

Country Risk

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This panorama first contains a study on the strength of the British recovery. Thanks to vigorous growth since the second quarter of 2012, we anticipate the UK economy to get back to its pre-crisis level in the third quarter of 2014. A positive short term economic context, like dynamic corporate investment, supported by the flexible monetary policy of the Central Bank, led us to upgrade our risk assessment for the UK to A2. This appraisal is strengthened by the recent decisions by the monetary authorities to cool down the real estate bubble.

Then we move on in details to the sectoral level, with an analysis from the risk underwriting director for Coface UK. Working in the field, he is on the whole optimistic about their evolution, but points out some remaining significant weaknesses in the British economy, in particular the indebtedness of the private sector and the persistent current account deficit. After a worrying process of de-industrialisation, the study pays particular attention to the renewal of the industry, in sectors which already display impressive successes : the automotive, aeronautics and pharmaceutical industries. Thanks to considerable investment in R&D and remarkable innovations, these sectors are composed of competitive firms which have managed in a relatively short period of time to become world leaders.

Finally, we present in this panorama the last changes in our country ratings (which measure the ability of companies in any given country to make payments), as well as an update on our analyses for countries that are currently under intense media coverage : Russia, Brazil, Italy, India or Algeria.

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The British recovery: miracle or mirage

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Group economic research

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Since the second half of 2012 the British economy has posted strong growth, which will enable production at last to return to its pre-crisis level in 2014. The current dynamism of economic growth and the early onset of the recovery are astonishing, set against the depth of the recession which affected the country deeply three years ago. In order to explain this apparent paradox, we will first examine the characteristics of this recovery and the reasons for this earlier than expected rebound by emphasising particularly the role of the central bank's ultra-expansionary monetary policy, as well as that of

the relative resilience of employment, even at the height of the crisis. We will then point out that, despite this good economic news, all the structural weaknesses of the British economy have not gone away. In particular, private sector debt is still a barrier to business investment, while the recent deterioration of the external accounts is also weakening the recovery. Beyond this mixed macro-economic context, we conclude by examining the sectors which characterise the revival of British industry, by stressing, in particular, the automotive, aeronautical and pharmaceutical industries.

1 / A REMARKABLE EMERGENCE FROM THE CRISIS

The symptoms of the crisis

The United Kingdom, whose economy had undergone a relative decline until the end of the 70s, largely caught up from 1979. Whereas in that year its GDP per capita was 10% below that of France and 14% below that of Germany, in 2007 it had closed the gap with these two economies. With a GDP per capita growth rate (at purchasing power parity) of nearly 2% p.a. over the period 1980-2012, the United Kingdom experienced the strongest growth of the G7⁽¹⁾ industrialised countries. The 2007-2008 crisis, however, marked a break in this growth trajectory and put an end to this convergence with the other large advanced economies.

UK performance is the fruit of a sharp increase in apparent labour productivity (particularly marked over the period 1997-2007, when GDP per hour worked rose by 2.4% p.a.) combined with the number of hours worked per person stabilising at a high level, above that of the main continental European countries (803.7 hours/person, or 92.4% of the American level, against 72.3% in France and 80% in Germany in 2007). The table below presents this breakdown of economic growth over the prosperous pre-crisis period:

TABLE 1: Breakdown of GDP per capita, 2001-2007

Contribution to GDP per capita growth (percentage points)	GDP per capita growth	GDP per hour worked	Hours worked per person
France	1.1%	1.5	-0.4
Germany	1.4%	1.6	-0.2
Netherlands	1.6%	1.8	-0.1
Italy	0.5%	0.2	0.3
United Kingdom	2.6%	2.5	0.1
United States	1.7%	2.1	-0.4

Sources: Coface, Centre pour la croissance et le développement de Groningen

The analysis of productivity changes by production factor and per sector suggests that UK pre-crisis performances were not based mainly on financial intermediation or on a property bubble. According to CEP⁽²⁾ calculations using the KLEMS⁽³⁾ database, financial intermediation would have accounted for only

(1) G7: United States, Canada, United Kingdom, France, Germany, Italy, Japan.

(2) Center for Economic performance, cf. «UK economic performance since 1997», D. Corry, A. Valero & J. Van Reenen, CEP Special report, November 2011, p. 1 - 17

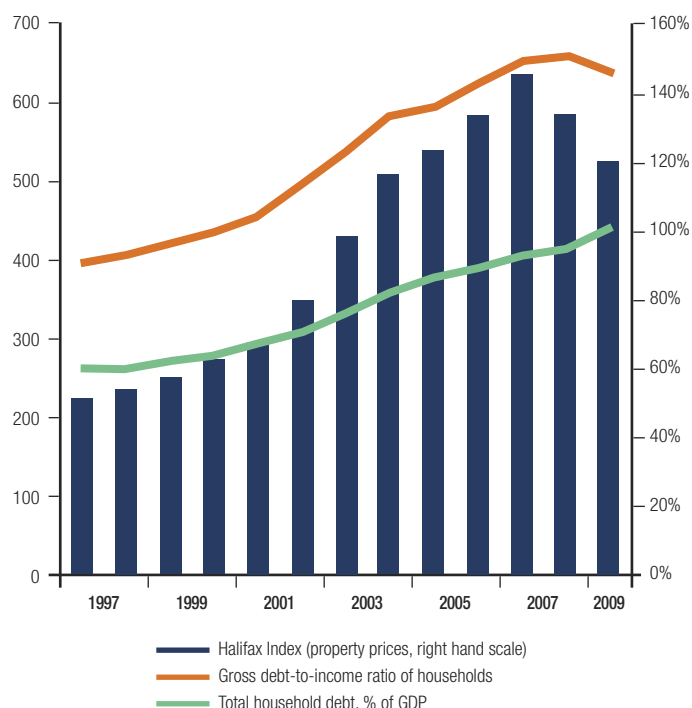
(3) The European KLEMS database (<http://euklems.net/>) provides detailed harmonised data on productivity by country and by sector.

14% of UK productivity growth over the period 1997-2007, against about 28% for services to businesses and 25% for distribution. An analysis of productivity factors highlights, besides total factor productivity (Solow residual⁽⁴⁾), the leading role played by the new information and communication technologies (NICT) and the growing skills base in the productivity gains over the period. For example, the proportion of university graduates in the working-age population rose from 23% in 1997 to 33% in 2008 - more than in France or Germany.

Despite these remarkable performances in terms of productivity, major imbalances were created during the 2000s. These contributed to the severity of the 2008-2009 crisis in the United Kingdom.

• **UK household debt shot up from 60% of GDP in 2000 to 101% in 2009** (+41 points) against a 15-point rise for the euro zone (from 49% to 64% of GDP). This surge in debt mainly reflects the boom in mortgage lending (86% of household debt in late 2011). Property prices thus tripled between 1997 and 2007. Fuelled by favourable fundamentals (rigid housing supply, the British preference for home ownership, low interest rates), the upward trend was maintained by greater credit availability (reduced selectivity exercised by banks) and rising debt ratios (see chart 1).

CHART 1
Property bubble and household debt



Sources: Halifax house price index, Eurostat (Gross debt /gross disposable income), Bank of England and OECD (Household debt, GDP).

• **The UK share of the export market deteriorated** (UK exports fell from 5.2% to 4.2% of world exports over the 2002-2007 period) and consequently the current account deficit (-3.3% in

2006) widened, despite the surge in exports of services (generating a surplus of 3% of GDP in 2007), particularly financial services (between a fifth and a third of exports of services).

• **The financial sector became overblown.** While the leverage ratio⁽⁵⁾ of financial institutions (901% in 2007) was one of the highest in Europe, consolidated private debt was close to 180% of GDP in 2007 (against 157% in 2002, or +23 points in 5 years), in a context of insufficient prudential regulation.

From August 2007, UK banks, more dependent on wholesale funding than their counterparts in other European countries and very exposed to the American mortgage risk, had been increasing their volume of refinancing operations with the central bank. In September 2007, the mortgage lender Northern Rock fell victim to a bank run with depositors withdrawing GBP 2bn of deposits in a few days. Weakened by its heavy dependence on short-term funding and on the securitisation of mortgage loans, which had become impaired (because of the subprime crisis and the local property market downturn from mid-2007), the bank was kept afloat by the authorities until its nationalisation in February 2008. The considerable banking sector losses (estimated by the Bank of England at between 2 and 4.8% of GDP) caused a credit crunch, (a sudden halt to bank lending); households, hit by a negative wealth effect as a result of a fall in the value of property and financial assets, reduced their consumption. According to a study by the IFS on the reaction of UK households⁽⁶⁾, where the head of household is aged over 50, to the erosion of their wealth during the financial crisis, the adjustment of consumption represented 2.1% of the change in wealth each year.

As a result of a sharp fall in consumption and investment, the United Kingdom experienced a more violent recession than the majority of European countries (-5.2% of GDP in 2009, the lowest point being reached in the first quarter). Safeguarding the financial system also required the vigorous intervention of the authorities through cash injections and the purchase of certain assets, as well as the direct recapitalisation of several banks, notably RBS and Lloyds Banking group, for about GBP 70bn. In total, the net cost of direct support to the UK financial sector, estimated at 6% of 2010 GDP by the IMF, is one of the highest in the European Union (after Ireland and Germany).

In response to this situation, the recovery plan put in place in 2008-2009 consisted of a temporary cut in VAT and income tax and an acceleration of public investment.

Factors explaining the recovery

The deterioration of public finances was one of the sharpest among OECD countries, with a public sector deficit of nearly 11.4% of GDP in 2009 (against 5.3% in France). The size of the public debt in 2009 (67.1% of GDP) led the authorities to take fiscal adjustment measures. Two years of contraction in internal demand followed. However, the crisis did not lead to a sharp rise in unemployment as in previous crises (see box 1, page 6).

(4) The Solow residual (also called total factor productivity) represents empirical productivity growth or growth which cannot be explained by the accumulation of factors of production (accumulation of capital, population growth or rise in the number of hours worked). Technology is the main component of the Solow residual.

(5) Debt/Equity, cf. MIP database: http://ec.europa.eu/economy_finance/indicators/economic_reforms/eip/sba/index.cfm

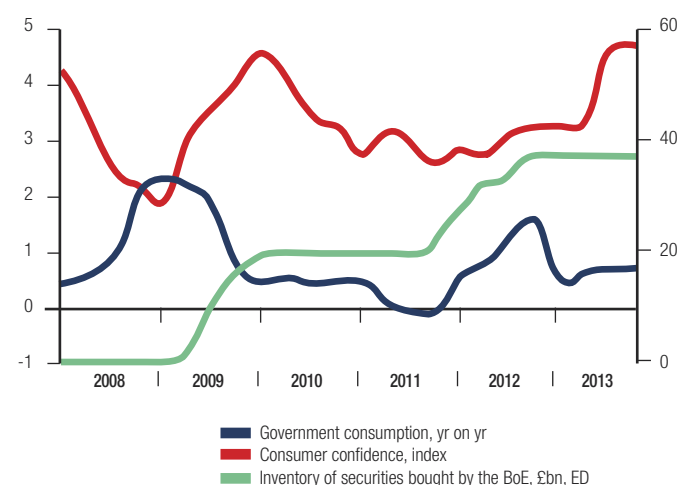
(6) Cf. The effect of the financial crisis on older households in England, IFS Working paper W12/09, Crawford and al, pages 7-8 and 22-23-24, October 2013.

The adjustment was made through wages (the average gross annual wage in services and industry was €36,386 in 2009 against €40,171 in 2008 according to Eurostat) and the length of the working week (31.3 hours in April 2011 against 32.2 hours in February 2008 according to the ONS). A turning point came when private consumption (+0.6% quarter on quarter) took over from net exports as the engine of growth in fourth quarter 2011.

2012, a pivotal year of recovery

In 2012, the scale of the fiscal adjustment was first of all reduced, with public spending contributing positively to growth. The government increased its final consumption expenditure⁽⁷⁾. Moreover, the Bank of England (BoE) decided on a second wave of massive securities purchases (eligible corporate bonds and gilts) through the «Asset Purchase Facility» (APF) in order to increase the liquidity available in the UK economy. At the end of 2012, the BoE injected £375bn into the economy. This led to a rebound of household confidence and a recovery of consumption.

CHART 2
2012, Expansory policy



Sources: Coface, BoE, ONS

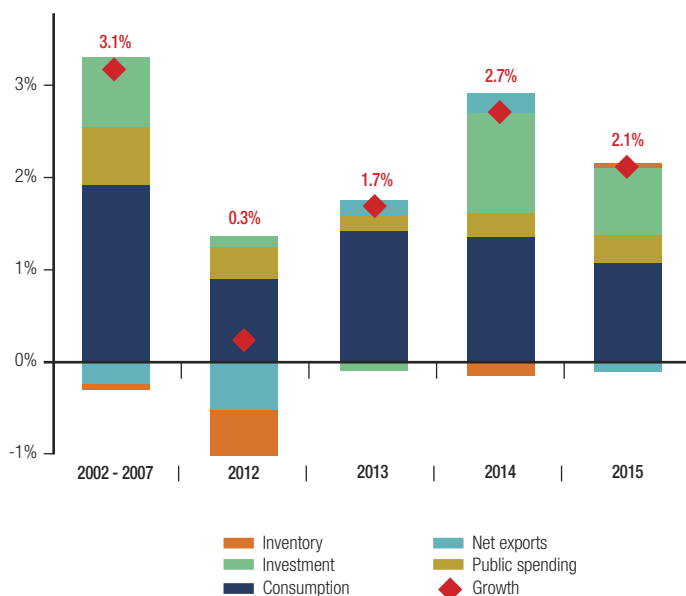
2013 and 2014, two years of vigorous growth

This confidence was strengthened in 2013 thanks to a reduction in the unemployment rate (-0.7 points over one year) and an easing of credit conditions. As a corollary to the fall in unemployment, the markets' anticipation of an end to the BoE's ultra-accommodating monetary policy (cut in the quantity of securities bought and a key rate hike) triggered a reaction by households expecting higher consumer borrowing costs.

TABLE 2: Main economic forecasts

	2012	2013	2014 (f)	2015 (f)
GDP growth (%)	0.3	1.7	2.7	2.1
Inflation (annual av.) (%)	2.8	2.6	1.8	1.8
Budget Balance / GDP (%)	-6.1	-5.8	-5.4	-4.9
Current Account Balance / GDP (%)	-3.7	-3.3	-2.7	-2.9
Public Debt / GDP (%)	88.6	92.1	92.5	91.8

CHART 3
UK, contributions to growth



Sources: Coface, ONS

Meanwhile, the government and the Bank of England introduced measures aimed at reviving the construction sector (Funding for lending and Help to buy⁽⁸⁾), which was followed by a rise in property prices in 2013. UK households enjoying high net worth⁽⁹⁾ (700% of annual income) received a boost from the rise in property prices (+8% in late December 2013 compared with December 2012), a price increase which impacted positively on private consumption. According to the study by Crawford et al⁽¹⁰⁾, the impact of a rise in real annual property prices of 2.5% over one year generates real income equivalent to 17.5% of GDP (wealth effect), which helped push up consumption by 0.4%.

GDP thus grew by 1.7% in 2013 and Coface predicts that growth will be even more vigorous in 2014 (+2.7%), with strong household and business confidence indicators at the end of May 2014. Meanwhile, a drop in the savings rate, which fell by 2.2 points of disposable income (DI) in 2013 (5.1% of DI against 7.3% in 2012), is underpinning consumption. Moreover, household disposable income tends to increase in the first four months of the year (+3.3% in Q1 2014 relative to Q4 2013). After consumption, investment is expected to be the second driver of growth this year.

(7) The government's final consumption expenditure covers all government spending on the purchase of goods and services (including employees' pay).

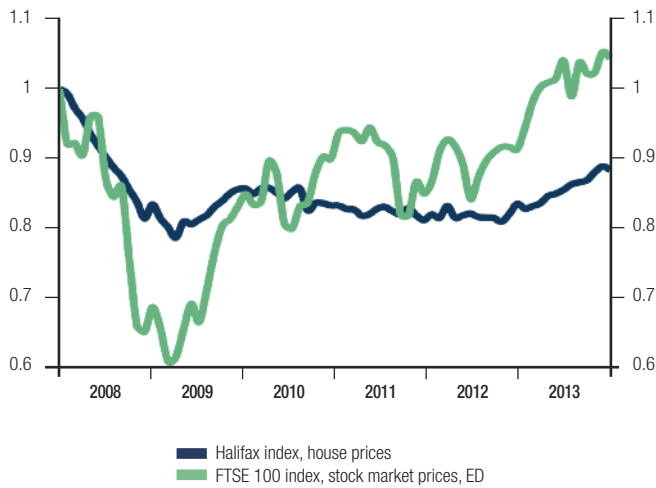
(8) The Funding for Lending Scheme (FLS) was introduced on 1 August 2012 and runs until 31 January 2015. It allows banks to obtain liquidity at lower cost from the BoE. In exchange the banks must increase the volume of their loans to the private sector and particularly to SMEs.

