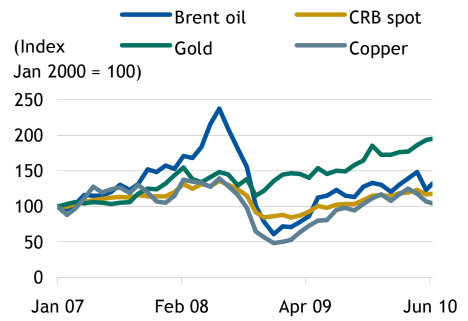
Notwithstanding a modest recent dip, the broad-based rise in commodity prices from lows in Q109 is also signalling strengthening activity in EMs. Commodities are a cause as well as an effect of inflation in EMs as food in particular has a high weight in CPI baskets; and the rebound in commodities explains part of the pick-up in headline inflation rates over the past 12 months or so.

Commodity Prices



Source: Economist

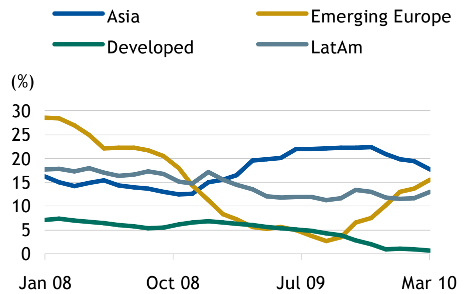
Commodity Prices



Source: CRB, LME, Datastream and Fitch

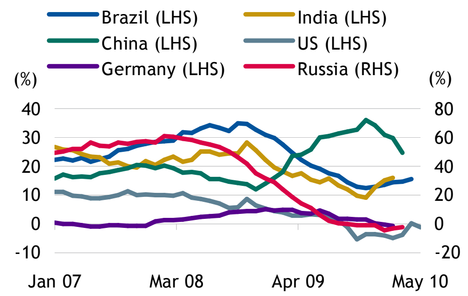
In most large EMs (including Brazil, China and India), broad money growth and bank credit growth to the private sector are also outpacing rates in developed countries. Fitch estimates broad money (M2 where available) grew by a (weighted) average of 18% in the 12 months to March 2010 in emerging Asia, compared with just 1% for developed countries. Both China and Vietnam saw bank credit to the private sector surge by over 30% in real terms in 2009, moving them to Fitch's highest risk category (MPI 3) on its macro-prudential indicator. The MPI 3 reading for China in particular chimes with increased concerns among Fitch's sovereign and bank analysts about the country's excessive credit growth and property bubble.

Broad Money Growth



Regions based on 2008 GDP weights
Source: IMF and Fitch

Bank Private Credit Growth



Source: IMF, National Sources and Fitch

Latest inflation rates paint a mixed picture across major EMs. In some countries, including Turkey, Argentina, Nigeria, India, Venezuela and to a lesser extent Saudi Arabia it has picked up sharply or is running at fairly elevated levels, albeit partly reflecting the surge in commodity prices and indirect tax or administered price rises. Such countries risk getting behind the curve in the event of further inflationary surprises or adaptive price expectations. Fitch believes Brazil and Mexico are in danger of missing their inflation targets this year. In other countries, latest inflation prints remain low (including South Korea (Korea), Poland, Taiwan and Colombia) or are declining from higher levels (including Russia, Ukraine and South Africa), but the pressures described above could translate into upward pressures and dictate that central banks stand ready to tighten policy rates if required.

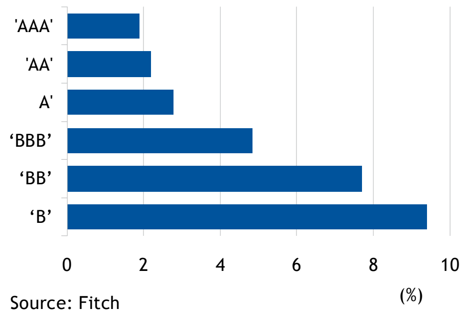
Inflation in Largest 15 Emerging Markets

	Latest CPI	Month	Target[a]	Policy rate	Real interest rate
China	3.1	May	3	5.3	2.2
Brazil	5.3	May	4.5 +/-2%	10.25	5.0
India	10.2[b]	May	n.a.	3.75	-6.5
Russia	6	May	n.a.	7.75	1.8
Mexico	3.9	May	3 +/-1%	4.5	0.6
Korea	2.7	May	3	2	-0.7
Turkey	9.1	May	6.5	7	-2.1
Indonesia	4.2	May	4 - 6	7.25	3.1
Poland	2.2	May	2.5 +/-1%	3.5	1.3
Taiwan	0.7	May	n.a.	1.375	0.7
Saudi Arabia	5.4	May	n.a.	0.25	-5.2
Venezuela	32	May	n.a.	14.5	-17.5
South Africa	4.8	April	3-6	6.5	1.6
Thailand	3.4	May	1.75[c]	1.25	-2.2
Colombia	2.1	May	2 - 4	3	0.9

[a] End-2010 if time specific; [b] Wholesale price index; [c] Target is core inflation
Source: Datastream, National sources and Fitch

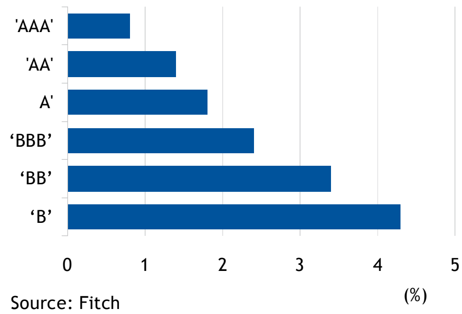
At times, financial markets have sold off sharply on announcements of policy tightening measures aimed at countering inflation — presumably on the basis of weaker growth expectations and a higher discount rate. However, inflation can have an insidious impact on sovereign creditworthiness by heightening macroeconomic volatility, eroding the real value of local-currency assets, encouraging a flight into foreign assets and increasing the risk of exchange rate and banking crises. Fitch would, therefore, view appropriate policy tightening measures that help to prevent GDP growing above potential and inflation picking-up as positive for macroeconomic stability, medium-term growth prospects and creditworthiness. Conversely, a failure by EM policy-makers to act in time to prevent an increase in inflation, overheating, asset bubbles and macro-financial instability could lead to negative rating actions.

Consumer Price Inflation
Five-year average 2005-2009



Source: Fitch

Consumer Price Inflation
10-year standard deviation



Source: Fitch

2010 and 2011 Elections

Country	Type	Scheduled date
Poland	Presidential, 2nd round	4 Jul 10
Latvia	Parliament	2 Oct 10
Brazil	Presidential, 1st round	3 Oct 10
Brazil	Presidential, 2nd round	31 Oct 10
Azerbaijan	Parliament	7 Nov 10
Egypt	Parliament	Nov 10
Estonia	Parliament	Mar 11
Nigeria	Presidential	Apr 11
Nigeria	Parliament	Apr 11
Peru	Presidential	Apr 11
Guatemala	Presidential	Aug 11
Egypt	Presidential	Sep 11
Poland	Parliament	Oct 11
Croatia	Parliament	Oct 11
Bulgaria	Presidential	Oct 11
Argentina	Presidential	Oct 11
Cameroon	Presidential	Oct 11
Turkey	Parliament	Nov 11
Russia	Parliament	Dec 11

Source: Election Guide

Capital Controls Back on the Menu, But Not Necessarily a Popular Choice

Brazil's imposition of a 2% tax on short-term foreign portfolio investments and an influential IMF Staff paper has reignited the debate on the merits of capital controls[6]. Capital inflows are generally beneficial in that they allow countries with low savings to increase investment and GDP growth, as well as in some cases boosting technological transfers and trade. However, they can be detrimental in circumstances where they are large, temporary and reflect global interest rate differentials ("carry trade", "hot money", etc) rather than economic fundamentals, and when borrowers and lenders do not make far-sighted decisions. Adverse effects can include exchange rate overshooting (with a long-term impact on the trade sector), credit booms, asset bubbles and macro-financial instability. Capital controls can be a solution to the "impossible trinity": that economic policy cannot achieve more than two of three out of a fixed exchange rate, an independent monetary policy and an open capital account.