The Help to buy scheme allows a buyer with a deposit of at least 5% of the transaction amount to benefit from a government loan of up to 20% of the value of the property. The buyer pays no interest during the first five years.

(9) Wealth adjusted by the value of their debt.

(10) The effect of the financial crisis on older households in England, IFS Working paper W12/09, Crawford and al, pages 7-8 and 22-23-24, October 2013.

CHART 4
Change in property and stock market prices, 2008 = 100



Sources: Coface, Halifax, FTSE

With high levels of production capacity utilisation (82%), the renewal of fixed capital will support activity. Easier access to credit for businesses will facilitate this. The «Funding for Lending Programme» had two parts, loans to SMEs and mortgages. The BoE has now decided to target loans to SMEs while halting the programme of those related to property. Moreover, corporate tax will be cut again by one point (20%) in January 2015 to improve the competitiveness of British businesses. This rate was 28% in 2010.

Will the monetary policies referee the growth in 2015?

If the policies put in place bear fruit, the United Kingdom will approach 2015 with a sustained rhythm of growth (after an expected increase of 2.7% in 2014) with inflation above 1.5%. This favourable dynamic will encourage the authorities to cut asset purchases and, during 2015, to raise the Central Bank's key rate (base rate). Coface estimates that growth in the United Kingdom will be +2.1% in 2015, because households will slightly slow their purchases (contribution of 0.8 of a percentage point) as the cost of consumer borrowing rises. On the investment side (contribution of 1.1 percentage points), the renovation of equipment will continue and we estimate that the Funding for Lending Scheme will be extended for a further year. Moreover, the new cut in corporate tax will bring in other foreign enterprises attracted by the UK tax regime and the proximity of the European market.

But the European Central Bank's monetary policy will put pressure on the British economy. Indeed we can expect that the United Kingdom's real exchange rate will appreciate, in conjunction with the BoE's monetary tightening combined with the ECB's expansionary policy. As a result, although a stronger supply of British products will contribute to a slight increase in exports in 2014, export growth will be outstripped by that of imports. Accordingly, net exports will contribute negatively to growth (-0.1 percentage points).

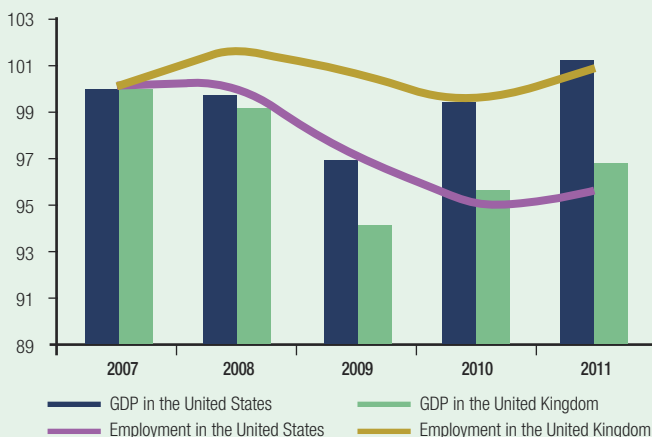
Despite the slight slowdown in growth expected in 2015, buoyant investments will mark the necessary turn towards higher potential growth. However, the burden of private debt places a curb on recovery and is a significant weakness for the United Kingdom.

Box 1

HAS THE BRITISH LABOUR MARKET REALLY RECOVERED?

According to the latest estimates, the United Kingdom's unemployment rate (6.8% in Q1 2014) has fallen by one point in the past year and dropped below the 7% threshold for the first time since the end of 2009. Employment held up particularly well during the crisis, given the scale of the recession in 2009 (5.2% contraction of GDP): the unemployment rate reached a peak of 8.5% only in late 2011. Thus, despite a recession more severe than that of the United States, the fall in employment was much less pronounced (see chart 5):

CHART 5
Change in the GDP and employment indices in the United Kingdom and the United States, 2007=100



Sources: International labor statistics, BLS; OCDE, National accounts

On a downward trend since that date, the unemployment rate was 3.5 points below the EU15 average (Western Europe) in 2013 (7.5% against 11.9% for the EU15). At the same time, the employment rate has risen since 2011 and should be close to its pre-crisis maximum at 72.7% of those aged between 16 and 64. It has for several years been distinctly above the average of the OECD countries (65.3%) and of the EU (64.2%).

The positive impact of this recovery in employment on household consumption and on growth must, however, be qualified. First of all, we are seeing a sharp rise in part-time work, temporary contracts and above all of self-employment, while the number of full-time workers is still slightly below its 2008 level (see chart 6). Over a quarter of British workers (25.5%) are part-time, a larger proportion than in the rest of Western Europe (22.8% for the EU15). A growing proportion of them (4.7% of total employment) are in involuntary part-time employment: this proportion remains, however, below that observed in France (5.4% of total employment). These precarious contracts have resulted in an increase in the number of poor workers⁽¹¹⁾. However, since last year, the growth of full time employment (+2.6%) has been stronger than that of part time employment (+1%). The continuation of this trend will allow a more generalised and more robust improvement in the job market.

(11) The historically high rates of involuntary part-time jobs and employees on temporary contracts looking for permanent contracts (40% of employees on temporary contracts) are indicators of under-employment.

CHART 6
Contribution to the changing employment levels



Sources: Coface, ONS

Part-time workers, whose hourly pay is generally lower (low-skilled work), earn on average a third of the wages of full-time workers. These part-time workers are often young adults⁽¹²⁾ whose place in the job market is insecure: the youth unemployment rate (21% for 16-24 year-olds) has fallen only by one point from its 2011 maximum, and the proportion of unemployed young people (12%, number of young unemployed relative to young people as a whole) was above the European average (10%) in 2013.

The fall in the number of unemployed is also linked to a decline in real wages (nominal wages are growing significantly more slowly than inflation) since 2008. This decline concerns all workers (with the exception of very high earners)

but is particularly marked for low wages and young workers aged between 18 and 29. Thus, since 2008, the median wage has fallen by 10% in real terms. Some economists, such as professors Blanchflower and Machin⁽¹³⁾, hold the view that the current economic recovery will not automatically lead to a renewed rise in real wages, at least around the median wage. The revision of the forward guidance issued by the Bank of England, which considers the recovery to be still weak and that inflationary pressures are non-existent despite the fall in unemployment to below the 7% threshold, also suggests the existence of under-employment and the absence of upward pressures on wages.

The surge in temporary and part-time work and the fall in real wages are helping to maintain the poverty rate⁽¹⁴⁾ at a relatively high level (around 10%). Consequently, the United Kingdom is one of the most «unequal» countries in Europe, with a Gini⁽¹⁵⁾ coefficient (0.36 in 2011) above the great majority of European countries (for example, the coefficient was 0.31 in France and 0.29 in Germany in 2011). Income from work largely contributed to this rise in income inequality: the real hourly wage rose by 3% p.a. for the best paid 10% between 1985 and 2005, against 1.8% for the 10% at the bottom of the wages ladder. The incomes of lower-income households, strongly supported by social security benefits during the crisis years, are expected to suffer from their planned reduction, while the marginal tax rate on the highest incomes was cut from 50% to 45% in 2013, reducing the redistributive impact of the tax and benefits system

(12) 18-25 year-olds are the only category for which the relative poverty rate increased between 2007 and 2010.

(13) For an informative summary see «Falling real wages», Cf. Center for economic performance, Center piece Spring 2014 <http://cep.lse.ac.uk/pubs/download/cp422.pdf>

(14) Proportion of the population whose income per unit of consumption is below 50% of median income. Source : OECD, income distribution database, 2010. The poverty rate after housing costs is estimated by the Institute of fiscal studies, cf. «Living standards, Poverty and inequality in the UK 2013», IFS Report R81, part 4.

(15) The Gini coefficient is a synthetic indicator of income inequalities. It varies between 0 and 1. It is equal to 0 in a situation of perfect equality where all incomes would be equal and to 1 in the situation of the greatest possible inequality, where all incomes except for one would be nil. Between 0 and 1, the higher the index, the greater the inequality

2/ THREATS TO RECOVERY

Although the UK economy is healthy, it seems, however, more vulnerable than recoveries from past crises.

TABLE 3: UK, crisis exits

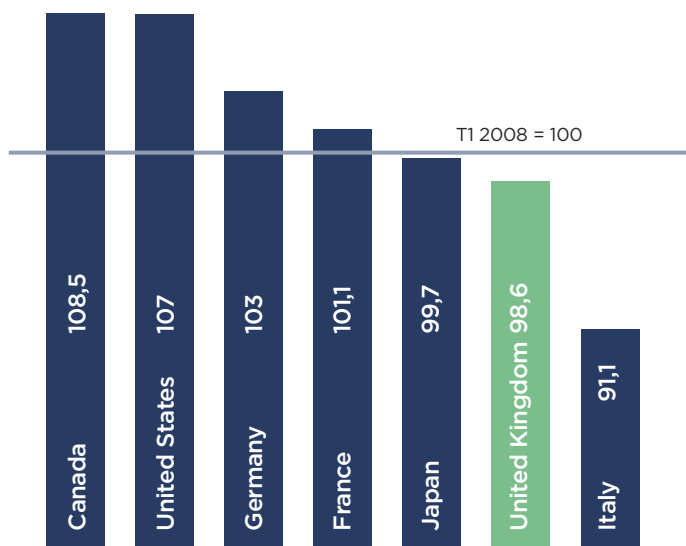
Crises	Number of quarters needed to return pre-crisis production
Q2 1973	11
Q4 1979	13
Q1 1990	10
Q2 2008	26 (Coface estimate)

First of all, although experiencing a high level of growth since the second half of 2012, the United Kingdom has still not regained pre-crisis production levels. Never has the country taken so long to recover from a crisis (see table 3).

We believe that the recovery will take place in the third quarter of 2014, or six and a half years after the start of the shock to the British economy.

Among the G7 economies, only Italy has fallen more significantly behind in its recovery process. Admittedly the British unemployment rate has resisted well compared to the other European economies, but the adjustment has been made by a contraction in working hours and a reduction in wages, while inequalities remain very sharp in the United Kingdom (see box 1 page 5).

CHART 7
The G7 and the emergence from the crisis, GDP in Q4 2013

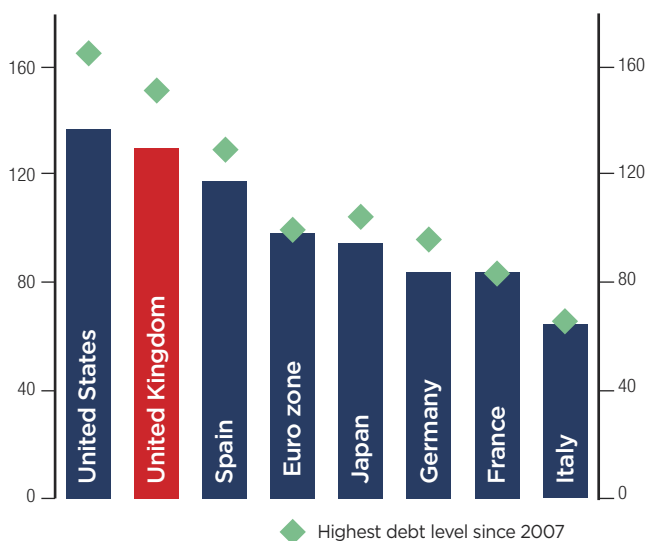


Sources: Coface, National statistics

Colossal private debt

There is enough renewed household confidence to generate consumption. However, it is mainly due to wealth effects (see previous section). The rise in prices for property and financial assets needs to be controlled as it consolidates gaps in wealth between owners and tenants and strengthens the appetite for mortgage credit. Indeed, according to the council of Mortgage Lenders (CML), the number of home loans increased by 33% between February 2013 and February 2014. Risks of property bubbles are appearing, because UK households remain heavily indebted (129.9% of disposable income (DI) in the Q3 2013). Among the G7 advanced economies, only North American households have higher debt levels (137% of DI in the United States). Furthermore, despite a 3.4% growth in disposable income in the first quarter of 2014 relative to the fourth quarter of 2013, the trend has been towards a slowdown since 2008, in contrast to the period 1990-2007. This fact penalises households' capacity to rapidly clear their debts with regard to their income.

CHART 8
Household debt, % DI



Sources: Coface, Banque de France

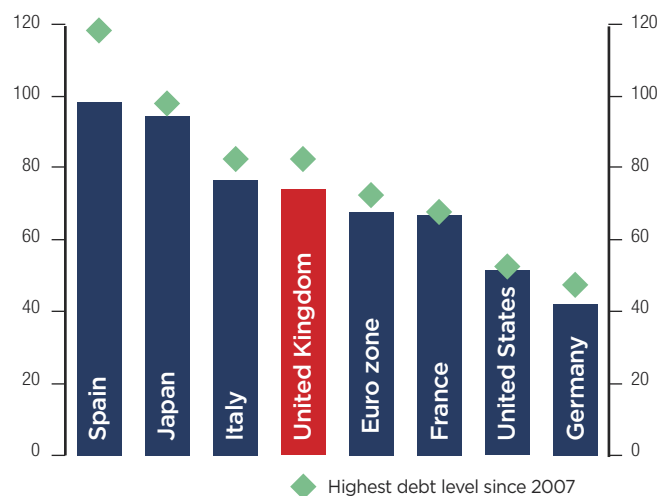
Feeling confident, households are therefore reducing their savings in order to consume more. Interest rates have reached a historically low level enabling households and businesses to reduce their debts by renegotiating their loans (see charts 8 and 9).

The ultra-expansionary monetary policy coming to an end soon

A rise in rates linked to a low unemployment rate and inflation within the 2% target set by the BoE constitutes a major risk. This is because the confidence curve could rapidly reverse as households come under pressure from the burden of private debt (165% of GDP in 2013). Moreover, the decline in savings relative to disposable income could adversely affect the external accounts in the medium term by restricting investment.

Business investment constitutes another point of weakness, because although big businesses can easily access the financial markets and can thus finance themselves by issuing debt, SMEs, like households, are highly indebted and, taken individually, have a marginal importance in the economy, which limits their financing capacity without recourse to credit. Although the BoE wants to stimulate credit to businesses through «Funding for lending», outstanding credit to non-financial businesses continues to decline (-4.1% in March 2014 over 12 months and for SMEs alone by -3%)

CHART 9
Debt of non-financial companies, % GDP



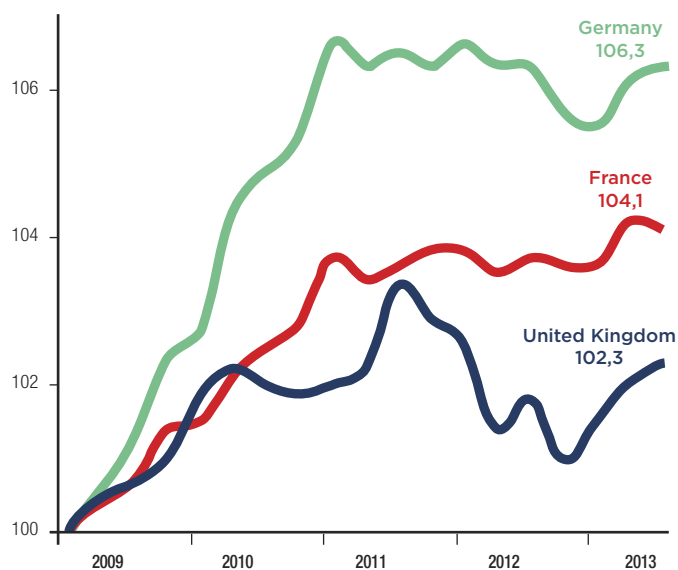
Sources: Coface, Banque de France

Low productivity

On the credit demand side, the margin⁽¹⁶⁾ of non-financial companies (32%) remained lower than the euro zone average (37.5%) in 2013 and did not encourage businesses to invest. However, despite high debt, the risk of investing for businesses is seemingly unimportant, as the UK economy suffers from a productivity level below that of the other developed economies (see chart 10). After having caught up in the 90s, the gap with France and Germany widened again between 2009 and 2012. These deficiencies with regard to productivity result chiefly from under-investment. The production capacity utilisation rate is high (82% at the end of 2013), reflecting a tension between supply and demand.