Controls can include "indirect controls" such as fiscal measures or macro-prudential measures such as differential reserve requirements on non-resident or foreign currency borrowing, rather than necessarily blanket barriers or limits on volumes. And they can be targeted on less desirable forms of inflows such as foreign currency debt rather than FDI. Moreover, restrictions on capital inflows are less damaging than on outflows that can have a long-lasting impact on investor confidence.

The IMF authors argue that in such cases, if more conventional policy responses such as lower interest rates or tighter fiscal policy are undesirable, then capital controls can be a justified as part of the policy toolkit, if:

- capital inflows are likely to be transitory;
- the economy is operating near potential;
- the exchange rate is not undervalued;
- foreign exchange reserves are adequate (or sterilisation costs prohibitive).

Fitch does not view many countries as obviously meeting these conditions at the moment and does not anticipate a rush of countries imposing major capital controls, although some may deploy macro-prudential measures to discourage FX lending. However, assuming the global recovery takes hold and output gaps close, then more may meet these conditions.

Russian Deputy Prime Minister Igor Shuvalov said in May that Russia may decide, by the end of 2010, to impose higher bank reserve requirements on short-term foreign borrowing. The Korean government is also mulling curbs on banks' short-term external borrowing. For years, India has set an annual cap on portfolio debt inflows and has restricted non-residents' bank deposits. China continues to monitor and restrict capital flows, especially outflows, including limiting investment in portfolio securities to special programmes. Brazil could further tighten capital controls if the exchange rate is seen to be overshooting.

However, as the IMF authors note, countries should take into account the multilateral consequences of capital controls: if they deploy them to prevent the appreciation of undervalued exchange rates this will thwart global recovery and rebalancing and store up future problems for the global economy.

Political Risk

As always, political risk will remain an important issue for EMs and have the capacity to generate shocks. In April, Fitch revised the Outlook on Thailand's Local-Currency (LC) IDR of 'A-' to Negative from Stable owing to the escalation in political uncertainty, coupled with a slow economic recovery and a deteriorating

[6] "*Capital Inflows: The Role of Controls*," Ostry, Ghosh, Habermeier, Chamon, Qureshi and Reinhardt, IMF Staff Position Note (February 2010)

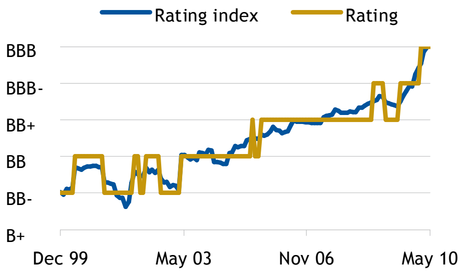
policy environment (it had downgraded both the Foreign-Currency (FC) IDR and LCIDR by one notch in April 2009). The election schedule looks relatively light in H210 and H111. The Brazilian presidential election in October 2010 stands out as a key event, while Nigerian presidential elections scheduled for April 2011 could heighten tensions.

Credit and Rating Outlook

Overall, EM creditworthiness has proved relatively resilient to the global financial crisis and recession to date. However, the risk of a renewed deterioration in the economic and financial environment stemming from the euro area sovereign debt crisis leaves the outlook uncertain.

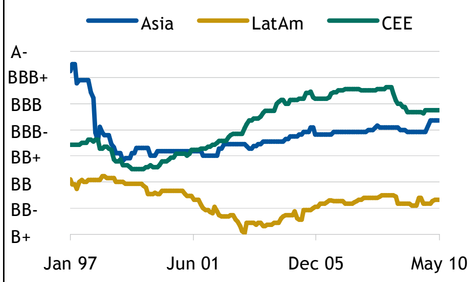
In H110, four EM countries were upgraded, including two to investment grade: Indonesia to 'BB+' from 'BB', Lebanon to 'B' from 'B-', Panama to 'BBB-' from 'BB+' and Azerbaijan 'BBB-' from 'BB+', as well as Jamaica on completion of its debt exchange to 'B-' from 'RD', having been downgraded from 'CCC' earlier in the year (all FC IDRs). Apart from Jamaica, there were no EM downgrades. As a result, the trailing 12-month sum of EM countries upgraded rose to seven (up from none in July 2009), exceeding the sum of five EM downgrades (down from 16 in July 2009). The Fitch average rating of the JP Morgan EMBI Global Index increased by another notch to 'BBB' in H110.

EMBIG Weighted Average Rating
Weight in JPM EMBI global index



Source: Fitch estimates and JP Morgan data

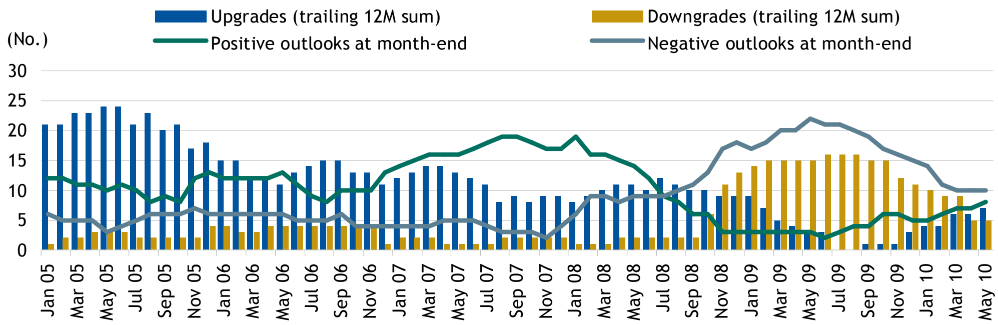
Simple Average Rating by Region
Long-term foreign currency IDRs



Source: Fitch

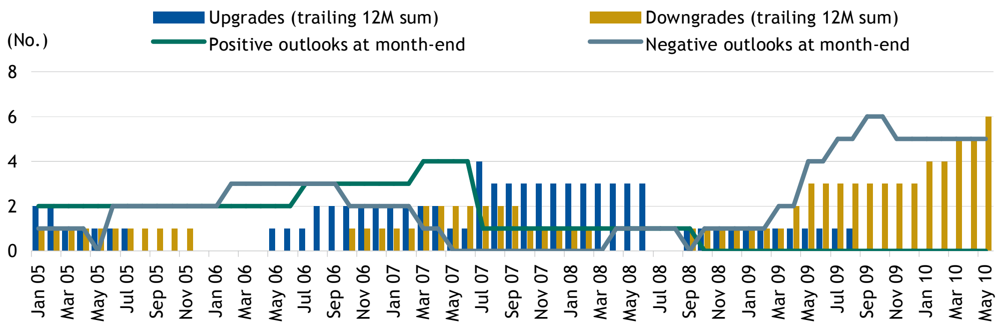
The trend of improving EM creditworthiness stands in stark contrast with developed countries, of which six were downgraded and none upgraded over the 12 months to May 2010.

Emerging Market Sovereign Rating Trends



Source: Fitch

Developed Country Sovereign Rating Trends



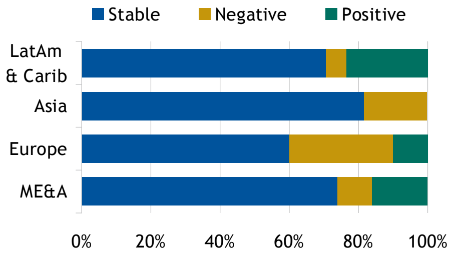
Source: Fitch

Moreover, there has been a significant rebalancing of EM rating Outlooks. The number of countries on Positive Outlooks increased to 10 at end-May 2010, from just three at end-May 2009, while the number of countries on Negative Outlooks declined to 10 from 22. Nonetheless, the balance of Outlooks is still slightly negative.