(16) For a business the margin is the relationship between the gross operating surplus and the business's added value.

CHART 10
Productivity per worker, Q1 2009 =100



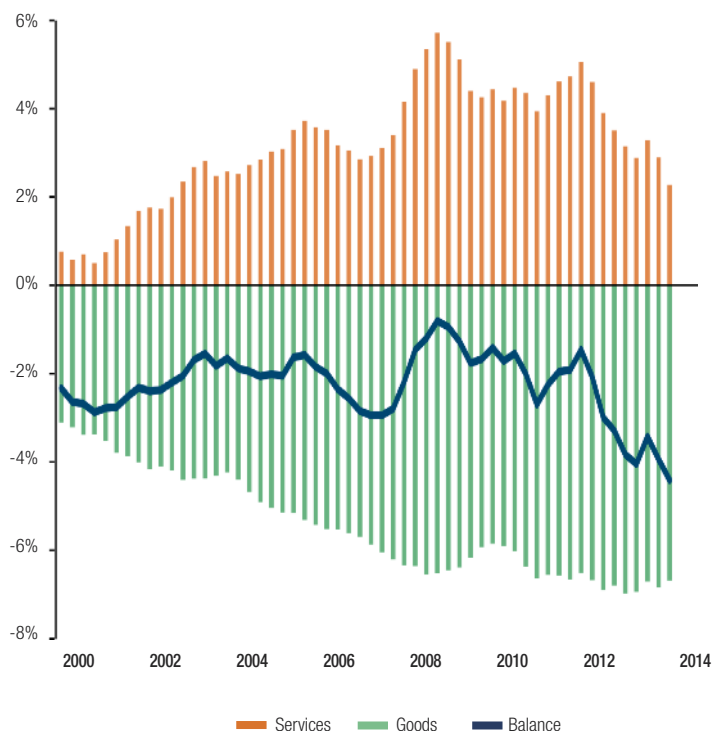
Sources: Coface, Eurostat

The most recent trends are, however, positive, as the growth in productivity per worker was greater in the United Kingdom than in France or Germany. The dynamics of investment have been strong since the second half-year of 2013 (+4.1% of investment in machines and capital goods in Q3 2013 compared to Q2) and have enabled a significant improvement in productivity. This increase is expected to enable a reduction in the trade deficit in the medium term. The growth in the supply of manufactured products will reduce imports if it concerns highly price-competitive public goods. But this growth can also benefit exports if, as with cars, it is focused on high value-added sectors or niche markets. In order to have a higher leverage effect, UK businesses need to increase their research and development spending. Compared with the other G7 countries, only Italy (1.2% of GDP) and Canada (1.7%) spend less than the United Kingdom (1.8%). Germany and the United States devote one point more of GDP (2.8%) to the search for innovation.

A persistent current account deficit

The United Kingdom's balance of trade is traditionally in deficit. This deficit was close to 2% between the beginning of the years 2000 and 2008, the deterioration of the balance of goods being offset by an increased services balance surplus, linked in part to the financial sector (see chart 11). Exports of financial services explain 46% of the balance of services surplus. After having been partially absorbed in 2009 and 2010, the deficit worsened distinctly from 2012, mainly because of lower exports of services, to reach 4.4% in late 2013. An indication of this mixed picture is the fact that the United Kingdom went from being the 5th biggest world exporter of goods in 1990 to 11th in 2012 (behind Belgium, in particular), while it is the 2nd biggest world exporter of services behind the United States.

CHART 11
The United Kingdom's trade balance (as % of GDP, source: ONS)



Sources: Coface, ONS

The origins of these gaps with regard to exports of goods are diverse. They arise firstly from the classic problems from which the major developed economies suffered in the first decade of this century, i.e. the loss of export market share to the benefit of the emerging countries. Between 2000 and 2011, the UK's share of world exports dropped from about 5% to less than 4%. The trend and the levels are identical for France and similar in the United States, Japan and Italy. Only Germany has not suffered (about 8% in 2000 as in 2011).

But beyond these common trends, British exports have also suffered from more specific shortcomings, as is shown by total export growth since the early 2000s. With an increase of 85% since 2001, the United Kingdom has done distinctly less well than Germany (+140%), the United States (+115%) and Spain (+181%). But the level is slightly above that of Japan and France.

Exports suffer in particular from the weak orientation of the United Kingdom's trade towards the emerging countries: the share of exports to Brazil, China, India and Russia (BRIC) scarcely exceeded 5% in 2011 – a lower level than all the other G7⁽¹⁷⁾ countries.

But between 2007 and 2011, UK exports to the BRIC countries were on average more than two times lower than those of the United States, Japan or even Germany. The United Kingdom's very poor export performances therefore do not arise only from a more unfavourable structure of their trade, which is directed more towards the lower-growth advanced economies. They are also explained by problems of competitiveness.

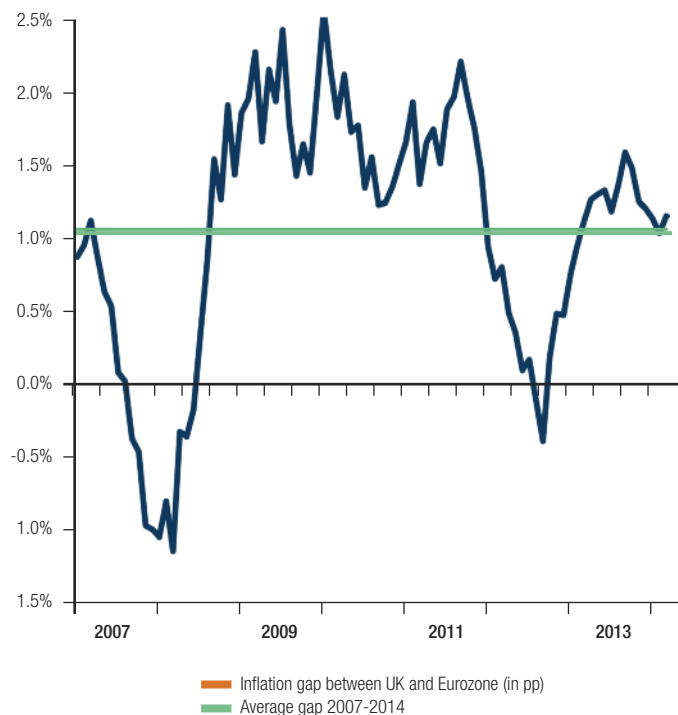
(17) International Monetary Fund, United Kingdom 2013, Article IV consultation

Marked increase in unit labour costs in the 2000s

UK exporters are in fact penalised by the strong increase in unit labour costs (+33% between 2001 and Q3 2013). This increase is more marked than in the United States (+17%), Germany (+11%), Japan (+16%) and even France (+26%). Only Italy did less well over the same period (+34%).

This increase in unit labour costs reflects a structurally higher inflation rate than in the other advanced economies: the consumer price index has increased by 3.0% p.a. on average since early 2007, or about one point higher than in the euro zone (see chart 12, average inflation at 1.9% since 2007) and than in the United States (+2.1% on average over the same period).

CHART 12
Inflation gap between the United Kingdom and the euro zone
(in % points, sources: central banks)

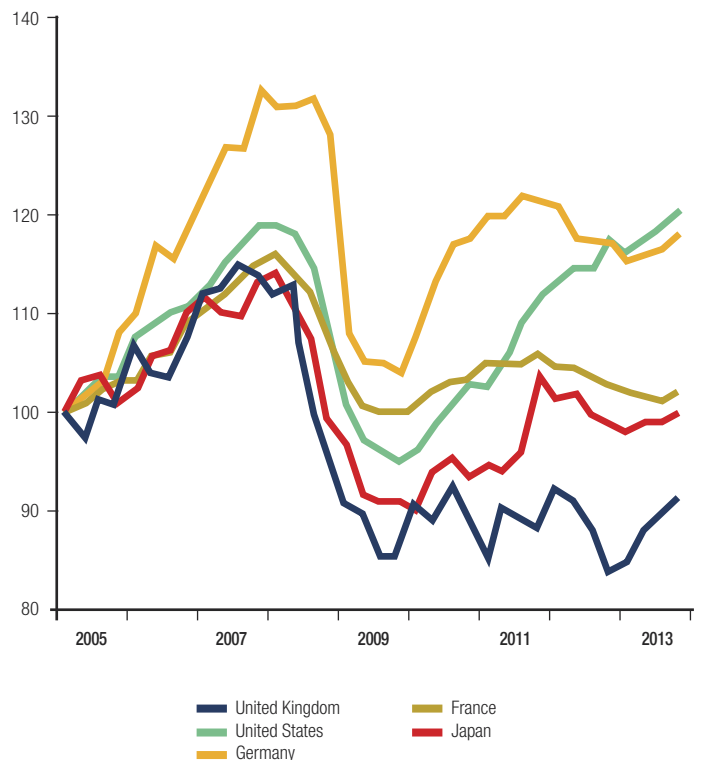


Sources: Coface, Central banks

Admittedly, certain temporary factors such as VAT increases decided in the context of public spending cuts or imported energy price rises played a role in this high level of inflation. But they do not explain the gap in level with the euro zone. The gap between the average underlying inflation, i.e. excluding energy and food, of the United Kingdom between early 2007 and March 2014 and that of the euro zone is even greater (+2.6% against only 1.4% in the euro zone, or 1.2 points of difference). Even after the 2008-2009 crisis, underlying inflation fell little, remaining close to 3% throughout 2010 and 2011. Now, in any market, prices reflect the balance between supply and demand. High inflation thus reflects a too low level of the first relative to the second. This relatively high level of inflation excluding energy and food, therefore, reflects in part inadequacies of supply and therefore of production capacity.

The dynamics of investment in fixed assets (i.e. excluding construction) in the past decade confirm this. Such investment has fallen by 9% in real terms since early 2005 in the United Kingdom, while at the same time growing noticeably in the United States and Germany (respectively +20% and +18%) and remaining almost unchanged in France and Japan (respectively +2% and 0%). This chronic under-investment by businesses in equipment has various origins: outstanding bank loans more oriented towards construction, the desire of businesses to reduce their debt, the depth of the 2008-2009 crisis... Whatever the reasons, it goes some way to explaining this imbalance between supply and demand and, therefore, relatively high inflation. In other words, the stock of machines is aging and is not being renewed quickly enough, which adversely affects the production capacity and competitiveness of local businesses.

CHART 13
investment in fixed assets
(Q1 2005 = 100, national sources)



Sources: Coface, national sources

... does not explain everything

The recent changes in the structure of goods exports confirm the loss of competitiveness of the sectors whose products have relatively high price elasticity: electronic goods represented only 8% of total foreign sales at the end of 2013 against 14% eight years earlier. This decline was offset by aeronautics (the share of which in the total rose from 6 to 9%) as well as by vehicle sales (up from 10 to 12%). These are precisely the three sectors on which we focus in the following section.

But despite this relatively high inflation, the real effective exchange rate has depreciated since 2005 (-16%), i.e. by more than that of the United States (-13%), Germany (-10%), Spain (-9%), France (-2%) and Italy (+1%). Only the yen lost more of its

value over the same period (-31%). However, this depreciation of the sterling did not significantly impact the trade balance, its deficit having been stable (above 6%) for nearly 6 years. This implies that variables other than the price are behind the deficit. The positive effects of this depreciation on exports seem thus to have been offset by the negative ones linked to higher import prices (particularly for oil which contributes over 11% to the total deficit). Finally the strength of domestic demand and particularly of the growth of credit before the 2008 crisis and since 2012

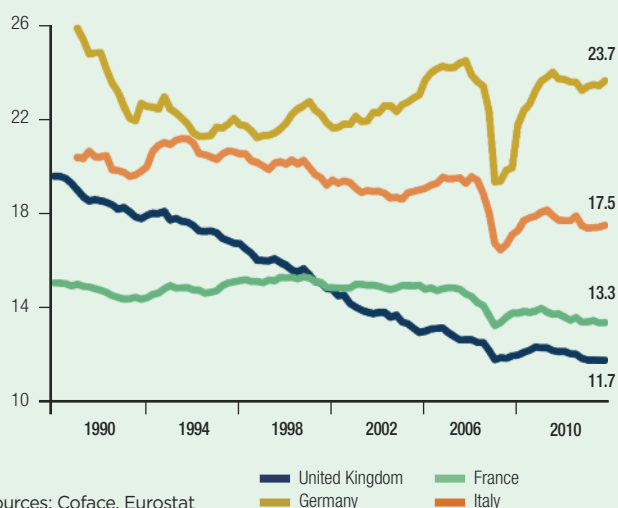
may also have had a positive effect on imports. In the end, the dynamics and structure of the United Kingdom's external trade confirm both the strengths and the structural weaknesses of its economy. The trade balance reflects the country's internal imbalances (particularly the investment shortcomings), even if its structure underlines the United Kingdom's comparative advantages: services and high value-added industries such as the vehicle and aerospace industries.

Box 2

BRITISH DE-INDUSTRIALISATION: ITS EXTENT?

The decreasing importance of the industrial sector has been a phenomenon common to the advanced countries since the 1970s. In the case of the United Kingdom the importance of manufacturing has contracted more rapidly than in the main European economies.

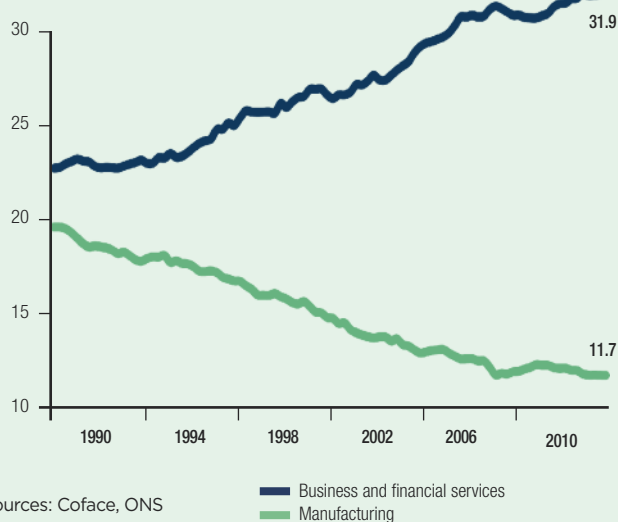
CHART 14
Manufacturing, % GDP



Sources: Coface, Eurostat

This is because the added value generated by the financial services and business services sectors has very largely made up for the decline in industry. Although the contribution of the manufacturing sector to total added value declined by 8 percentage points between 1990 and 2013, that of financial and business services increased by 10 points.

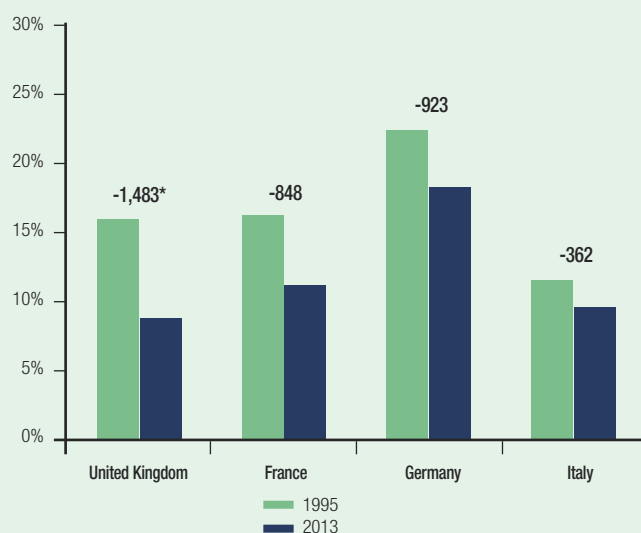
CHART 15
Contributions to GDP, p%



Sources: Coface, ONS

This change, though on the whole benefiting the British economy because of exceptionally high growth between 1990 and 2007 (+2.9% p.a.), destroyed a number of jobs, unparalleled in Europe. 1.5 million jobs were lost in the industrial sector, of which more than 400,000 were in the textile sector, a similar number in metallurgy and about 200,000 in the chemicals sector.

CHART 16
Jobs in industry, % total

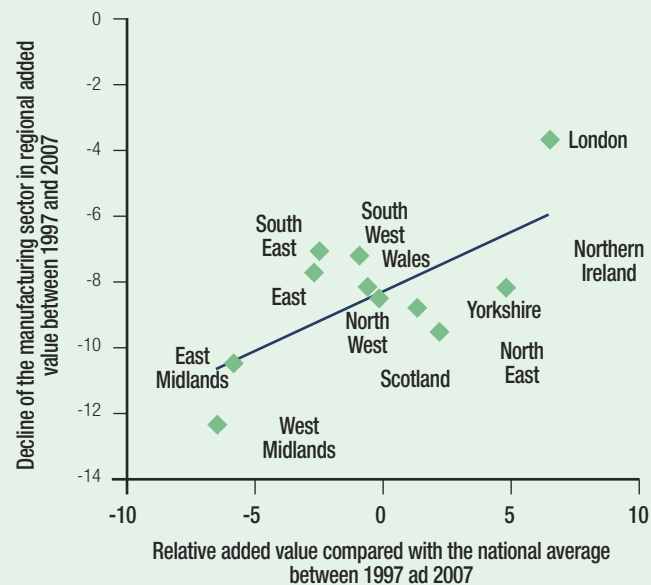


* 1,483 thousand jobs lost between 1995 and 2013

Sources: Coface, Eurostat

Although these job losses did not have a major effect on the unemployment rate at national level, because of the economy's vigorous growth, there was great regional disparity. A study made by Natixis in 2012 (Migration in European industry: a map-based illustration) reveals the migratory flows of European industry. From the study we see that the textile industry left the East and West Midlands for redeployment in Bulgaria, Italy and Greece. The regions of the West Midlands and Yorkshire were also affected by the shrinking of the metals industry. Part of the chemicals industry migrated from Cheshire, Derbyshire and London to Germany. Despite increased wealth during the period, many households in the former key industrial regions (Midlands) saw a growing gap between their income and average UK household income.

CHART 17
Industrial decline affecting the centre



Sources: Coface, ONS

Although the United Kingdom has suffered from a lower cost competitiveness vis-à-vis the Central European and Asian economies, this weakness is not enough to explain the size of the external trade deficit. Rather, there is a second aspect which weakens the British economy: namely competitiveness excluding costs. This symbolises the capacity to move up-market via innovation, research and development. Between 1989 and 2007, according to Kitson and Michie ⁽¹⁸⁾, manufacturing business assets (equipment and structures) prizes increased by 0.8% p.a. against 1.9% in the United States, 3.4% in Japan, 1% in Germany and 1.1% in France. Moreover, the lack of skilled labour available in sectors as different as construction and health adversely affects the country's capacity to reindustrialise and to reduce its deficit vis-à-vis its partners. In fact, according to UKCES ⁽¹⁹⁾ (UK Commission for Employment and Skills), one job requiring qualifications or experience out of five was difficult to fill for lack of competence in 2013 compared with one out of six in 2011.

(18) Kitson et Michie «the deindustrial revolution : the rise and fall of UK manufacturing, 1870-2010», oct 2012

(19) UK Commission's Employer Skills Survey 2013: UK Results

3/ WHAT INDUSTRIAL RENEWAL?

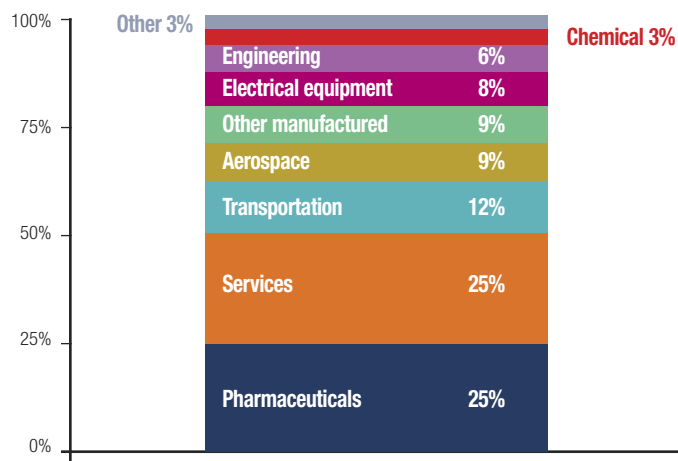
Although the UK trade balance is in substantial deficit (-6.5% in Q4 2013, if we disregard services), some high-tech sectors are managing to buck the trend, such as the aerospace, pharmaceutical and automotive industries. Sustained by constant innovation, enabled by considerable R&D investment, these sectors remain competitive and are world leaders. We shall develop the case of the pharmaceutical and aerospace industries as well as the defence sector in order to better grasp their distinctive features. Moreover, certain companies are succeeding in creating innovation niches in sectors, which are, however, very competitive, such as Dyson in durable goods (box 3 page 14). Focus on this United Kingdom which innovates.

The pharmaceutical industry, leader in Europe

The United Kingdom is at the leading edge of the pharmaceutical industry. About 15% of the most used medicines in the world come from British research centres. Only the US pharmaceutical research centres can boast of doing better. According to the Association of the British Pharmaceutical Industry (ABPI), the sector, more than any other, generates an annual trade surplus of 6 billion euros. Its position as the largest contributor to external trade embodies the dynamism of the sector, which was only the fifth biggest contributor in 1977 and the third in 1990.

The British pharmaceutical industry is also the one which invests most in R&D, accounting for nearly €6 billion a year (according to the ONS) or a quarter of total R&D spending in 2012. This amount is growing strongly, as evidenced by nearly 50% growth since 2005. By way of comparison, the pharmaceutical industry invests as much in R&D as the whole of the tertiary sector.

CHART 18
Distribution of R&D in the United Kingdom

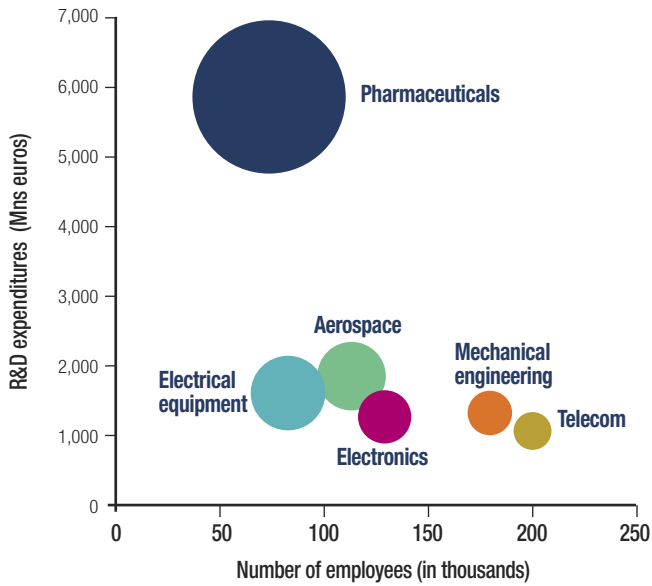


Sources: Coface, ONS

At European level, the pharmaceutical industry holds a leading place representing about 10% of total world spending (according to the ABPI) ahead of its German (7%) and French (6.5%) counterparts.

Although the industry itself finances 65% of its R&D spending, the British authorities play a significant role. Having entered into force in April 2013, the «Patent Box» is a law allowing a reduced rate of corporate tax on profits, down from 21% to 10% for products patented in the country. It therefore greatly benefits the pharmaceutical industry. Moreover, the industry works in close collaboration with the universities and, in particular, finances over 600 doctoral candidates annually (ABPI).

CHART 19
R&D and number of employees
 (figure = R&D per employee in EUR thousands)

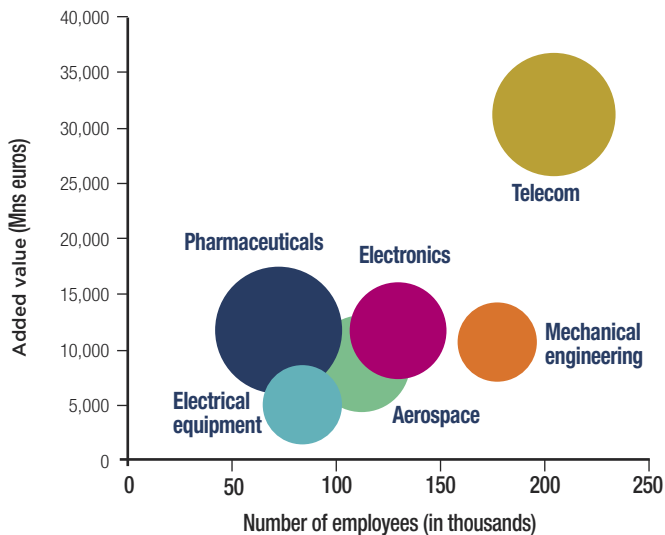


Sources: Coface, ONS, ADS

Moreover, it directly employs nearly 73,000 workers (26% of the total work force) in the country, 23,000 of them in highly skilled jobs. Also, more than 60% of the investments in R&D in the sector relate to wages (according to the ABPI).

Finally the sector generates almost €10 billion of added value, or a similar level to that of electronics or transport, which employ considerably more workers (according to ABPI). The productivity of the pharmaceutical industry is therefore extremely high.

CHART 20
Added value and number of employees
 (figure = added value per employee in EUR thousands)



Sources: Coface, ONS, ADS

The sector is fragmented at world level. So for example, the Swiss company Novartis, number 1 in the world, had a market share of 5.8% in 2013. Two British groups, whose market shares exceed 3.5%, stand out on the international stage: Glaxo-

SmithKline (world's 6th largest pharmaceutical firm in 2013) and AstraZeneca (8th). Present in more than 100 countries they achieved respectively turnovers of €23.7 and €22 billion and each invested nearly €5 billion in world R&D. They are, among others, at the cutting edge of innovation in the treatment of cancer, respiratory, cardiovascular and disorders of the nervous system. These two groups also produce some of the main blockbusters (medicines generating over one billion dollars p.a.), such as Crestor (cholesterol) and Nexium (stomach illnesses) for AstraZeneca or Seretide (asthma) for GSK.

US firm Pfizer's attempted bid to acquire AstraZeneca illustrates the attractiveness of the British pharmaceutical industry. The transfer of Pfizer's head office to the United Kingdom, where corporate tax is 21% against 35% in the United States, was one of the reasons given. However, Pfizer's interest in its British counterpart cannot be explained exclusively by tax reasons. It is due also to AstraZeneca's sound financial health and the development of innovative products absent from Pfizer's range, the British company having a fuller pipeline in certain therapeutic areas, such as oncology, than its American counterpart.

Exceptional civil and military expertise

The British aerospace industry and defence sector are among the most competitive in the world. Only the United States performs better in this field. According to Aerospace, Defence and Security (ADS), the professional association of the British aeronautical industry, with 17% of market share, the British aerospace industry is the biggest in Europe, similar to defence, which accounts for a fifth of world exports.

The aerospace industry directly employs 113,000 people, or 0.40% of the total labour force. This high figure rises to almost 250,000 if we take into account indirect jobs (according to the ADS). The aerospace industry is dual: it can be military or civil. The civil branch has displayed uninterrupted growth in the United Kingdom, at the remarkable pace of 28% in 2013. In total nearly 1,300 new planes were delivered and over 3,000 orders were received in the course of the year. Civil aerospace exports total more than €12 billion, generating a trade surplus of nearly €3 billion (according the ADS). Increased demand from emerging countries, such as India or Russia, suggests sustainable growth in this sector.

Like the pharmaceutical industry, the aerospace industry is particularly R&D intensive, as it needs to constantly innovate to remain competitive. Accordingly over €1.7 billion is invested every year in R&D in the sector in the United Kingdom (according to the ADS). Moreover, the government gives considerable support to the industry, particularly through The Aerospace Growth Partnership (AGP) created in 2012. The aim of this partnership is to establish a long-term global strategy that allows the British aerospace industry to stay ahead of the competition. With a view to this, over €2.5 billion is expected to be invested by 2020 through the AGP.

The weight of the defence sector is even more important in terms of staff: over 155,000 people are directly involved and nearly 300,000 in total (according to the ADS). The sector's annual turnover is estimated at \$27 billion. Despite budget cuts,

the British government is the main client, spending more than €16 billion a year on defence. Exports, which constitute the rest of the sector's activity exceeded €10 billion in 2012, up by 62% (according to the ADS).

R&D investments too are crucial and substantial: they amount to more than €4 billion p.a. with 50% undertaken by The British Ministry of Defence. As with the aerospace industry, a partnership has been established between the industry and the government under the name of the Defence Growth Partnership (DGP).

The defence sector contains more than 9,000 enterprises, essentially SMEs. By way of comparison, the United Kingdom has more SMEs in this sector than France, Spain, Italy, Germany and Norway together. However, it also has several major groups, among the world's biggest in the defence sector. BAE systems is thus the world's third largest group in the defence sector, behind the US groups Lockheed Martin and Boeing. Established in 1999 through the merger of Marconi Electronic Systems and British Aerospace (co-developers of the Concord), its turnover amounted to €21.2 billion in 2011. It has over 88,000 employees, nearly 35,000 of them in the United Kingdom. It produces, among other things, military aircraft, tanks and aircraft-carriers. Another British giant, Rolls Royce is the world's second largest producer of aircraft engines (civil and military), behind the American firm General Electric Aircraft Engines. It also makes engines for ships and for electric generators. Its turnover reached €19 billion in 2013, against less than €7 billion six years previously. It employs more than 55,000 workers, 24,800 of them in the United Kingdom. Meanwhile, the Airbus and Boeing groups also have production sites in the country, a sign of the UK's attractiveness. So, between 20% and 25% of the value of each aircraft is produced on British soil. This proportion even reaches 40% for the Airbus 380, whose engines are made by Rolls-Royce.

Recent Developments In The British Automotive Market

The automotive market in Britain is a peculiarity in Western Europe. For two years there has been uninterrupted growth in new car sales. The dynamism results notably from the re-orientation of its production towards premium new models, making it one of the most dynamic export sectors.

An industry which has successfully reoriented itself

The health of the British automotive industry contrasts sharply with that of its continental neighbours (except Germany). Between 2012 and 2013, private car production grew by 3.1%, namely the fourth consecutive year of growth (growth rate respectively of 9%, 5.8% and 27% between 2012 and 2010).

This current success contrasts with past difficulties, illustrated by the bankruptcy of the Rover Group in 2005. Like its Southern European counterparts, British car manufacturers had an offer directed to the domestic mass market, which has turned into an

export-oriented premium offer. Accordingly, nearly 77% of vehicle production (cars and utility vehicles) is exported. The European Union accounts for nearly 49% of vehicles exported, highlighting the dependence of this industry on its neighbours. Paradoxically, the United Kingdom imports 80% of the new vehicles sold each year on its soil, mainly mid-range models.

Nevertheless, according to KPMG ⁽²⁰⁾, the UK's trade balance on this segment was positive in 2013 by £70 million, which, still according to KPMG, implies that the price of the vehicles exported was £20,600 against £13,000 for those imported, thus strengthening the idea of the success of the «premiumisation» of this sector. We only need to think of the makeover (and success) of the resolutely export-orientated makers of the MINI and the Land Rover, both owned by foreign groups (BMW and Tata Motors respectively). This move up-market was made possible by the presence of the world's largest component manufacturers as well as by R&D work carried out jointly by them and the car manufacturers. This joint involvement allows innovation to develop in areas such as the reduction of particle emissions from heat engines, the intelligent and connected car, the reduction of vehicle weight, hybrid and electric vehicles, etc. The state was also a driving force in these changes, as with the introduction of the above-mentioned Patent Box in April 2013 considerably cut the rate of tax on profits (from 23% to 10%) resulting from an innovation patented in the UK or in a European Union country.

Then, the injection of funds for the training of technicians or engineers through apprenticeships, on top of a new research centre co-funded by the Secretary for Business, Innovation and Skills and the major groups in the automotive sector. The Advanced Propulsion Centre was set up in 2014 to develop, commercialise and facilitate the production of advanced propulsion technologies. The start-up capital for this joint initiative is £1 billion, funded equally by the UK government and the automotive industry.

Moreover, the UK automotive industry is unusual in other ways too: all its flagship companies are now integrated into large multinationals. After the tribulations of the Rover Group during the 1990s and the disappearance in 2005 of the Rover brand, the Jaguar-Land Rover manufacturer was taken over by Tata Motors in 2008, thus saving it from bankruptcy. The same thing happened to the MINI brand, bought by BMW in 1994.