Emerging Europe remains the region under greatest downward rating pressure, owing to its large pre-crisis imbalances and greater exposure to the euro area. Six countries are still on Negative Outlook: Bulgaria, Croatia, Hungary, Latvia, Macedonia and Serbia. However, the Czech Republic is now on Positive Outlook and Estonia on Positive Watch; and over the past 12 months, Fitch has revised the Outlooks to Stable from Negative for a total of seven countries. There are also two countries in EM Asia on Negative Outlooks (LC IDRs) — Taiwan and Thailand — and one on a Negative Watch, while in both Latin America and the Middle East and Africa, Positive Outlooks significantly outweigh Negative ones.

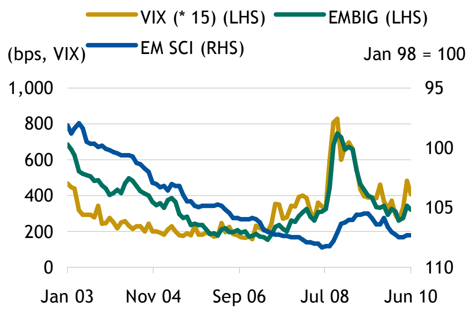
However, the increase in spreads on the EMBI Global Index from a recent low of 243 basis points on 5 April 2010 to 320bp on 22 June (albeit down from 363 on 25 May) raises the question of whether EM ratings will follow. The Fitch Sovereign Credit Index (SCI) for EMs, which is an unweighted chain-linked index of average ratings (and therefore controls for the effect of changes in ratings coverage on the average level) is, not surprisingly, correlated with the EMBIG (see chart below), although it is less volatile. If the rise in spreads has been driven by a temporary increase in global risk aversion and financial market volatility, as captured by the VIX, then ratings, which reflect credit fundamentals should prove robust. However, if the rise in spreads reflects a material increase in financial distress that persists and causes or foretells a worsening in economic conditions, then the trend in ratings would also be expected to deteriorate.

Ratings Outlook: EM Sovereigns



Note: based on rating Outlooks/Watches on 74 EM sovereigns (FC and LC LT IDRs)
Source: Fitch

Sov. Credit Index, EMBI & VIX



Source: JP Morgan, CBOE & Fitch

Emerging Europe

Overall, the economic and sovereign credit outlook for emerging Europe has continued to improve this year after being severely affected by the global financial crisis, although downside risks remain significant in many countries in the region. Most countries have returned to economic growth and made great progress in reducing CA deficits, speaking to impressive economic flexibility and policy discipline, while financial sectors have generally proved more stable and politics more cohesive than had been feared. However, deep recessions have led to increases in budget deficits and many countries face painful, multi-year consolidation programmes. Emerging Europe is also highly exposed to the risk of a crisis in the euro area — its main trading partner, source of capital inflows and location of parent bank headquarters.

Fitch forecasts real GDP to rebound by 3.6% in 2010 after a slump of 5.5% in 2009, helped by a stabilisation in confidence, progress in reducing macroeconomic imbalances, the global recovery, low foreign-currency interest rates, IFIs financing, favourable base effects, a positive contribution from inventories, and (in the Commonwealth of Independent States — CIS) higher commodity prices. However, growth in most countries will be more subdued as the aggregate is buoyed by growth of 5% in Russia and 6% in Turkey, the two largest economies in the region.

Emerging Europe: Key Indicators

(USDbn)	2009	2010f	2011f	2012f
Real GDP growth (%)	-5.5	3.6	3.7	4.1
Inflation (%)	7.1	5.8	5.3	5.4
Government balance (% of GDP)	-6.1	-4.7	-3.6	-3.0
Government debt (% of GDP)	29.3	30.4	31.4	31.7
Current account balance	10	25	8	-19
%of GDP	0.3	0.7	0.2	-0.4
Debt service	345	366	370	337
% of CXR[a]	24.4	23.5	22.0	18.8
Gross financing need[b]	261.7	269.1	288.6	281.1
% of reserves	30.0	28.7	28.4	26.3
Net external debt	267	215	184	187
% of CXR[a]	18.9	13.8	10.9	10.5
Net public external debt	-478	-515	-580	-630
% of CXR[a]	-33.7	-33.0	-34.4	-35.2
Reserves incl. gold	891	971	1,065	1,143

[a] Current external receipts; [b] Current account balance, plus amortisation payments on medium- and long-term debt. Aggregate calculation excludes countries with no demonstrable financing need
Source: Fitch

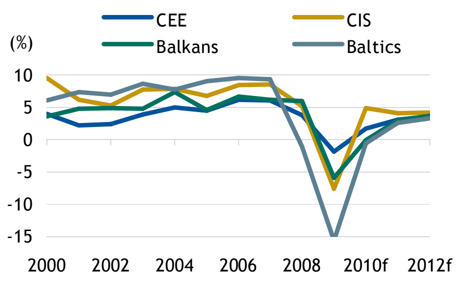
Fitch forecasts the sharpest rebound in the CIS, with GDP growth of 4.8% in 2010, following a stabilisation of confidence and rebound in commodity prices. In central and eastern Europe (CEE), where the downturn was shallowest, the agency expects more moderate growth of 1.8% in 2010 and firming to 3.1% in 2011, as the region is relatively exposed to trade with the EU (Poland less than the others). It forecasts both the Baltic and Balkans region, where pre-crisis imbalances were the greatest, to record another year of annual average declines in GDP, albeit only slight. Furthermore, Fitch does not anticipate the region recapturing pre-crisis growth rates as the previous growth model of large private-sector capital inflows and rapid bank credit growth appears severely impaired.

Banking Sectors

2009[a]	NPLs[b]	Capital[c]
Slovakia	4.3	12.3
Armenia	4.8	28.3
Estonia	5.2	15.7
Czech Rep	5.3	14.1
Turkey	5.7	20.4
Hungary	5.9	13.1
Bulgaria	6	17.3
Croatia	6.4	16.2
Poland	7	13.1
Georgia	7.3	26.6
Macedonia	9.5	16.5
Russia	9.6	20.9
Romania	14.8	13.7
Serbia	15.5	21.2
Latvia	16.4	14.6
Lithuania	19.4	14.2
Kazakhstan	21.2	-9.1[d]
Ukraine	33.8	15.6

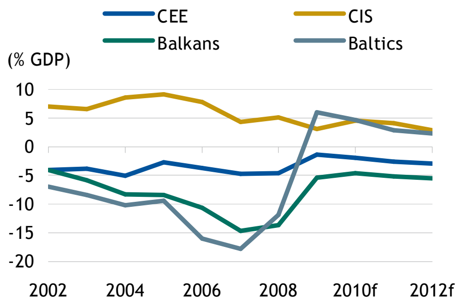
[a] Latest; [b] Non-performing loans (% total loans); [c] Bank regulatory capital to risk-weighted assets; [d] Before BTA debt restructuring
Source: IMF Global Financial Stability Report, April 2010

Emerging Europe Growth



Source: National Sources and Fitch

Emerging Europe Current Accounts



Source: Fitch

A key reason for a reduction in the region's vulnerability over the past 12 months is its success in reducing its macroeconomic imbalances, helped by sharp contractions in domestic demand, impressive economic flexibility and in some cases nominal exchange rate depreciation. Large pre-crisis CA deficits, rapid banking credit growth, high external debt ratios and foreign-currency exposures in banking systems left many countries — particularly the Baltic and Balkans states, as well as Hungary and Ukraine — facing severe external financing and financial sector pressures at the onset of the global crisis. The adjustment has been most spectacular in the Baltic states: for example, Latvia recorded a CA surplus equivalent to 9.7% of GDP in 2009, compared with deficits of 13.3% in 2008 and 22.3% in 2007. There has also been strong adjustment in most countries in the Balkans, though they were hit by the crisis later than the Baltic states and are further behind in the process. For example, Bulgaria reduced its CA deficit from 23.8% of GDP in 2008 to 9.2% in 2009.

IMF-led support packages for the most vulnerable countries, commitments by foreign parent banks to maintain exposure and strong appetite for sovereign eurobonds (USD22.3bn year-to-date) have helped to meet external financing needs. Overall, financial sectors have performed above expectations in terms of asset quality, while pre-impairment earnings and (in many cases) re-capitalisation by foreign parents, governments (in Russia and Kazakhstan) or IFIs (including in Latvia and Georgia) have helped to maintain and even increase capital ratios to relatively high levels. One downside risk, however, is exposure to Greek parent banks.

However, the price of shrinking of CA deficits has been deep recessions and deterioration in budget balances. Fiscal stimulus measures in the Czech Republic, Poland, Kazakhstan and Russia, and the 2009 drop in oil prices in Azerbaijan, Kazakhstan and Russia also adversely affected budget positions. The median budget deficit increased to 6.2% in 2009, up from 2.7% in 2008. The biggest deterioration was in Russia, where the general government budget swung from a surplus of 4.9% in 2008 to a deficit of 6.2%. However, the median general government debt ratios was a moderate 32% of GDP at end-2009 — another reason why concerns about eastern Europe have eased as the focus of the crisis has shifted on to public finances. Nonetheless, debt ratios are rising steeply — Fitch forecasts the median will be 38% of GDP at end-2010, up from 19% at end-2008 — underlining the challenge that many countries face to cut budget deficits and stabilise debt dynamics.

Emerging Europe ratings are continuing to stabilise: after 12 notches of downgrades in H208 as the global crisis intensified and five more in H109, there were only two in H209 and none in H110. The only rating change so far this year was the upgrade of Azerbaijan to investment grade (to 'BBB-' from 'BB+'), reflecting the rapid increase and prudent management of oil revenues that are being used to build a strong public and external net creditor position. Turkey ('BB+'), which Fitch upgraded two notches in December 2009, is recovering strongly and announced a new fiscal framework that enhances confidence in its public finances. However, inflation has increased to 9.1% and political risk has come back to the surface.

Trade Links With EU

	% of 2009 exports
Argentina	18.5
Brazil	22.2
Chile	17.8
Colombia	14.3
Mexico	5.1
Peru	15.7
Uruguay	15.4
Venezuela (2008)	8.3

Source: Fitch

Six countries remain on Negative Outlook, including Bulgaria ('BBB-'), Croatia ('BBB-'), Macedonia ('BB+') and Serbia ('BB-'), where GDP growth is yet to clearly recover, CA deficits remain sizeable, budgets are under pressure and (except for Croatia) exposure to Greek banks are a downside risk. Latvia ('BB+') is making good progress with its "internal devaluation" but recovery remains elusive and the budget deficit is still projected at 8.5% of GDP this year, underlining that further austerity measures are required to stabilise its public finances. Hungary ('BBB') recorded its first annual CA surplus in 2009 since 1992 and positive qoq GDP growth in Q409 and Q110. But the Negative Outlook reflects uncertainty about the fiscal plans of the new Fidesz government and the vulnerability inherent in its high government debt ratio of 78.3% of GDP at end-2009, highlighted by market volatility after the government's communication own goal in comparing the country with Greece.

In June, Fitch revised the Outlook on the Czech Republic ('A+') to Positive from Stable after a surprise election result led to the formation of a coalition government with a strong mandate for a faster pace of budget deficit reduction. Estonia ('BBB+') is on Positive Watch and Fitch expects to upgrade it after a formal decision by EU Finance Ministers in July that it can adopt the euro in January 2011. Furthermore, over the past 12 months, Fitch has revised the Outlooks to Stable from Negative for a total of seven countries (Georgia, Kazakhstan, Russia, Ukraine, Estonia, Lithuania and Romania).

Nevertheless, Romania ('BB+') faces significant challenges. A worsening in growth prospects to -0.5% in 2010 and weaker fiscal performance has left it needing to implement painful austerity measures to meet a revised IMF budget deficit target of 6.8% of GDP. In June, the government survived a no confidence vote on measures including a 25% cut in public wages and 15% cut in pensions. But the two notch downgrade in November 2008 has left greater room for tolerance at its rating level. Ukraine ('B-') was also moved back to a Stable Outlook after presidential elections cleared the way for greater political stability, while the recovery has started and the CA is in surplus. However, uncertainty about the size and financing of the budget deficit and, therefore, confidence in macroeconomic stability and its crisis recovery path are constraining further positive rating actions for now.

Latin America

The economic recovery is occurring at multiple speeds in Latin America. The global economic rebound, higher commodity prices and supportive domestic economic policies have benefited the region's macroeconomic performance. Fitch forecasts that real GDP growth could reach 4.6% in 2010 after a contraction of 2.5% in 2009. Fitch judges that most countries in the region are in a good position to cope with the fallout from concerns about sovereign risk in Europe, although it will continue to monitor any effects. Among the major countries, Argentina, Brazil, Chile, Colombia, Peru and Uruguay have the most extensive trade links with Europe. Latin America has obtained a fair share of foreign direct investment (FDI) from Europe, particularly Spain.

The upward revision in the region's GDP growth forecast since the December 2009 "*Sovereign Review and Outlook*" reflects better-than-expected high-frequency production and consumption data. Among the larger economies, Fitch has revised up GDP growth forecasts for Argentina, Brazil and Mexico to 4.9%, 7% and 4.2% respectively. Fitch believes Chile, Brazil, Peru and Panama will be the most dynamic economies in 2010, underpinned by healthy consumption and investment growth. In contrast, in most countries in Central America as well as Colombia, the high reliance on the US for trade, overseas remittances and foreign investment as well as the small size of the domestic markets is weighing on recovery. The speed of Colombia's recovery is also constrained by high unemployment, trade barriers and sluggish growth in key export markets such as Venezuela and Ecuador. Fitch expects Venezuela to be the only country to suffer a deeper recession in 2010, although Jamaica is not expected to grow either.

Latin America: Key Indicators

(USDbn)	2009	2010f	2011f	2012f
Real GDP growth (%)	-2.5	4.6	3.8	4.1
Inflation (%)	6.2	6.1	6.7	6.4
Government balance (% of GDP)	-3.1	-2.7	-2.4	-2.5
Government debt (% of GDP)	46.1	47.7	46.7	45.1
Current account balance	-14	-47	-73	-101
%of GDP	-0.3	-1.0	-1.5	-1.9
Debt service	148	151	146	149
% of CXR[a]	17.1	15.2	13.6	12.7
Gross financing need[b]	120.1	155.9	174.4	197.5
% of reserves	26.4	28.6	30.8	34.1
Net external debt	-168	-169	-154	-129
% of CXR[a]	-19.4	-17.0	-14.3	-11.0
Net public external debt	-150	-156	-152	-137
% of CXR[a]	-17.3	-15.7	-14.1	-11.8
Reserves incl. gold	547	586	608	619

[a] Current external receipts; [b] Current account balance, plus amortisation payments on medium- and long-term debt. Aggregate calculation excludes countries with no demonstrable financing need
Source: Fitch

Inflation is set to increase in the region as economic recovery gathers momentum. Among the inflation-targeting central banks, Mexico and Brazil are most at risk of missing their targets. Last year's tax reform has led to price increases in Mexico while a robust economic recovery and tight labour markets are pressuring Brazil's inflation. But inflation rates will remain within the target bands in Chile, Colombia and Peru. Inflation risks is rising in Venezuela despite its deteriorating growth prospects due to domestic supply constraints, indexation of import prices to the depreciated parallel market exchange rate and a faster pace of expenditure related to legislative elections in September.