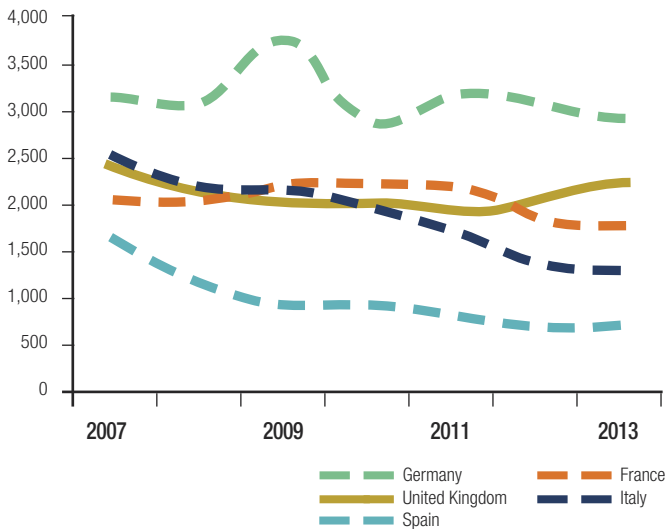
Finally, the attractiveness of the whole British automotive industry is underlined by the establishment in Britain of the major Japanese groups: Toyota, Honda and Nissan, the latter a member of the Renault-Nissan Alliance, has, for example, a plant at Sunderland (North East of the UK). Nearly 500,000 vehicles leave it every year thanks to 7,300 employees, which makes it one of the most productive of the Alliance and of the continent.

(20) KPMG, SMMT, cf «The UK Automotive Industry and the EU», April 2014.

Constantly growing domestic sales

British car sales have performed positively in the last two years. In fact, in contrast to the difficulties encountered by the countries of continental Europe, UK demand has enabled manufacturers to partially offset their losses. Thus, while between 2007 and 2013, the main continental markets collapsed, that of the United Kingdom began to recover in 2012, enabling it to occupy second place in Western Europe (see chart 21).

CHART 21
Growth in new car registrations in the main European countries in thousands of units



Sources: Coface, ACEA

What could be the reasons for this recovery?

The first reason is the more favourable macro-economic environment: cash inflows associated with low interest rates allow consumers to pay for their car on favourable terms. Thus a good many consumers benefit from an attractive form of medium term rental (3 years on average). This phenomenon is coupled with a recovery of household confidence and falling unemployment.

The second reason is the arrival of new, more energy-efficient models. The entry of these new models onto the market enables the aging car pool to be renewed after several difficult years due to the crisis, which in turn offsets the high fuel prices.

Finally, and this is also the case on the continent, British consumers have been able to benefit from consecutive discounts in a very competitive market.

Despite the undeniable difficulties which it is facing, the British economy has a remarkable abundance of expertise, almost unique in certain segments. The sectors highlighted are the symbol of British high-tech industry, which must not be overlooked.

Box 3

DYSON, EVERYDAY INNOVATION

The Dyson bagless vacuum cleaner is the absolute current benchmark in the field. The business bearing the name of its founder, the inventor, James Dyson, symbolises British success in the innovative sectors. Founded in 1992, Dyson is present in 45 countries and employs 4,500 workers, of which more than 1500 are engineers, 850 of them working at the company headquarters in Malmesbury, in the south west of the UK. The company's turnover in 2012 was nearly €1.5 billion, up by 20%, and profits were about €450 million. Dyson has, moreover, undergone exceptional internationalisation: the share of its foreign sales has shot up from 30% in 2007 to 85% today. Dyson now sells more vacuum cleaners than its competitor, Hoover, in the United States. The Dyson success story was not, however, immediate. In 1978, James Dyson noticed that when he used the vacuum cleaner, the bag got clogged with dust and the vacuum cleaner lost power. For six years, the inventor then worked relentlessly to create a bagless vacuum cleaner, making no fewer than 5,127 prototypes (all numbered). However, the G-Force vacuum cleaner did not achieve the expected success. The multinationals were reluctant to invest in it and patent it because it would mean the end of a very lucrative market in

spare bags. It was finally in Japan that Dyson associated himself with a manufacturer in 1986. However, his product cost £1,200 and therefore remained very up-market, far from the ideal of its inventor. Various judicial procedures then followed against other vacuum cleaner manufacturers for patent infringement. It was only in 1992 that Dyson decided to market his bagless vacuum cleaner himself by creating his own business. Success was practically immediate: two years later it became the vacuum cleaner most sold in the United Kingdom. James Dyson then decided to adapt his Dual Cyclone technology to more modern canister vacuum cleaners. In 1998, Dyson vacuum cleaners accounted for 20-30% of the UK market. The business's UK market share reached 65% in 2013. This formidable development, both locally and abroad, is explained by the constant effort to innovate which characterises Dyson. The reason for this success? Massive investments in R&D. Dyson had accordingly re-invested 36% of his 2011 profits in R&D. Today, specialised in fans, heaters and hand dryers in addition to vacuum cleaners, the business has filed over 1,900 patents and invented more than 300 innovative products. Dyson promises to be one of the jewels of British innovation for a long time to come.

INTERVIEW

GRANT WILLIAM, Risk underwriting director for Coface UK

What is the impact of the recovery of the British economy for Coface? Is there an impact on claims and new insurance-credit contracts?

18 months ago, the UK economy wasn't doing well however things are now viewed more positively, but we are yet to see a dramatic change in our activity. Claims of exporters to the UK are stable and at a low level, there are very few insolvencies. However, the UK still appears to see challenges in terms of its export, especially concerning the markets of central and northern Europe.

What are the healthiest sectors in the UK today and what are the poorest?

The sector that is the biggest driver of growth would be the financial services sector: banking, insurance, etc. which employs a significant share of the labour force [%]. Construction appears to have rebounded well and we are seeing a stronger performance in the construction sector both in terms of civil and residential projects. Retail is clearly a good barometer of consumer confidence with many retailers now reporting improved results albeit that there are some profit warnings being issued and lower margins achieved.. The specialist engineering and technology sectors remain strong export performers and there is currently a lot of interest in the pharmaceutical sector with fresh talk of takeover activity.

Manufacturing remains under pressure due to competition from overseas players and there is also a link to delays in investments by both corporates and Government departments. Is there currently a new real estate bubble in the UK? Aren't there too many companies in this sector?

There is some concerns with the UK that that the sharp increase in property prices in recent months could lead to the market

over heating and with it problems for consumers and the economy. The Government scheme to encourage mortgage lending and assist borrowers has kick started the market and this has now lead to more stringent criteria being introduced for those wanting to mortgage a property which should start to slow the real estate market. The property market and growth still remains very regionalized across the country.

Regarding companies, construction is very diverse in terms of the sub sectors, and the risk now I think is underpricing of contracts, more in the middle to small end of the spectrum as firms try to secure work and material prices fluctuate. Risks concentrated at the tail end of a project, e. g. smaller companies doing the fit out of a building, might suffer if a project is not running to time or to cost.

What are the brakes to industry growth?

The first one would most certainly be bank lending: through 2012-2013 banks wanted to rebuild their balance sheets and lending criterias to corporates and individuals reduced access to debt. It is the SME area that has most certainly suffered from the lack of access to funding. Even though various initiatives have tried to kick start that, but it has been very slow in the uptake. So having the money available to invest is really the first thing.

In certain areas of industry and specialist trades, redundancy and low salaries have forced people into other jobs, and the required levels of skilled labor is no longer there. The added problem for some is immobility of labour sometimes linked to the housing market.

Conclusion

This panorama shows how difficult it is to transform a service economy, essentially linked to finance, into a more diversified economy based on services and a specialised and competitive industry. However, key sectors, such as pharmacy, automotives and aeronautics are sharing in the development of UK specialisation with the growing importance of an industry of excellence. Moreover, the example of a company such as Dyson shows that levers exist in sectors as competitive as capital goods. Other examples will be needed for the recovery of British industry to be more complete. However, the dynamic investments (in capital goods) since 2013 are helping to boost productivity and increase the potential growth of the economy. According to the IMF's latest estimates the productivity gap separating the potential of the British economy from its achievement level is likely to be closed from 2019. This is why UK country risk as assessed by Coface (which measures the short-term payment behaviour of a country's businesses) was, in spring 2014, regraded as A2⁽²¹⁾.

We would add that the government and the monetary authorities have put in place incentive policies, both on the supply side and the demand side, indispensable for relaunching investment in the short term, so that interest rates will remain low in 2014, before a possible hardening of monetary policy from 2015. This means that the economic risks have not disappeared: a rise in interest rates could affect activity in a context of substantial private debt, as this affects the ability of households to borrow and businesses to refinance themselves. The government and the financial authorities have nevertheless taken a series of measures (ending of the Funding for Lending scheme intended for mortgages and mortgage affordability calculations based on individuals' expenditure and no longer only based on income) which are expected to enable a soft landing after the property buying spree.

(21) Coface évalue le risque de crédit moyen des entreprises d'un pays.

COUNTRY RISK ASSESSMENTS CHANGES

Assessment either upgraded, or removed from negative watch list or placed under positive watch list

COUNTRY RISK ASSESSMENTS

Country	Previous	New
Germany	A2↗	A1
Austria	A2↗	A1
United Kingdom	A3↗	A2
Spain	B	B↗
Kenya	C↗	B
Sri Lanka	C	C↗
Nigeria	D↗	C
Rwanda	D↗	C

Germany : A1

- High household and business confidence;
- Household spending driven by rising incomes and employment;
- Housing and Public Works supported by low interest rates and the financial health of local communities;
- Increased external demand coming from key export markets (the US, the UK, recovery in the Eurozone);
- Dynamic business investment driven by low corporate debt, high confidence and low interest rates;
- Balanced public accounts cares for a slightly accommodative fiscal policy;
- Overdues have been at low level for several months and continuation of the decline in the number of bankruptcies.

Austria : A1

- High business confidence;
- Increased external demand coming from key export markets (Germany, the US, Italy, France);
- Low credit cost and comfortable business cash;
- Employment growth;
- Recovering domestic demand: consumption and investment;
- If failure of Alpine, mainly due to mismanagement and external markets, ignored, delinquencies and bankruptcies have been declining for several months.

United Kingdom : A2

- 2014 GDP growth forecast hiked to 2.7% (2.1% in 2015);
- The unemployment rate is declining (6.8% May). Furthermore, the level of full time job in the economy will catch up the 2008 level;
- Private consumption is driving growth (+2.2% YoY in 2013 and we forecast it at +2.1% in 2014);
- Fixed asset investment is likely to benefit from the «funding for lending» scheme of the BoE, which aims at boosting credit to SMEs;
- The level of production capacity is high (82%). As a result, the equipment investment's growth has increased in last 3 quarters and we expect the trend to continue in the remainder of 2014 and in 2015;
- Household and business confidence are trending up.

Spain : B↗

- Domestic demand is showing signs of improvement and contributes now positively to growth;
- Exports of goods increased by over 7% in 2013. To deal with particularly unfavourable conditions, Spanish companies adjusted their labour costs to regain competitiveness (downsizing resulted in a fall in unit labor costs of 6.1% in 2012-2013);
- Companies' financial situation has improved: gross margin (near to 45%) and self-financing (over 100%) rose. Therefore, despite a drying-up of credit, corporations are able to start investing. Business confidence indexes, although still relatively pessimistic, are improving;
- Foreign direct investment grew 8.8% in 2013. This trend confirms the recovery of foreign investor confidence, mostly from the euro zone, towards Spain.

Kenya : B

- Strong and resilient GDP growth (expected at 5.6% in 2014) on the back of dynamic demographics and an emerging middle class;
- The economy is diversified (performing services sectors such as telecoms and finance);
- Despite the unsecure sentiment in Kenya, investment flows are not decreasing. Moreover, FX reserves are high;
- Diversified primary sector;
- Both current account and fiscal deficits remain at high levels but should be reduced in the medium-term as soon as oil production starts.

Sri Lanka : C↗

- Growth has been accelerating and the country is benefitting from high growth potential: GDP expanded by 7.3% in 2013 (8.2% yoy in Q4 2013);
- The 2009 end to Sri Lanka's long-running civil war allows the country to benefit from growing FDI;
- Most of the current economic potential is in the tourism sector and the diversified agricultural production;
- Private consumption (70% of GDP) will be the main driver of economic expansion fuelled by rising incomes and remittances from Sri Lankans abroad;
- The current account deficit is continually falling. The trade deficit is in part offset by rising tourism revenues and steady private transfers.

Nigeria : C

- First African economy (ahead of South Africa) since the new calculation based on a new year of reference to compute GDP, leading to the increase from 270 bl \$ to 510 bl \$;
- Beyond the statistical «artifice», this confirms that the Nigerian economy is driven by services (finance, telecom) accounting for more than 50% of the GDP and no more by the oil and gas sector (14% of GDP);
- Consumer demand remains buoyant;
- Oil production remains below capacity owing to continued oil theft and production losses due to sabotage of pipelines;
- Security, especially in the North, is a fundamental challenge for the government, like the fight against corruption;

Rwanda : C

- Rebound in growth expected in 2014 (6%) due to some aid flows recover and improvement (even modest) of economic situation in Eurozone, on which Rwanda depends for export market;
- Activity will be sustained services (trade, finance, telecom), agriculture production and implementation of the public investment programme;
- Private sector credit has recovered strongly (+13% in March 2014/ March 2013);
- Public finances still rely on grants. Excluding grants, the current account deficit (14% of GDP in 2014) and the fiscal deficit (-11.5% of GDP for 2014) are stabilizing but both remain high;
- Significant reforms have favoured the improvement of the business climate (especially for the fight against corruption and quality of legal framework).

Assessment either downgraded, or removed from positive watch list or placed under negative watch list

COUNTRY RISK ASSESSMENTS

Country	Previous	New
Latvia	B↗	B

Latvia : B

- The overall economic outlook remains favourable;
- The unstable geopolitical context in Russia/Ukraine undermines the outlook;
- The country depends entirely on Russian gas and for 10% of his exports;
- We cannot totally rule out risks of additional sanctions against Russia and so risks of gas supply disruptions in the region. In this risk scenario Latvia could find alternative sources of gas (for example coming from Norway), but the additional cost would definitely weigh on local corporate competitiveness.

Coface Assessments

A4	Country risk
B	Business climate
RATHER LOW RISK	Medium term

Main economic indicators

	2011	2012	2013 (e)	2014 (f)
GDP growth (%)	2.8	3.3	3.0	4.0
Inflation (yearly average) (%)	4.5	8.9	3.3	4.0
Budget balance (% GDP)	-1.2	-4.5	-1.5	-2.0
Current account balance (% GDP)	9.0	6.0	1.0	0.2
Public debt (% GDP)	9.5	9.2	9.4	10.2

(e): estimate
(f): forecast

Risk assessment

A rebound of growth, still driven by the hydrocarbon sector and public spending

The rate of growth in 2013 was lower than expected, mainly as a result of reduced oil and gas output, due in particular to the negative impact of the terrorist attack on a major gas production facility in mid-January 2013.

Growth will speed up in 2014, thanks to a moderate increase in hydrocarbon production and to the public investment programme over the 2010-2014 period (housing, road and railway construction). Household consumption, still sustained by higher public sector wages as well as by subsidies on basic commodities, could also be boosted by a possible easing of credit, as could private investment.

Inflation should remain moderate thanks to the cautious monetary policy, price ceiling on food stuffs, and reductions in import duties on these products and better management of their distribution.

Low public debt and solid external financial position

The dependence of public accounts on oil and gas will continue, since they represent around 70% of government revenues. With the presidential election that occurred in April, a slight increase in the fiscal deficit is likely in 2014. The hydrocarbon revenues held in the Revenue Regulation Fund will in any case cover the financing of this deficit and the country benefits from a low level of public debt.

The trade balance surplus should decline further in 2014, despite hydrocarbon exports – accounting for 97% of currency revenues – and prices which should remain firm. These exports are being sustained by the start-up in 2013 of the Menzel Ledjmet Est gas production facility and the El Merk oil and gas field, as well as, in 2014, the coming on-stream of two new liquefied natural gas terminals in Arzew and Skikda. Algeria nevertheless remains fairly largely dependent on Europe for its foreign trade and the gloomy prospects in this area are likely to hinder Algerian sales. On top of this, hydrocarbon sales to the United States will be limited by the ongoing expansion there of shale gas and oil exploitation.

Meanwhile, imports will continue to be limited due to the restrictive measures put in place by the authorities since 2009, despite large-scale wheat purchases, with Algeria one of largest importers in the world, and imports of capital goods linked with the infrastructure projects.

In this context, there should be just a slight surplus in the current account balance, with its decline due both to a drop in revenues and a reduction in net transfers. The country's large foreign exchange reserves (at just under three years of imports) will, however, ensure the continuation of its solid external financial position. Moreover, the active policy of external debt reduction, mainly by prohibiting businesses from borrowing abroad, will help maintain the debt/GDP ratio at a very low level (less than 3%).

Challenges in the political, social, security and business spheres

After fifteen years in power, President Abdelaziz Bouteflika, aged 77, was re-elected in mid-April 2014 for his fourth 5 year term.