External accounts remain comfortable for most Latin America countries. While CA balances are likely to deteriorate due to the economic recovery, an expected pick-up in FDI, continued capital flows and the greater access of issuers to the international markets will buttress the region's capital accounts and allow for a sustained accumulation of international reserves. Fitch projects that the region's stock of reserves could increase to USD586bn in 2010 from USD547bn in 2009.

While the recent bout of higher risk aversion emanating from the events in Europe has hit some regional currencies and stock markets, most countries are still well-placed to attract capital inflows due to their relative economic resilience, favourable commodity prices and their healthy fiscal and external balance sheets. Continued multilateral support in the form of the IMF's FCL to Mexico and Colombia, and the several stand-by programmes in the region provide additional foreign exchange buffers to countries in the event of negative shocks.

The biggest challenge confronting the region is to exit from the expansionary monetary and fiscal policies that were put in place during the global credit crisis. On the monetary policy front, Brazil was the first in the region to tighten policy by increasing its benchmark interest rate and raising bank reserve requirements. Fitch expects most other inflation-targeting central banks to begin the process of normalising interest rates during the course of the year as output gaps close, economic growth becomes more firmly rooted and risks to inflation increase.

On the fiscal policy front, most Latin American countries are gradually proceeding to consolidate fiscal accounts in order to strengthen their fiscal credibility, which should be complemented by the effect of the economic cycle. While some countries were able to implement counter-cyclical fiscal policies in response to the global credit crisis, the scope for a sustained fiscal expansion is limited due to low and often volatile revenue bases, high level of budgetary rigidities and the less developed local capital markets. The scope for most Latin American sovereigns to provide another round of fiscal stimulus will be more limited should the regional economies suffer another significant blow to growth owing to events in Europe.

In Chile, the recent earthquake has pushed back the fiscal consolidation process although the county's comparatively low debt burden and sizable resources in the stabilisation funds provide it with ample room for manoeuvre. In Mexico, the implementation of a revenue-enhancing tax reform last year has provided it the fiscal headroom to face the challenges related to reduced oil output and continued spending pressures. Brazil has mostly unwound the selective tax breaks it introduced last year although the quasi-fiscal stimulus through the sustained lending by the BNDES (the national development bank) has continued into this year. Peru and Panama's fiscal accounts will continue to benefit from robust economic growth and the implementation of revenue-enhancing tax reforms in the case of the latter. On the other hand, owing to the election cycle, fiscal policies in Argentina and Venezuela are expected to remain largely expansionary this year. The only country where debt dynamics appear unfavourable is El Salvador.

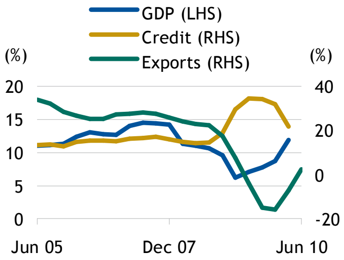
So far, presidential election outcomes in the region (Chile, Costa Rica and Uruguay) have been credit-neutral. Fitch expects the trend of greater pragmatism in policy choices displayed by most Latin American countries to continue as the benefits of such policies were evident in the region's resilience to the global credit crisis. However, the resumption of a reasonably good growth cycle could reduce the political appetite for far-reaching structural reforms.

Colombia's newly-elected President Manuel Santos is likely to continue to stress security and market-friendly economic policies, but the scope for structural reforms designed to strengthen fiscal accounts is uncertain. The two front-runners in Brazil's presidential election are likely to continue with the main thrust of existing economic policies although there may be some shift in policy priorities depending on who wins the race. The two leading candidates in Peru are centrists, but with elections nearly a year away, Fitch does not rule out a rise in political uncertainty if a "political outsider" begins to rise in the polls. The election cycle in Argentina and Venezuela could increase policy unpredictability. The tightening of regulations related to Venezuela's parallel foreign exchange market, increased government interventions in financial institutions and a step-up in nationalisation highlight such risks. Meanwhile, despite an improved economic environment, in Fitch's view, political calculations will likely continue to prevail over the implementation of sustainable and credible policies in Argentina as well.

Since the December 2009 "*Sovereign Review and Outlook*", most rating actions in Latin America have been positive ones. Fitch recently upgraded Panama's ratings to investment grade ('BBB-') and maintained the Positive rating Outlook. It also assigned Positive Outlooks to Peru's and Brazil's sovereign ratings. Finally, Jamaica's ratings were upgraded to 'B-' following the successful completion of its debt restructuring and the approval of a sizeable IMF financing package. Fitch also affirmed Chile's sovereign ratings despite the challenges posed by the devastating earthquake earlier in the year. The sovereign ratings of Brazil ('BBB-'), Panama ('BBB-'), Peru ('BBB-'), Suriname ('B') and Uruguay ('BB-') are on Positive Outlook, suggesting the credit cycle has turned. A successful conclusion of the proposed USD18.3bn "holdout" debt exchange will likely prompt Fitch to raise Argentina's FC Long-Term IDR out of 'RD'.

China Through the Crisis

YoY Growth



Source: CEIC, Fitch

Asia-Pacific

Emerging Asia's growth prospects are the strongest of the four EM regions and Fitch has revised up its forecast for the region's aggregate growth to 7.6% in 2010, from 6.7% in the December 2009 "*Sovereign Review and Outlook*". Growth is being buoyed by residual impetus from domestic stimulus programmes (particularly in China and India) and recovering trade flows. While global economic conditions remain the key risk to Asia's economic outlook, home-grown worries over inflation are becoming more significant. It is the only EM region to see a forecast increase in inflation in 2010, underscoring Fitch's concern about potential overheating pressure in some countries. Some governments and central banks appear to be holding back from exiting stimulus mode on lingering fears over the strength of the global recovery, most recently crystallising around concerns over euro area sovereigns. Strong GDP growth will contribute to a modest decline in the region's gross government debt/GDP ratio in 2010.

Emerging Asia: Key Indicators

(USDbn)	2009	2010f	2011f	2012f
Real GDP growth (%)	5.1	7.6	7.4	7.1
Inflation (%)	1.1	4.2	3.8	3.8
Government balance (% of GDP)	-4.1	-3.7	-2.9	-2.6
Government debt (% of GDP)	37.0	36.6	35.7	34.5
Current account balance	427	380	439	452
%of GDP	4.9	3.8	3.8	3.4
Debt service	169	212	223	223
% of CXR[a]	5.2	5.8	5.3	4.7
Gross financing need[b]	43.9	104.1	99.4	118.8
% of reserves	12.1	14.6	22.9	19.3
Net external debt	-3,281	-3,633	-4,056	-4,484
% of CXR[a]	-101.9	-98.9	-96.5	-94.1
Net public external debt	-3,320	-3,761	-4,212	-4,667
% of CXR[a]	-103.1	-102.4	-100.2	-97.9
Reserves incl. gold	3,695	4,115	4,542	4,966

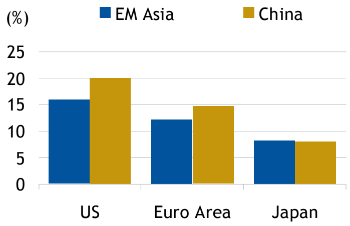
[a] Current external receipts; [b] Current account balance, plus amortisation payments on medium- and long-term debt. Aggregate calculation excludes countries with no demonstrable financing need
Source: Fitch

Stronger growth prospects formed part of the rationale for the revision of the Outlook on India's LC IDR to Stable from Negative in June 2010. Fitch upgraded Indonesia to 'BB+' with a Stable Outlook in January 2010 in recognition of sustained improvements in the public finances and a reduction in vulnerability in the external finances. However, some downwards pressure on the region's ratings remains. The Negative Outlooks on the LC IDRs of Taiwan and Thailand reflect specific concerns over the slow pace of fiscal consolidation in Taiwan's case, and over the impact on growth from political risk in Thailand. The assignment of a Negative Watch on Vietnam's ratings in March 2010 was driven partly by concerns about inappropriate policy settings leading to an overheating economy.

China's recent shift to policy tightening boosts chances that the economy will avoid overheating and move towards Fitch's base case of growth remaining around 9% pa out to 2012. However, the agency's concerns over a potential hangover from recent strong credit growth weigh on China's ratings. The economy grew a blistering 11.9% yoy in Q110, boosted by 31% credit growth in 2009 — enough to help take the country into the highest risk bracket in Fitch's macro-prudential risk framework. Tighter bank lending regulations reined in credit growth to 21.5% yoy by May 2010, indicating official concern about a build-up of financial risk, particularly about exposures to the real estate sector and to special-purpose funding vehicles of sub-national government units. Fitch's bank analytical team believes substantial losses may be hidden in the banking sector, potentially requiring sovereign resources to clean up and weighing on sovereign creditworthiness.

Euro Area Exposure

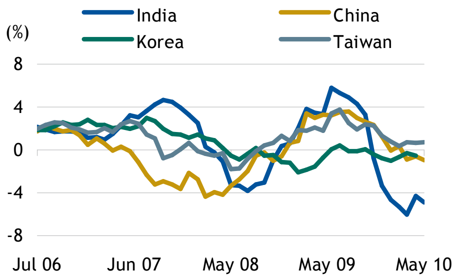
Developed economies as % Asia exports



Source: IMF DoTS

Real Policy Rates (1)

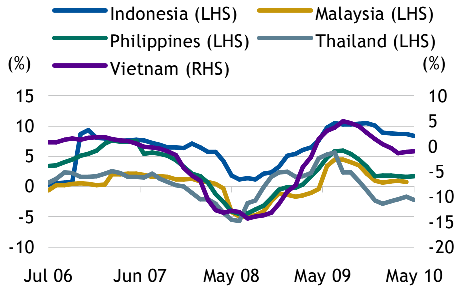
Policy rate minus YoY inflation



Source: CEIC, Fitch

Real Policy Rates (2)

Policy rate minus YoY inflation



Source: CEIC, Fitch

Despite the recent announcement on CNY flexibility, Fitch expects only a moderate CNY revaluation against the USD in 2010, partly owing to official doubts about the sustainability of the global recovery and partly because of the politics of China's relationship with the US. The authorities have recently acquiesced in a wave of labour militancy that has driven strong wage growth (around 20%) in important exporting industries and regions. The Chinese authorities appear to be trying to manage an "internal revaluation" through faster wage growth to support demand and rebalance the economy towards stronger consumption while throttling back on credit-driven stimulus.

Fitch expects inflation to increase in every country in the region in 2010. India's inflation rate ran at an uncomfortably high 10.2% in May 2010. It should ease as better harvests help tame food prices, but there is a risk that inflation expectations could get out of hand and increase the risk of a sharp policy adjustment sufficient to disrupt financial markets. The Bank of Korea has yet to lift its key policy rate from 2% despite a resumption of strong GDP growth (+8.1% in Q110) after a relatively mild slowdown and a pick-up in inflation to 2.7% yoy in May. Fitch expects the annual average inflation rate will marginally exceed the official 3% target in 2010 as prices accelerate later in the year.

Nonetheless, a forecast decline in emerging Asia's aggregate gross GGD/GDP ratio to 36.6% by end-2010 supports the region's sovereign credit outlook. Debt ratios are projected to drop in India and Indonesia, which both saw positive rating action in 2010. But the broadly favourable regional picture masks worries over public finances in some countries where a perceived need for fiscal stimulus has interrupted necessary fiscal consolidation. Taiwan's 'AA' LC IDR remains on Negative Outlook owing to Fitch's concern at the lack of a credible fiscal consolidation plan. A lack of urgency in tackling the deficit continues to weigh on Malaysia's 'A-' rating. Meanwhile, global recession coupled with electoral pressures saw the budget deficit of the Philippines rise to 4% for 2009, with no improvement expected for 2010. However, the region's external debt issuers retain financing flexibility, with Indonesia, Malaysia, the Philippines and Vietnam all able to issue external sovereign debt so far in 2010.

Emerging Asia's external finances were generally robust through the global crisis, notwithstanding specific worries in the case of Vietnam where overly-expansionary policy will see the CA deficit surpass 12% of GDP in 2010 on Fitch's projection. The external finances of Korea, Malaysia, Indonesia and the Philippines all exhibited greater resilience than might have been expected before the crisis; Malaysia and Indonesia's official reserves proved to be adequate buffers against temporary capital outflows, while overseas Filipino workers' remittances grew 5% in USD terms in 2009, helping the Philippines to avoid recession.

Korea's banking system went into the crisis as its relatively high short-term external debts left it exposed to near-closure of global interbank wholesale markets beginning in Q308, but the sovereign's deployment of FX resources tided the system through the worst of the crunch. By end-May 2010, Korea's official reserves were USD270.2bn, back above the pre-crisis peak of USD264bn recorded in March 2008. Fitch notes the Korean authorities are considering fresh measures to curb banks' short-term external borrowing.

Mongolia continues to implement one of the Fitch emerging Asia region's two IMF assistance programmes successfully while benefiting from a recovery in copper prices, helping to consolidate the IDRs at 'B'. However, Sri Lanka's programme has been impeded by excessively loose fiscal policy, taking the 2009 budget deficit to 10% of GDP. The end of Sri Lanka's long-running civil war in May 2009 should be bolstering the country's investor appeal and economic prospects, but Fitch is increasingly concerned by signs that the government's commitment to developing stable democratic institutions may be weak.

Political risk moved centre-stage in Thailand and Korea in H110. In Thailand, rolling protests against the government of Prime Minister Abhisit disrupted central Bangkok for weeks in April-May 2010 and eventually saw bloodshed. Political risk weighs on Thailand's ratings primarily through the impact on investor confidence and growth prospects rather than risk of more serious political turbulence, although Fitch recognises that the basic tensions in Thai society that led to the protests remain unresolved and could flare up again. Tensions on the Korean peninsula escalated in May when the South Korean government officially blamed the North for sinking its warship Cheonan. Fitch ascribes a very low probability to an outbreak of full-scale fighting on the peninsula, as it is not in any key player's interest. However, the background risk of an escalation weighs on Korea's 'A+' rating.