With regard to the uprisings that have occurred since early 2011 in other Arab countries, the government has taken measures to combat youth unemployment and increase the availability of social housing in order to defuse political and social protest.

Though the security situation has improved somewhat, the activism of radical Islamist groups has intensified on the country's southern borders, as illustrated by the mid-January 2013 terrorist attack on the large In Amenas gas facility. This is making some foreign firms more security conscious.

Moreover, restrictions on imports and foreign investment, aimed at protecting the local economy and promoting national industries, were introduced in the Supplementary Finance Law of 2009. Therefore, the business environment remains hardly conducive to the expansion of the private sector and foreign investment, except in the hydrocarbons sector and particular cases such as the Renault automotive plant under construction in Oran. An easing of the legal business framework has, however, been introduced by the 2014 Budget Law. Procedures for the approval of foreign direct investment or investment in partnership with foreign capital are alleviated. In addition, while since 2009 letters of credit had become compulsory for payment of imports, the law allows again payment with documentary collection.

Strengths

- Large oil and gas reserves
- Potential in the areas of renewable energy and tourism
- Strong external financial position (very low foreign debt, huge foreign exchange reserves).
- Public policies aimed at economic diversification

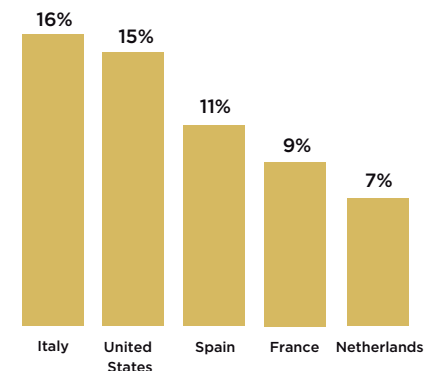
Weaknesses

- Highly dependent on hydrocarbons and problems in using this income
- Fault lines between the authorities and the population
- High youth unemployment rate
- Excessive weight of the public sector
- Red tape and problematic business environment

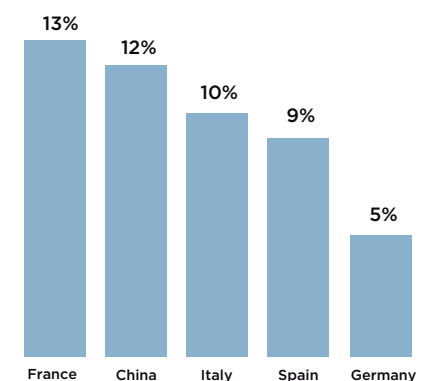


Trade exchanges

Exports of goods, as a % of total



Imports of goods, as a % of total



Coface Assessments

A4

Country risk

A4

Business climate

**RATHER
LOW RISK**

Medium term

Main economic indicators

	2011	2012	2013 (e)	2014 (f)
GDP growth (%)	2.7	0.9	2.3	1.3
Inflation (yearly average) (%)	6.5	5.8	5.8	6.0
Budget balance (% GDP)	-2.6	-2.5	-3.2	-3.8
Current account balance (% GDP)	-2.1	-2.4	-3.6	-3.6
Public debt (% GDP)	68.0	68.0	67.0	67.0

(e): estimate
(f): forecast

Risk assessment

Sharp slowdown in growth

Growth will be weak in 2014. Domestic consumption, the longstanding driving force behind economic growth, is likely to disappoint. The creation of jobs has started slowing down. The supply of credit, the critical fuel for consumption, will fall as the banks become more circumspect and because of high household debt levels (debt servicing accounts for 21% of income), in the face of higher interest rates. Investment is likely to stall with the delaying of several major projects (concessions), with the elections scheduled for October 2014 inducing increased uncertainty among decision-makers. Construction should continue to benefit from public financing of social housing and the completion of sports venues. Exports will feel the positive impact of any recovery in the United States (11% of exports) and a revival in the Eurozone (16%), but suffer from the recession in Argentina (8%) and the slowing of Chinese growth (17%). Oil exports will increase as production gets going from new oilfields. With raw material prices (50% of export sales and including iron, soya, cereals, coffee and sugar) stabilising, there is less chance of any significant growth in earnings. The depreciation of the real in 2013 will only help the price competitiveness of exports of manufactured goods, in sectors such as automotive, avionics, iron and steel, paper pulp, orange juice and meat products.

Will budgetary and monetary policies be tightened in 2015?

Given the deterioration in public sector accounts and the reservations among investors, a tightening in budgetary policy is likely for 2015 and will happen after the October 2014 elections. The people's favourite remains President Dilma Rousseff of the Partido dos Trabalhadores, even though she lost ground following surveys in April-May, increasing the likelihood of a second round of voting. The government does however have to take into account the promises made at the time of the demonstrations in mid-2013 (investments in healthcare, public transport and education). Current expenditure, the main element of the budget, with wages and social benefits indexed against inflation, continues to rise. On top of this, following the drought which has led to increased use of expensive thermal power stations as opposed to hydroelectric plant, and the delaying of the announced rise in electricity prices in 2015, the government will have to support the energy sector (subsidies should amount to approximately 0.3% of GDP in 2014). Budgetary policy is therefore likely to be moderately expansive in 2014, with the primary surplus probably below the government's target of 1.9% of GDP. This primary balance surplus will however help keep the public debt (mainly denominated in reals and thus with a low external percentage) stable (at 67% of GDP for gross public debt, but 34% net). Unlike the budgetary policy, monetary policy has been used in the counter inflationary pressures (policy interest rate increased to 11% in April, a rise of 3.75 points in 1 year). The Central Bank has also acted on the currency markets to ease the depreciation of the real, which contributed to the firming up of the Brazilian currency between February and May 2014, when it rose 8% against the dollar. The struc-

tural causes behind inflationary pressures will however restrict the effectiveness of this policy; inflation remains close to 6.5%, the upper limit of the target set by the Central Bank (2.5% - 6.5%). Whilst in the short term the Central Bank needs to pause in its cycle of interest rate rises, these inflationary pressures mean that a further tightening of monetary policy in 2015 is likely.

Solid external accounts, slight upturn in exports

The depreciation of the real in 2013 helped close the current account deficit, which will hold steady at 3.6 % of GDP in 2014. The trade surplus, in decline since 2008 and to the point of almost disappearing in 2013 (0.1% of GDP), has been restored to health with the gradual upturn in manufacturing exports, despite the low level of exports to Argentina, currently in recession. The deficit regarding services and income (tourism, dividends, interest) will remain. The current account deficit will be covered at 40% by direct foreign investments and the rest by foreign investments in Brazilian debt. The level of external debt stands at 33% of GDP. The proportion of public debtors (15%) has been sharply reduced in favour of the private sector. Servicing the debt, as well as the current deficit, is easily covered by foreign exchange reserves, currently at one and half years of imports.

Growth potential undermined by structural failings

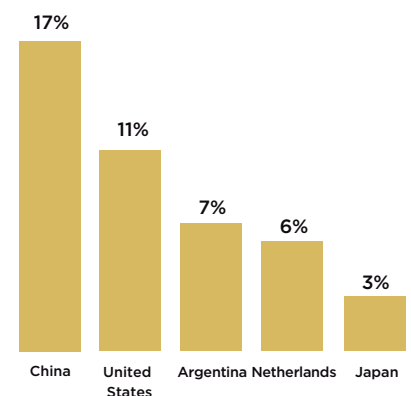
Brazil has abundant resources and diversified industry, but these are hindered by a lack of appropriate infrastructures and qualified labour, excessive state interventionism and bureaucracy. These factors weigh heavily on the supply, with companies' costs increasing faster than productivity, forcing them to raise prices and undermining their competitiveness. Protectionist and fiscal measures have been adopted with the aim of relieving these pressures. The level of fiscal pressure however remains high (public expenditure accounts for 37.2% of GDP, a very high percentage for South America). The slowdown in consumption has increased the pressure on those industries and businesses that are dependent on it: electrical household goods, electronics, automobile, etc. The 2013 real depreciation also impacted on companies with increased levels of foreign currency debt.

Strengths

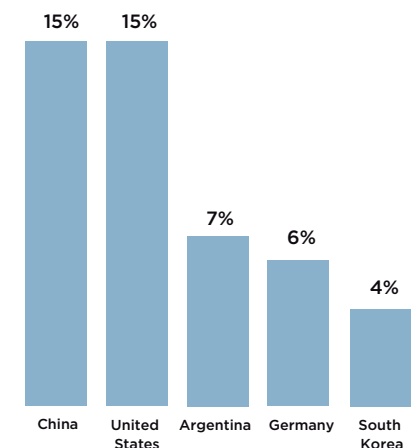
- World's 6th largest economy
- Growing workforce
- Varied mineral and agricultural resources
- Cutting edge manufacturing industry: aeronautics, chemicals, pharmaceuticals, oil engineering
- Resistance to external shocks: primary budget surplus, net external creditor position, considerable reserves
- Maintenance of key macroeconomic balances

Trade exchanges

Exports of goods, as a % of total



Imports of goods, as a % of total



Weaknesses

- Lack of skilled labour / deficient educational
- Infrastructure shortcomings (transport, energy)
- Inadequate investment (18% of GDP)
- High production costs (wages, energy, logistics, credit)
- High and inefficient public spending
- High public debt and debt servicing costs
- Corruption thriving on inequalities

Coface Assessments

A3

Country risk

A1

Business climate



Main economic indicators

	2011	2012	2013 (e)	2014 (f)
GDP growth (%)	2.1	0.4	0.4	0.8
Inflation (yearly average) (%)	2.3	2.2	1.0	0.9
Budget balance (% GDP)	-5.1	-4.8	-4.2	-4.0
Current account balance (% GDP)	-1.8	-2.2	-1.3	-1.1
Public debt (% GDP)	84.4	88.7	91.8	94.5

(e): estimate
(f): forecast

Risk assessment

The recovery remains fragile, held in check by high unemployment, further fiscal consolidation and lack of competitiveness

Consumption has, so far, proven relatively resilient thanks to the existence of «automatic stabilisers» and wage rigidity, but this traditional lynchpin of French economic growth is now struggling to rally. There was even a sharp decline in household consumption in the 1st quarter 2014, although it should be noted that there were some exceptional factors involved (mild winter temperatures, increase in ecological «malus» and VAT in January 2014). Household spending has on a more general level been restricted by the high level of unemployment (10.4% in March 2014, unchanged year on year). Fiscal retrenchment, up until now fairly limited, and set to be tightened this year, is also not going to help boost economic activity. At the same time, business investment remains at a low level, despite the fact that access to credit is easier than in many other Eurozone countries. Companies are however struggling to rebuild their margins, which are some of the slimmest in the Eurozone, and, as a result, are delaying any expansion plans. Exports, driven by external demand, should accelerate but will continue to be handicapped by the lack of competitiveness.

Financially weak companies and insolvencies running at high level

The capacity of French companies to recover is relatively limited due to low profit margins (29.5%) and self-financing rates (76.3%). Too small, compared with their German counterparts, they are insufficiently innovative and export oriented. They lack sufficient presence in the rapidly growing emerging markets. Their production costs, for the mid and bottom range products, are too high compared with those of their competitors, and there is not enough upmarket movement. The number of corporate insolvencies has remained at a high level (just over 64,000 in the year ended April 2014), higher than the 2009 peak. Those among intermediate sized companies have however decreased, which means a reduction in the financial costs falling on suppliers. Despite the numbers dropping at the beginning of the year, insolvencies during 2014 are still expected to exceed 63,000. Whilst the largest number of these are still to be found in the construction sector, those sectors that are currently suffering most are the services to companies and local authorities, the agri-food, paper-wood and transport sectors.

Difficult adjustment efforts

Despite the weakness of the economy and the growth in the public debt, investors have, so far, retained their appetite for French debt, which was, at the end of May 2014, still being traded at historically low rates. The budget deficit is slowly reducing. The weight of public expenditure however remains one of the highest in the

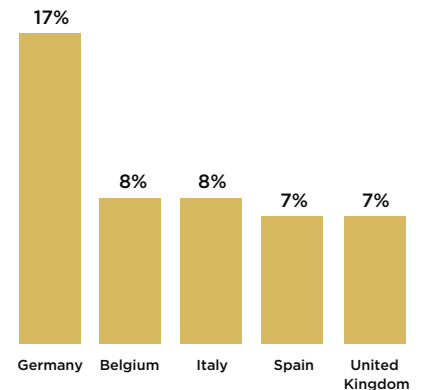
Eurozone (57% of GDP), with means a high tax burden, well above the European average. The high tax and social security burden and wage rigidity continue to weigh on corporate profitability and development. The government is hoping to enhance in a sustainable way corporate productive capacities thanks to the implementation of the Pacte de Responsabilité et de Solidarité (Responsibility and Solidarity Pact), which complements the Cr dit d'Imp t pour la Comp titivit  et l'Emploi (CICE) (Competitiveness and Employment Tax Credit) and should help drive down labour costs by means of a significant reduction of employers' social security contributions on low wages. Companies should also feel the positive impact of a gradual reduction in taxes and a simplification of administrative procedures. The government's room for manoeuvre however has been seriously limited following the Socialist Party's bitter defeat and the rise of the National Front in recent municipal and European elections, which could hamper the implementation of the Pact and of far reaching reforms.

Strengths

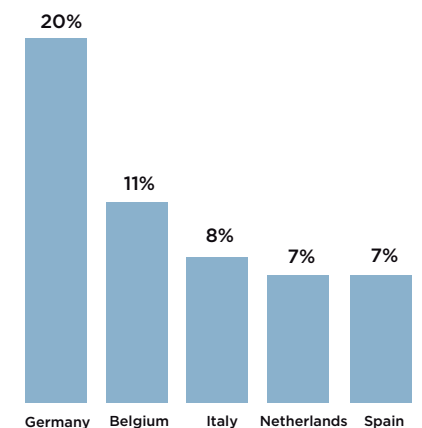
- Quality of infrastructure and public services
- Skilled workforce, demographic dynamism
- Competitive international groups (energy, aeronautics and space, environment, pharmaceuticals, luxury goods, agri-food, distribution)
- World's top tourist destination and leading agricultural power
- High savings level, low household debt

Trade exchanges

Exports of goods, as a % of total



Imports of goods, as a % of total



Weaknesses

- Insufficient number of exporting companies, loss of competitiveness and market share
- Insufficient innovation effort, low level of product range
- Low employment rate of young and older workers
- High public debt

Coface Assessments

A1

Country risk

A1

Business climate



Main economic indicators

	2011	2012	2013 (e)	2014 (f)
GDP growth (%)	3.3	0.7	0.4	2.0
Inflation (yearly average) (%)	2.1	2.0	1.6	1.1
Budget balance (% GDP)	-0.8	0.1	0.0	0.1
Current account balance (% GDP)	6.2	7.0	7.5	7.2
Public debt (% GDP)	80.0	81.2	78.3	76.0

(e): estimate
(f): forecast

Risk assessment

Recovery acceleration

The economic recovery will gain speed in 2014 before stabilizing at a good level. It will be based on household consumption as before and, a new element, on an upturn in business investment. The contribution of foreign trade to growth will again be slightly negative, with imports increasing a little more rapidly than exports. Further employment gains will boost household consumption, while immigration and increased female employment will increase the number of people in work. Disposable income will rise by nearly 3% (by almost 2%, allowing for inflation) due to wage increases in the private and public sectors, abolition of the medical consultation fee (Praxisgebühr) which had to be paid for each visit to a doctor in any one quarter of the year, and the raising of the threshold for income tax liability, pensions and of allowances for dependent children. Business investment in equipment and building is expected to increase steadily after three years of stagnation. Decision makers are drawing comfort from the overall improvement in the economy and are set to benefit from still favourable credit conditions. Public works are expected to pick up strongly thanks to the good financial health of most local authorities, while housing construction is expected to remain buoyant, particularly in the big cities and in regions attracting the most immigrants like Bavaria, Baden-Württemberg, Hessen and Berlin. Exports, which represent over 50% of GDP, are expected to benefit from stronger economic recovery in North America (8% of sales) in the non-eurozone European countries (20%), as well as from the resilience of emerging Asia growth (10%). Capital goods and intermediate products make up respectively 45% and 30% of exports, with China absorbing 20% of the former and 5% of the latter. Much will therefore depend on the investment component of world growth and the trend in Chinese economy. It would, though, be futile to expect strong export growth without better growth in the eurozone, which still absorbs 37%.