Middle East and Africa

Oil Exporters Tested by Lower Oil Prices

The addition of Angola ('B+'/Positive) to the portfolio of Fitch rated MEA sovereigns in May makes oil exporters a slight (51%) majority in MEA region aggregate GDP. Angola's rising oil production and revenues have allowed substantial increases in infrastructure spending which should benefit long-term growth. And macro-financial management should be sounder under the auspices of an IMF programme. Ghana ('B+'/Negative) will join the ranks of oil exporters later this year, bringing sizeable revenue increases which, if wisely applied, could enhance creditworthiness in the medium-term. But in the short-term Ghana faces challenges due to serious fiscal slippages up to 2008, with a higher than average budget deficit and debt burden in Sub-Saharan Africa and among the highest inflation. Uganda ('B'/Positive), with oil

Middle-East & Africa: Key Indicators

(USDbn)	2009	2010f	2011f	2012f
Real GDP growth (%)	1.5	4.0	4.6	4.6
Inflation (%)	6.2	5.5	5.1	4.9
Government balance (% of GDP)	-5.0	-1.8	-0.1	-0.1
Government debt (% of GDP)	37.6	36.5	36.3	36.1
Current account balance	12	63	78	64
%of GDP	0.7	3.2	3.6	2.7
Debt service	52	53	56	63
% of CXR[a]	7.0	6.1	5.8	6.1
Gross financing need[b]	63.4	59.2	62.3	71.7
% of reserves	35.7	24.4	24.6	27.5
Net external debt	-673	-780	-903	-1,011
% of CXR[a]	-89.9	-89.2	-93.6	-98.2
Net public external debt	-676	-773	-891	-999
% of CXR[a]	-90.3	-88.4	-92.5	-97.0
Reserves incl. gold	817	933	1,060	1,166

[a] Current external receipts; [b] Current account balance, plus amortisation payments on medium- and long-term debt. Aggregate calculation excludes countries with no demonstrable financing need
Source: Fitch

exporter status still a couple of years away, has a better macro track record which puts it in a better position to reap the benefits of eventual higher oil output, supporting the Positive Outlook assigned last year.

The past two years have emphasised the vulnerabilities of high oil dependence. Although oil prices recovered strongly during 2009 and will this year average their highest in any year except 2008, all Fitch-rated oil exporters in the region suffered varying degrees of stress, though in most cases the worst seems to be over. **Angola** entered the crisis with an overly ambitious budget which though eventually cut back still resulted in substantial domestic supplier arrears, despite high international reserves and domestic deposits. Defence of an unrealistic exchange rate peg also brought substantial reserve loss, eventually forcing the authorities to turn to the IMF in November 2009, the only country in the region with an SBA.

Nigeria ('BB-'/Stable) entered the crisis with larger buffers, thanks to savings in its Excess Crude Account, but by the end of 2009 these were almost exhausted as the authorities grappled with below budget oil revenues and high spending demands, while reserves were lost defending the exchange rate. The response was confused and poorly communicated until new leadership took over at the central bank. Decision-making was further hampered by the political vacuum from November 2009 when the president was hospitalised. His death in May led to the formal accession to power of his deputy, Goodluck Jonathan, who will serve out the remainder of his term until elections in April 2011. His priorities are to raise the credibility of the election process and outcome; consolidating the peace effort in the Niger Delta; and maintaining budget discipline while implementing infrastructure plans to reduce growth bottlenecks. In fact, Nigeria's non-oil growth remained surprisingly buoyant during the crisis, averaging over 7% last year. Libya's ('BBB+'/Stable) non-oil growth remained at 6%. Non-oil GDP only contracted in Gabon ('BB-'/Stable), where its other commodity exports suffered and political uncertainty increased temporarily after the death of President Bongo.

Gulf oil exporters emerged with strong sovereign balance sheets largely unscathed, despite varying challenges. Abu Dhabi's ('AA'/Stable) USD10bn loan to Dubai, equity and loan injections to its flagship SOEs, and equity infusions to banks, resulted in a double-digit budget deficit but this was offset by capital gains on its SWF whose assets remain in excess of 200% of GDP. The Dubai World restructuring, though not involving a formal haircut, will raise UAE bank NPLs nearer to 10% but capital ratios have been rising and should be able to absorb the hit. Kuwait's ('AA'/Stable) gross external asset-to-GDP ratio is a similar order of magnitude to Abu Dhabi's; and it continues to generate impressive fiscal and current account surpluses — 23% and 32% of GDP respectively last year — allowing room to support its troubled financial institutions. Saudi Arabia's ('AA-'/Stable) gross external assets, though higher in absolute terms than either Abu Dhabi or Kuwait, are less as a ratio to GDP. Saudi Arabia pursued an active counter cyclical fiscal response, pressing ahead with ambitious infrastructure spending. However, its budget deficit was a modest 2% of GDP.

Growth has Held Up and Rises in Public Debt Ratios Generally Contained

In the rest of MEA, only South Africa, Namibia and Seychelles suffered outright recessions last year. South Africa ('BBB+'/Negative) was hit by the global recession but also needed to adjust domestically after a rapid credit boom. However, its banks have not required official assistance of any sort. Newly rated Seychelles ('B-'/Positive) suffered the biggest drop in GDP last year of -7.5%, reflecting a radical adjustment programme prompted by its 2008 default. Private creditors agreed a restructuring, including a 50% write-down on its Eurobond, in February. Compliance with its three-year IMF programme has been exemplary and the Positive Outlook reflects the potential for rapid improvements in creditworthiness if this continues.

Elsewhere in non-oil MEA, growth averaged a respectable 4.3% last year. The best performer by far was Lebanon ('B'/Stable), with 8% growth, a figure likely to be repeated this year, as it continues to benefit from a political thaw and strong inflows into its banking system. Strong growth is also making rapid inroads into its high debt burden which has fallen by roughly 10pp per annum since 2006, reaching 148% of GDP last year, despite a still stubbornly high budget deficit. Improved debt dynamics largely explain the rating upgrade to 'B' earlier this year, though further progress will require advances in the government's policy agenda.

Lesotho ('BB-') attracted the only Negative rating action in MEA so far this year — a Negative Outlook on its LC IDR. Members of the South African Common Monetary Area (CMA) (which also includes Namibia — 'BBB+'/Stable) have been hit hard by reduced transfers from South Africa as its customs duties, which are distributed among CMA member countries, have fallen sharply. Lesotho is projected to register double digit deficits for the next two years. Deposits saved from past windfalls have financed the deficit so far but this cushion is now much reduced. It signed an IMF Extended Credit facility in June 2010.

By end 2010, debt ratios are expected to have risen most in Bahrain, Cape Verde and South Africa, in each case up by over 10% of GDP compared to end 2008. The worsening in public debt dynamics in South Africa is one of the reasons why its rating was placed on Negative Outlook at the end of 2008. Although the budget deficit has started to decline, and growth has resumed, the debt ratio is expected to continue rising for the foreseeable future, reaching just above the prospective 'BBB' median by 2012. Prospects for growth and debt dynamics will be key to resolving the rating outlook later this year.

Bahrain ('A'/Stable) has increased borrowing to finance counter-cyclical fiscal spending but a stabilisation of its debt ratios is clearer to see than in South Africa and is less than 30% of GDP. In Cape Verde ('B+'/Stable), the debt increase is linked to infrastructure spending – a common theme in the region — but a concern as the country already has the highest debt ratio among 'B' rated sovereigns, although the borrowing is mainly concessional. Egypt ('BB+'/Stable) is another country with a combination of a high debt and deficit. However, the deficit has increased only slightly and debt ratios have been broadly stable during the crisis.

Annex: Lessons From Recent Debt Restructurings

Where sovereigns face an unsustainable debt position, no amount of international liquidity support will solve the problem, though it is often difficult to distinguish clearly at the time whether debt crises are driven by liquidity or solvency. The following sovereign and "sovereign-related" debt restructurings have taken place, which may hold lessons for other countries.

Jamaica

On 3 February 2010, Fitch downgraded Jamaica's FC and LC IDRs to 'RD' following the execution of a domestic debt exchange, which included foreign-currency-denominated locally-issued debt instruments worth over 10% of the total central government's foreign currency denominated debt owed to private creditors. The exchange did not involve a haircut on the face value of the debt, but it involved a lengthening of maturities and reduction in coupon rates; and Fitch believes that it constituted a coercive debt exchange, as outlined in Fitch's global criteria report, "*Coercive Debt Exchange Criteria*", published on 3 March 2009 and available at www.fitchratings.com. Although it deals with near-term liquidity pressures by lengthening maturities, creating cash flow gains to the budget and helping to secure IMF financing, Jamaica's government debt ratio is high at 122% of GDP at end-2009 and question marks over its solvency remain, consistent with its 'B-' rating.