Sound public and external accounts

Despite lower statutory charges and higher social transfers, revenues will grow faster than spending. Faster growth means revenues will increase mechanically while reducing the benefits paid to the unemployed. Moreover, the low rates charged on German debt are also containing expenditure. A slight surplus is expected on the public accounts and public debt will decline as a share of GDP. However, Greek debt relief and/or additional help for banks in difficulty would undermine this prognosis. But, as always, the objective of consolidating the federal public accounts (maximum structural deficit of 0.35%) contained in the «Schuldenbremse» (debt brake), incorporated in the Constitution in 2009, has already been achieved.

There will be an ample current account surplus thanks to the massive trade surplus (5% to 6% of GDP). The services balance is in equilibrium, with the tourism deficit offset by the surplus on services to business.

The income balance is slightly in surplus, as income from investments abroad exceeds transfers by immigrants and foreign investors to their country of origin. Ten consecutive years of current account surplus close to or above 6% have enabled the country to accumulate foreign assets well in excess of its foreign liabilities.

Healthy companies in a favourable political context

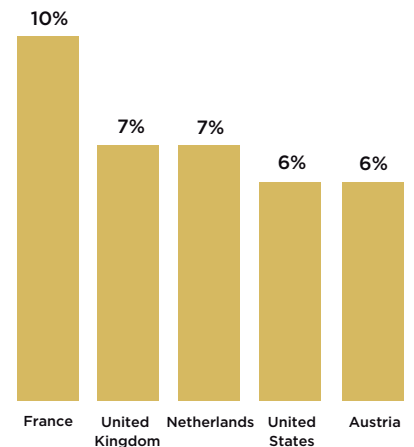
Businesses have benefitted since spring 2013 from an improving domestic and external economic situation. Non-payments are expected therefore to decline further in 2014. Moreover, the new «grand coalition» led by chancellor Angela Merkel (CDU) since the September 2013 elections, with Sigmar Gabriel (SPD) as vice-chancellor and head of economy and energy ministry, will be able to tackle a range of problems. In addition to European issues, one can cite financial solidarity between the Länder, the decreasing population, inadequate structures for young children, and worsening infrastructures and educational opportunities to the detriment of productivity. Funding the increase in renewable energy from 25% to 80% by 2050, with the exit of nuclear energy by 2022 and modernization of coal-fired plants, and the introduction of an 8.5 euro minimum wage on January 1st 2015 at a time when a quarter of jobs are poorly paid and temporary are the most controversial issues. The evolution of the situation in Ukraine and relations with Russia, with all the negative economic impact that would result from deterioration, adds up to the government's agenda.

Strengths

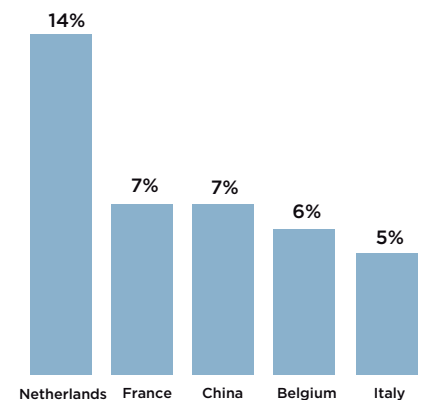
- Solid industrial base (1/4 of GDP)
- High quality contributing to competitiveness and profitability
- Geographically diversified export basis
- Export-oriented SMEs (Mittelstand) are family-minded and have strong regional base
- Central and Eastern Europe integrated in the production process
- Importance of the ports of Hamburg, Bremerhaven and Kiel
- Institutional system fosters representativeness and consensus

Trade exchanges

Exports of goods, as a % of total



Imports of goods, as a % of total



Weaknesses

- Aging infrastructures
- Demographic decline partially offset by immigration
- Lack of engineers and venture capital
- Highly dependent on world markets, particularly European ones
- Predominance of the automobile industry
- Persistent backwardness of the eastern Länder, though gap is narrowing
- High energy costs

Coface Assessments

A4

Country risk

B

Business climate

**RATHER
LOW RISK**

Medium term

Main economic indicators

	2011/12	2012/13	2013/14 (e)	2014/15 (f)
GDP growth (%)	6.7	4.5	4.7	5.5
Inflation (yearly average) (%)	9.5	10.2	9.5	8.0
Budget balance (% GDP)*	-8.5	-7.8	-7.7	-8.0
Current account balance (% GDP)	-4.2	-4.7	-2.0	-2.4
Public debt (% GDP)*	67.0	67.6	66.7	65.3

(e): estimate

(f): forecast

* Compromises federal and local authority public debt.
Fiscal year from April to March

Risk assessment

Moderate recovery in growth

The 2013-2014 fiscal year was marked by a further slowdown in growth due to weakening domestic demand and a fall in exports. In 2014-2015, the buoyant services sector will continue to contribute to growth, particularly in the area of high-tech. Exports will also benefit from a slight global recovery and the weak rupee. Although the rupee has risen by 14% since its lowest point in August 2013, it has depreciated by more than 8% against the dollar since May 2013. Lastly, consumption, the main growth driver, is expected to continue to grow at a moderate pace due to an increase in disposable household income. Moreover, the BJP has announced social measures in line with those initiated by the Congress Party and, in particular, a health system and housing subsidies. In 2014-2015, the possible introduction of major structural reforms due to Narendra Modi (BJP) taking up office points towards better prospects. Indeed, his campaign programme was based on economic development and improvement in governance. In order to encourage investments, a simplified approval mechanism is to be introduced particularly in energy and the environment. Furthermore, he has promised to create 10 million jobs per year and plans major infrastructure programmes (high-speed train network, construction of 100 new towns and new industrial areas).

In addition, inflation slowed in 2013 due to lower prices for manufactured products and oil and a tightening in monetary policy from September 2013. However, it will remain at a high level in 2014, particularly due to the poor harvests.

Persistence of twin deficits

The fiscal deficit at local and federal level remains high despite the willingness to consolidate public accounts. The amount of subsidies, for example, is set to remain high. However, the tax programme of the new government provides for greater fiscal discipline, harmonising of VAT at the federal level and a drop in subsidies particularly on commodities.

Regarding external accounts, the policies implemented to halt the fall in the rupee in the summer of 2013 (hike in key rates, taxes on metal imports, etc.) have paid off and the current account deficit has stabilised to roughly 2.5%. Although the size of oil, gold and coal imports prevents the full absorption of the current account deficit, the balance of services and transfers limit its size.

Furthermore, the public banks, which represent three quarters of banking assets and concern the financing of non-profitable sectors, have shown a deterioration in the quality of their assets. Lastly, the depreciation in the rupee has affected companies indebted in foreign currency and may also affect the quality of banking assets.

Victory for BJP in the April – May 2014 parliamentary elections

The 2014 parliamentary elections resulted in a victory for the BJP (Bharatiya Janata Party). The party obtained an absolute majority, winning 282 of the 543 seats in the Lok Sabha (lower house). For the first time in 25 years, Narendra Modi – the former Chief Minister of Gujarat – will be able to form a government without a coalition. Such conditions will be favourable for the introduction of the reforms announced in his programme. Nevertheless, the success that he has obtained in Gujarat will be difficult to apply on a national scale. The federal system complicates the adoption of reforms and his style of leadership risks clashing with national operations. Some reforms also require a change in the Constitution. Furthermore, Mr Modi's track record in Gujarat is tainted by the violence in 2002 during which thousands of Muslims were killed. He must overcome the suspicions about his role in these events and take measures to prevent inter-ethnic violence.

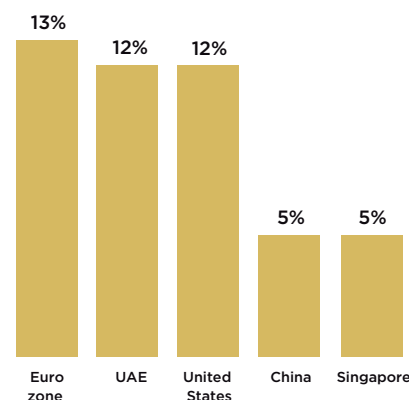
Despite the expected reforms, the business climate will continue to suffer from persistent weaknesses, such as high corruption and deficient energy supplies. Companies suffer from structural and regulatory constraints. Lastly, the presence of the Prime Minister of Pakistan at the investiture of Prime Minister Modi marks the start of an improvement in relations between the two countries.

Strengths

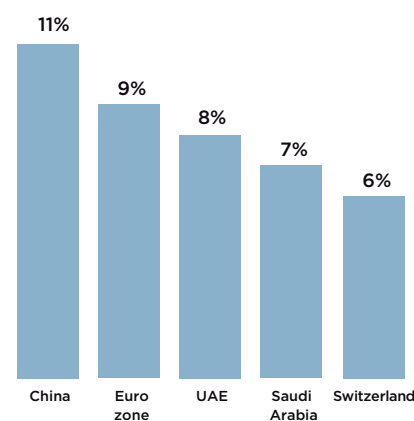
- Diversified growth drivers
- Solid fundamentals: high levels of savings and investment
- Effective private sector in services
- Moderate external debt and satisfactory foreign exchange reserves

Trade exchanges

Exports of goods, as a % of total



Imports of goods, as a % of total



Weaknesses

- Lack of infrastructure and shortcomings in the educational system
- Wage rises for skilled workers could erode comparative advantage
- Net importer of energy resources
- Rising debt of private businesses
- Weak public finances
- Persistent uncertainties over the Kashmir issue

Coface Assessments

B

Country risk

A2

Business climate

Main economic indicators

	2011	2012	2013 (e)	2014 (f)
GDP growth (%)	0.6	-2.4	-1.8	0.2
Inflation (yearly average) (%)	2.9	3.3	1.3	0.7
Budget balance (% GDP)	-3.7	-3.0	-3.0	-3.0
Current account balance (% GDP)	-3.1	-0.4	0.9	1.5
Public debt (% GDP)	120.7	127.0	132.6	136.0

(e): estimate
(f): forecast



Risk assessment

Weak recovery driven by exports

Italy is struggling to escape the recession. Real GDP shrank once again at the beginning of 2014, following on from the first slight improvement in two years in the final quarter 2013. Over the year as a whole, the outcome should nevertheless be slightly positive thanks to the strong performance of the export sector and the increase in productive investment. The level of activity however will be held back by the weakness of domestic consumption. The unemployment rate, at around 12.7% since the end of 2013, will remain high. The banks are expected to gradually relax credit conditions and this should help reverse the downward trend in credit curve slowly, and encourage investment. This upturn will mainly involve export sector companies whose business will be boosted by growing external demand. The stagnation in labour costs means there should be a slight improvement in competitiveness, and the country should benefit, in particular in the emerging economies, from its strong positioning in the mechanical engineering and metallurgy sectors. Inflation will slow as a result of the low level of wage rises, despite income tax cuts for low wage earners within the framework of the Renzi Plan. Given the relative weakness of domestic demand and the expected growth in exports, there should be an increase in the current account surplus.

The situation of Italian companies will only slowly improve. Coface payment experience continues to be poor and at a worse level than in the rest of Europe. This reflects, in addition to weak economic growth, the proportion of small, financially very fragile, companies and late payments in the public sector, until now well above the European average. The implementation of the plan for the payment of government arrears to the private sector (€68bn, of which €33bn has already been made available), one of the key elements of the Renzi Plan, should however help to significantly improve the cash flow of firms.

Public sector debt at record level

Despite the resumption of growth, public sector debt will continue on its upward trend and reach a new peak in 2014, even though the authorities have managed to reduce the budget deficit to 3% of GDP since 2012 (excluding debt interests, the budget has in fact been in surplus for several years). Yields on sovereign debt bonds have eased significantly on financial markets since the announcement, in September 2012, of the ECB euro area government bond-buying programme (OMT), but government solvency remains vulnerable to growth and interest rate shocks. Political situation has stabilised but potential setbacks within the banking sector (continued rise in the level of non-performing loans) could generate renewed stress on public finances.

Legitimacy of the Prime minister strengthened

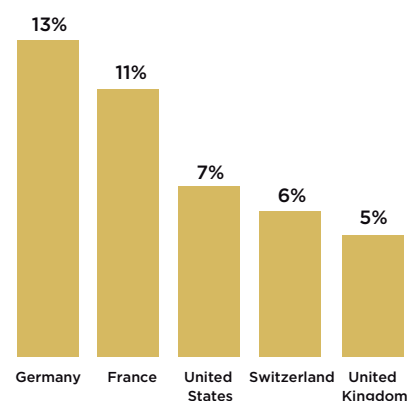
The political situation was especially unstable in 2013, endangering the pursuit of the reform effort embarked on between the end of 2011 and the end of 2012 by the former Prime minister, Mario Monti, relating to pensions and the labour and goods and services markets. General elections held in February 2013 were inconclusive with no party winning a majority and it took two months for Italy to find a way out of that deadlock, with the three main parties finally agreeing to create a broad-based government led by Enrico Letta of the Democratic Party. The resignation at the end of September of the Ministers belonging to Silvio Berlusconi's People of Freedom Party once again threatened the survival of the government, before Parliament could pass a vote of confidence. The splitting of the People of Freedom Party into two factions, Forza Italia, the new party of the «Cavaliere», and the New Centre Right, which then re-joined the parliamentary majority, in November 2013, resulted in a more limited but a priori more stable coalition. However, in February 2014, finding himself in the minority within his own party, Enrico Letta had to resign from office in favour of his rival from the Democratic Party, Matteo Renzi, the man behind the ambitious programme to return the economy to growth and speed up the economic and institutional reforms. Some of these reforms have already been approved (labour market, abolition of the provincial governments), others, more difficult to implement, have not (including the revision of the electoral law and the removal of the powers of the Senate). The Prime minister, thanks to the scale of the support for his party in the European elections (41% of the votes), can now claim increased legitimacy, which should help him in his work.

Strengths

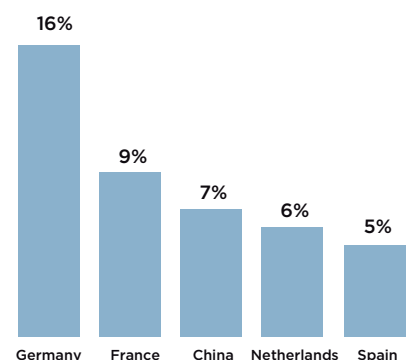
- Relatively important role of industry
- Production moving up-market and highly profitable niche products (luxury clothing, home equipment, agri-food, mechanical engineering)
- Low household debt and high savings capacity
- Wealth of tourism heritage

Trade exchanges

Exports of goods, as a % of total



Imports of goods, as a % of total



Weaknesses

- High public debt, tax evasion
- Important number of small, financially precarious businesses
- Drop in productivity
- Insufficient research and higher education
- Backwardness of the south

Coface Assessments

B	Country risk
C	Business climate
HIGH RISK	Medium term

Main economic indicators

	2011	2012	2013 (e)	2014 (f)
GDP growth (%)	4.4	4.6	4.7	5.6
Inflation (yearly average) (%)	14.0	9.4	5.7	6.6
Budget balance (% GDP)	-5.0	-6.2	-8.9	-7.4
Current account balance (% GDP)	-11.2	-10.4	-8.3	-9.6
Public debt (% GDP)	52.6	50.5	50.5	51.2

(e): estimate
(f): forecast

Risk assessment

Growth stimulated by private consumption

Kenya's economy is the largest in East Africa. In 2014, growth will be boosted, particularly due to investment related to the discovery of oil and gas at the end of 2012. Furthermore, the construction of a major railway line linking the port of Mombassa to Nairobi will begin. Private consumption (79% of GDP), in line with the expansion of a middle class, will remain the main driver of growth, provided that inflation is kept under control. However, the poor climatic conditions in the spring of 2014 could have an impact on food and hydroelectric output and thus lead to a rise in inflation. Under these conditions, the central bank should not lower its rates in 2014. Moreover, the many opportunities offered (telecommunications, factories, land use) make Kenya the second largest recipient of FDI in sub-Saharan Africa; and the services sector, boosted by telecommunications and financial services, is one of the most dynamic on the continent.

Concerning the banking sector, the wave of violence in South Sudan in January 2014, which followed the failed coup d'état, has caused disturbances for the Kenyan banks with investments there. Equally, the repatriation order of Somali refugees at the border in April could result in a withdrawal of Somali investments. The tourist sector has experienced an unfavourable 2014 due to the fear of attacks. The latest figures show a significant reduction in arrivals (-11.1% in 2013 compared to 2012). Following the attacks in May in the capital Nairobi, the evacuation of several hundred tourists and the cancellation of some flights until the end of October, should confirm this reduction in the short term.