Argentina

On 3 May 2010, Argentina made a USD18.3bn offer to holdout creditors who did not participate in the 2005 restructuring which will likely prompt removal of the sovereign's FC Long-Term 'RD' default rating. The government announced that following the exchange that closed on 22 June 2010, 92% of the bond debt that defaulted in 2001 has now been restructured, which could reduce risks associated with legal action by remaining holdout creditors. Although the government opted not to raise new money in the context of this exchange, it could also pave the way for Argentina to return to international capital markets for the first time since its 2001 default. This would benefit the financing flexibility of the central government, province and Argentine companies. Nevertheless, Argentina's post-default sovereign ratings are likely to remain in a highly speculative sub-investment grade category as sovereign creditworthiness remains constrained by its volatile macroeconomic performance, increased political tensions, weak institutional and policy credibility as well as high albeit declining public debt ratios relative to sovereigns rated in the 'B−', 'B', and 'B+' categories.

Dubai World

The announcement on 25 November 2009 by the Dubai Government of a "debt standstill" for its largest state-owned entity, Dubai World (DW) triggered a major jolt to market confidence and focused attention on sovereign creditworthiness and debt perceived to be "quasi-sovereign" (see December 2009 "*Sovereign Review and Outlook*"). In May, creditors accounting for 60% of bank debt gave agreement in principle to a restructuring. Maturities are extended at below market rates but with no principal haircut. The Dubai government will convert its USD8.9bn of claims into equity and provide additional funding of USD1.5bn. Terms of the Nakheel restructuring (a subsidiary of DW) are more generous, with sukuk holders repaid in full and on time. Dubai will provide USD1.2bn in equity and USD8bn in new funding over an unspecified period. Ultimately, Dubai, with the help of Abu Dhabi, has provided significant support to sweeten the deal but not to the extent of bailing out all creditors on existing terms.

BTA Bank

In March 2009, BTA, a Kazakhstan-based bank, effectively announced a default on its external debts and Fitch subsequently downgraded it to ‘RD’ on 24 April 2010 on that eventuality. Its debt restructuring is an interesting case as before its default it was the largest bank in the country and, therefore, of systemic importance; and many market participants (including Fitch) had thought there was a reasonable likelihood that the sovereign authorities would provide support. The bank had borrowed aggressively in the Eurobond and syndicated loan market in the credit boom and rapidly expanded its loan book, including to undisclosed related-parties. It then suffered a sudden stop in its international capital market access in summer 2007 and saw a rapid deterioration in asset quality, some of it attributed to fraud. The Kazakhstan government, through the National Welfare Fund Samruk-Kazyna acquired a 75.1% stake in BTA in February 2009 and injected around USD1.4bn of new equity to recapitalise the bank. However, in view of the scale of the reported losses and shortfall in its capital position, its new management announced a coercive debt exchange with a large haircut for foreign creditors (involving several options), while honouring obligations to depositors. The restructuring of some USD11.4bn of its debt has still not been completed, but indications are that this could take place by August, with the participation of 92% of creditors and involve the effective write-down of around USD7bn of debt. Alliance, the sixth-largest Kazak bank, went through a similar process.

Long-Term Issuer Default Ratings on 30 June 2010

	LTFC	FC outlook	LTLC	LC outlook	Ceiling
Western Europe & North America					
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	BBB-	Negative	BBB-	Negative	AAA
Iceland	BB+	Negative	BBB+	Negative	BB+
Ireland	AA-	Stable	AA-	Stable	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-	Negative	AA-	Negative	AAA
San Marino	A	Negative	-	-	AA
Spain	AA+	Stable	AA+	Stable	AAA
Sweden	AAA	Stable	AAA	Stable	AAA
Switzerland	AAA	Stable	AAA	Stable	AAA
UK	AAA	Stable	AAA	Stable	AAA
US	AAA	Stable	AAA	Stable	AAA
Emerging Europe					
Armenia	BB-	Stable	BB-	Stable	BB
Azerbaijan	BBB-	Stable	BBB-	Stable	BBB-
Bulgaria	BBB-	Negative	BBB	Negative	BBB+
Croatia	BBB-	Negative	BBB	Negative	BBB+
Czech Republic	A+	Positive	AA-	Positive	AA+
Estonia	BBB+	Rating watch positive	A-	Rating watch positive	A+
Georgia	B+	Stable	B+	Stable	BB-
Hungary	BBB	Negative	BBB+	Negative	A
Kazakhstan	BBB-	Stable	BBB	Stable	BBB
Latvia	BB+	Negative	BBB-	Negative	BBB
Lithuania	BBB	Stable	BBB+	Stable	A
Macedonia	BB+	Negative	BB+	Negative	BBB-
Poland	A-	Stable	A	Stable	AA-
Romania	BB+	Stable	BBB-	Stable	BBB
Russia	BBB	Stable	BBB	Stable	BBB+
Serbia	BB-	Negative	BB-	Negative	BB-
Slovakia	A+	Stable	A+	Stable	AAA
Slovenia	AA	Stable	AA	Stable	AAA
Turkey	BB+	Stable	BB+	Stable	BBB-
Ukraine	B-	Stable	B-	Stable	B-
Asia Pacific					
Australia	AA+	Stable	AAA	Stable	AAA
China	A+	Stable	AA-	Stable	A+
Hong Kong	AA	Stable	AA+	Stable	AAA
India	BBB-	Stable	BBB-	Stable	BBB-
Indonesia	BB+	Stable	BB+	Stable	BBB-
Japan	AA	Stable	AA-	Stable	AAA
Korea	A+	Stable	AA	Stable	AA
Malaysia	A-	Stable	A	Stable	A
Mongolia	B	Stable	B	Stable	B
New Zealand	AA+	Negative	AAA	Negative	AAA
Philippines	BB	Stable	BB+	Stable	BB+
Singapore	AAA	Stable	AAA	Stable	AAA
Sri Lanka	B+	Stable	B+	Stable	B+
Taiwan	A+	Stable	AA	Negative	AA
Thailand	BBB	Stable	A-	Negative	BBB+
Vietnam	BB-	Rating watch negative	BB-	Rating watch negative	BB-

Long-Term Issuer Default Ratings on 30 June 2010 (cont.)

	LTFC	FC outlook	LTLC	LC outlook	Ceiling
Middle East and Africa					
Abu Dhabi	AA	Stable	AA	Stable	AA+
Angola	B+	Positive	B+	Positive	B+
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	Negative	A
Libya	BBB+	Stable	BBB+	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
Seychelles	B-	Positive	B	Positive	B-
South Africa	BBB+	Negative	A	Negative	A
Tunisia	BBB	Stable	A-	Stable	BBB+
Uganda	B	Positive	B	Positive	B
Latin America and Caribbean					
Argentina	RD	-	B-	Stable	B
Aruba	BBB	Stable	BBB	Stable	A-
Bolivia	B	Stable	B	Stable	B
Brazil	BBB-	Positive	BBB-	Positive	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	CCC	Stable	-	-	B-
El Salvador	BB	Negative	BB	Negative	BBB-
Guatemala	BB+	Stable	BB+	Stable	BBB-
Jamaica	B-	Stable	B-	Stable	B
Mexico	BBB	Stable	BBB+	Stable	A-
Panama	BBB-	Positive	BBB-	Positive	A-
Peru	BBB-	Positive	BBB	Positive	BBB
Suriname	B	Positive	B+	Stable	B
Uruguay	BB-	Positive	BB	Positive	BB+
Venezuela	B+	Stable	B+	Stable	B+

Source: Fitch