Slight reduction in fiscal deficit

The fiscal deficit was high in 2013 due to the recurring increase in wages as well as investments in infrastructures, but should fall in 2014 following the harmonisation of VAT carried out in 2013 and the ambitious tax reform planned for 2014 (rise in capital gains tax).

Following the lead of several African countries, Kenya planned to issue sovereign debt bonds in 2014, but this has been delayed several times during the past months, leading to a greater dependence on domestic markets in the short term. Nevertheless, the level of debt remains sustainable in view of increased support from international partners.

Expansion of regional trade contributes to adjustments in the current account balance

Kenya's trade deficit will remain high until the country begins the exploitation of its titanium, oil and gas deposits (2018-2020) and develops the geothermal sector. The impact of the energy bill remains considerable (10% of GDP). Exports are dynamic, driven by the tea and horticulture sectors, which are benefiting from growing Asian demand, as well as trade within the East Africa Community. Furthermore, steadily growing FDI have enabled stable financing of the current account

deficit. As a consequence of the influx of investors, downward pressure on the shilling is easing and foreign exchange reserves are increasing.

The general elections of March 2013 were peaceful

In December 2007, the presidential elections brought the country to the brink of civil war, resulting in 1300 deaths. In August 2010 a new constitution was established to ensure a clearer separation of powers, to increase the power of local counties and to guarantee the transparency of future elections. In March 2013, the elections took place peacefully. Uhuru Kenyatta was elected President after the first round. The current government will therefore remain stable, with the new constitution not planning new elections before 2017-18. However, President Kenyatta is facing trial by the International Criminal Court, being accused of crime against humanity for having facilitated the violence of 2007. After a number of successive delays, this is now planned for October 2014.

The risk of terrorist attacks is high

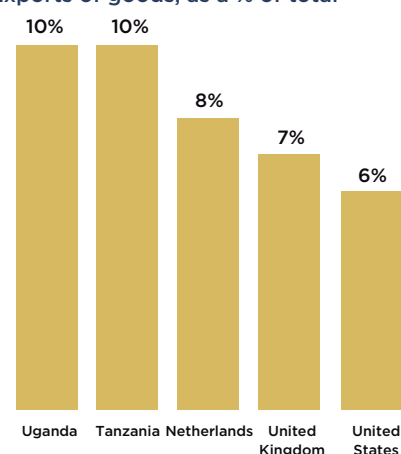
On the geopolitical side, the presence of Kenyan troops in southern Somalia since 2011 increases the risk of terrorist attacks on Kenyan territory despite significant progress in the offensive against the Somalia-based Islamist group Al-Shabab. On 21 September 2013, it led an attack on the largest shopping centre in Nairobi, in which 67 people died. Since March, and despite the new security measures taken by the government, several deadly explosions have occurred in Nairobi and Mombassa.

Strengths

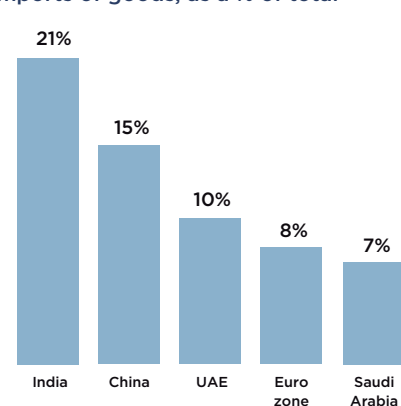
- Strategic position between West Africa and East Africa
- Pivotal role in East African Community, leading African common market
- Diversified agriculture (maize, tea, coffee, horticulture)
- Good telecommunications and financial services
- Lively demographics and emergence of a middle class
- Adoption of a new constitution in 2010

Trade exchanges

Exports of goods, as a % of total



Imports of goods, as a % of total

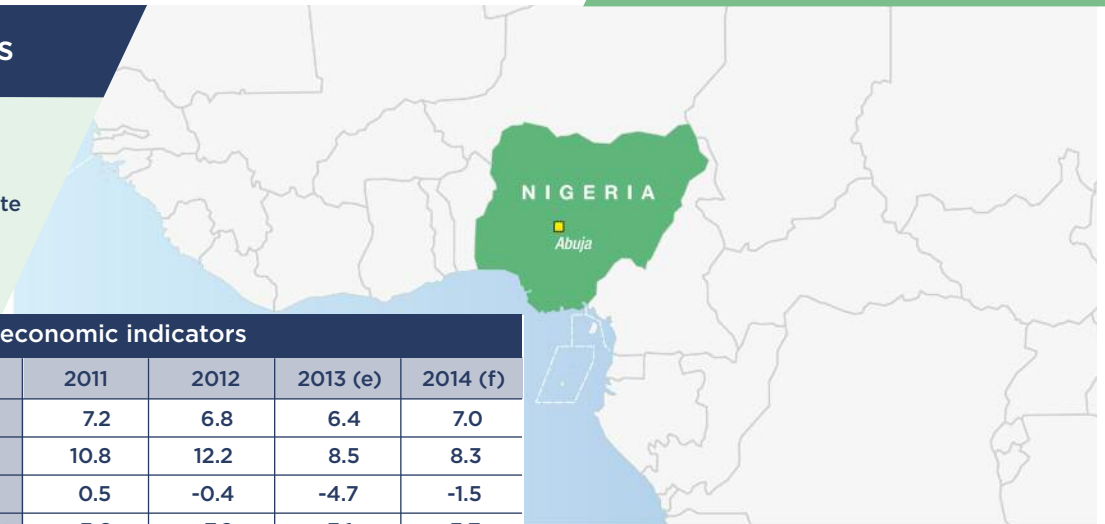


Weaknesses

- Agricultural production highly dependent weather conditions
- Inadequate infrastructure hinders economic development
- Widespread poverty
- Governance improving but persistent corruption
- Major terrorist risks due to the difficult geopolitical situation

Coface Assessments

C	Country risk
D	Business climate
RATHER HIGH RISK	Medium term



Main economic indicators

	2011	2012	2013 (e)	2014 (f)
GDP growth (%)	7.2	6.8	6.4	7.0
Inflation (yearly average) (%)	10.8	12.2	8.5	8.3
Budget balance (% GDP)	0.5	-0.4	-4.7	-1.5
Current account balance (% GDP)	3.6	7.8	3.1	3.7
Public debt (% GDP)	17.3	18.4	19.0	10.0

(e): estimate
(f): forecast

Risk assessment

Growth now driven by the non-oil sector

Since April 2014 Nigeria has become the leading economic power in Africa in terms of GDP, ahead of South Africa, due to the change in the reference year (2010 instead of 1990) as a calculation basis. This statistical development has led to a re-evaluation of close to 90% of the amount of GDP (from USD 270 to 510 billion) but above all establishes that the services sector contributes more to GDP (52%) than hydrocarbons (32%). The non-oil sectors (construction, telecommunications) will continue to drive Nigerian growth in 2014. The manufacturing industry (cement) will benefit from the implementation of infrastructure projects and a gradual improvement in the supply of electricity following the privatisation underway of the national electricity company (PHCN).

Oil production will continue to suffer from thefts and sabotage of installations. The new Petroleum Bill should not be adopted before the next elections in 2015. The lack of a legal framework and the uncertainties relating to this reform will contribute to a slowdown in hydrocarbon investments and development. Private consumption (54% of GDP) will still be boosted by social spending and continued moderation of price rises. The slowdown in energy price increases (electricity, petrol) as well as those of food, due to better harvests should stabilise inflation, with the depreciation of the naira, however, preventing its fall.

Delicate fiscal balance and current account surplus trending downward

The fiscal balance is expected to record a slight deficit in 2014 but the ratio compared to GDP should improve due to the re-evaluation of GDP. Social spending and wages should increase with the prospect of elections in 2015. The government will be able to benefit from revenues related to the privatisation of PHCN and higher non-oil tax income. However, public finances remain very dependent on oil revenue (80% of tax earnings), which will be constrained by the weak rise in prices and production. Finally a further cut in fuel subsidies seems unlikely a year before the elections.

The balance of reserve funds has been greatly reduced (from USD 11 to 3 billion between the end of 2012 and end of 2013) due to weaker than expected oil revenue, which is proof, in particular, of thefts of hydrocarbons, therefore reducing the Government's room for manoeuvre in controlling public finances.

The current account surplus is expected to continue to shrink slightly in 2014 as a result of increased imports, particularly refined oil products. Oil exports (90% of the total) will be constrained by structural problems (theft, lack of investment) and by a slowdown in US demand (37% of Nigerian oil sales) on the back of unconventional oil production.

The fall in the current account surplus, combined with a deterioration in the political and security situation as well as the impact of the less accommodating policy of the American Federal Reserve on market liquidity, should continue to impact the price of the naira. The authorities should avoid a too sharp depreciation to limit inflationary pressure, thanks to reserves that remain comfortable (6 months of imports) even if they are trending downwards.

The banking sector benefits from a satisfactory capitalisation and level of doubtful loans but its profitability remains weak.

The fundamental issues of security and governance

The security situation remains tense in the Niger Delta, the oil production area, and above all has sharply deteriorated in the north with the intensification of the actions of the radical Islamist movement Boko Haram. Generally, massive unemployment, poverty and regional inequalities are fuelling the violence and social instability. President Goodluck Jonathan is due to finish his term (2015), but strong disagreements within his Popular Democratic Party, as well as difficulties in the current government in managing the security problems increase the risk of tensions in the run-up to the elections.

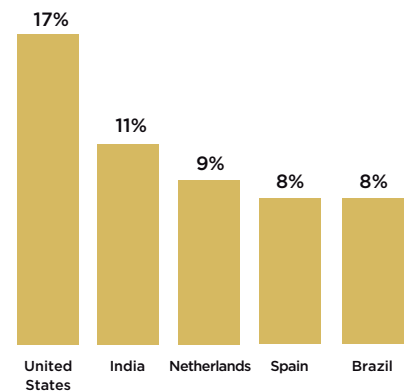
The country suffers from ineffective administration and a high level of corruption, as is shown by the suspicion of the embezzlement of USD 20 billion by the oil company NNPC, for which the Nigerian presidency announced a judicial inquiry in March 2013.

Strengths

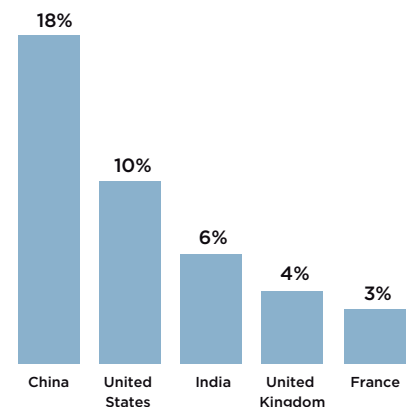
- Substantial hydrocarbon resources and considerable agricultural potential
- The most populated country in Africa (162 million)
- Low foreign debt
- Largely-consolidated banking sector due to reforms launched in 2009

Trade exchanges

Exports of goods, as a % of total



Imports of goods, as a % of total



Weaknesses

- High dependence on oil revenue (90% of exports, 80% of tax revenue)
- Very reduced refining capacity, resulting in burdensome imports
- Ethnic and religious tensions
- Insecurity, corruption restricting the business environment
- Unemployment, poverty, inadequate health and education system

Coface Assessments

B

Country risk

B

Business climate

**RATHER
LOW RISK**

Medium term

Main economic indicators

	2011	2012	2013 (e)	2014 (f)
GDP growth (%)	4.3	3.5	1.3	-0.5
Inflation (yearly average) (%)	8.4	6.6	6.5	6.2
Budget balance (% GDP)	1.6	0.0	-1.3	-1.8
Current account balance (% GDP)	5.3	4.1	1.6	0.8
Public debt (% GDP)	9.8	11.8	13.1	13.7

(e): estimate
(f): forecast

Risk assessment

Slowdown in growth in 2014, the size of which will on depend how the Ukraine situation develops

The growth in Q1 2014 (-0.5% compared to Q4 2013 and +0.9% year-on-year) confirmed the net slowdown in the Russian economy. Investment, sluggish in 2013, has shown a net fall in Q1 2014 (-4.8% year-on-year) and should remain very restricted by the rise in interest rates and the low level of business confidence, the composite indicator of manufacturing activity (PMI) being below 50% (48.3% in March). Industrial output clearly slowed down at the start of 2014.

Private consumption will remain the main driver of economic activity in a context of low unemployment (5.4%). But the public spending control imposed by the new budget rules should hold the government to moderate the rise in wages. Furthermore, the high level of inflation and growing household debt could begin to weigh on consumption.

Inflation should remain high in 2014. The rise in public services tariffs and the price of food, but also the depreciation in the rouble, which makes imported goods more expensive, sharply increases the upward pressure on prices. The rises in the key rates by the central bank (CBR) from 5.5% to 7% in March then to 7.5% in April 2014) combined with relatively contained demand could enable a slowdown in inflation in HY2 but the target of 5% cannot be complied with. A further deterioration in the Ukraine situation cannot be ruled out after the presidential election of 25 May 2014. In this hypothesis, any further international sanctions against Russia could accelerate the depreciation in the rouble and capital outflows (which reached USD 51 billion in Q1 2014), intensifying the slowdown in growth. Furthermore, the capacity (and/or willingness) for Russian companies, greatly indebted with non-residents, to repay their debts could be affected.

The fiscal balance will be difficult to reach in 2014

The slight fiscal deficit posted in 2013 should widen in 2014. Oil revenue (50% of the total) is not likely to increase and the weakness in economic activity will restrict non-oil revenue. Moreover, the defence budget should increase and costs linked to the annexation of Crimea, although staggered over time, should also affect the budget, like the recurring deficit in the pension system. A sharp deterioration in the Ukraine situation and new sanctions could widen the deficit taking into account the impact of the economic slowdown in tax revenue. Nevertheless, Russian public finances still remain solid with a public debt of around 13% of GDP, leaving the government with room for manoeuvre.

Slow, but persistent decline in the current account balance

The current account balance should remain in surplus in 2014, but will continue to deteriorate. Exports, dominated by oil and gas (two-thirds of export earnings) will be constrained by market prices which, at best, are expected to stabilise. Non-oil exports remain constrained by a moderate upturn in external demand and weak competitiveness that the depreciation in the rouble is not enough to boost. The improvement in the current account balance observed in Q1 is explained exclusively by a fall in imports, which should only rise slightly during the year.

A tense social and political context, with an unsatisfactory business environment

The Ukrainian crisis has led to a marked deterioration in relations between Russia, the US and the EU, resulting in political sanctions that could be increased if Russia continues to threaten the stability of the Ukraine after the election of Mr Poroshenko.

The popularity of Mr Putin at the national level has been increased by the intervention in Crimea but the social situation could deteriorate in a context of economic slowdown, a rise in inflation and hardening of the regime. The measures with a view to controlling the media and restricting free speech are increasing, considerably limiting the capacity for organising opposition movements.

The discrepancies with regard to protecting property rights, the weakness in governance and the lack of corporate transparency (particularly in terms of shareholders) greatly weaken the business environment. Russia is ranked in 176th place (out of 215) in terms of control of corruption according to the World Bank Governance indicators, which remains a recurring weakness.

Strengths

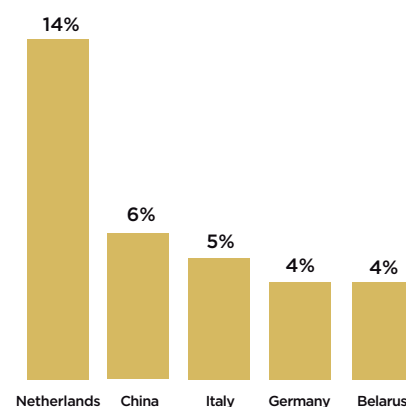
- Abundant natural resources (oil, gas and metals)
- Skilled labour force
- Low public debt and comfortable foreign exchange reserves
- Assertion of regional and energy power

Weaknesses

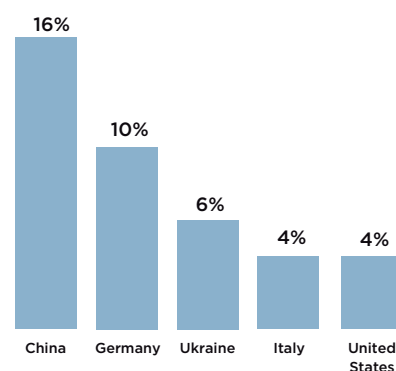
- Increased rentier character of the economy
- Lack of competitiveness in the industrial sector
- Weak private banking sector
- Weak infrastructures
- Declining population
- Persistent shortcomings in the business environment

Trade exchanges

Exports of goods, as a % of total



Imports of goods, as a % of total



Coface Assessments

B

Country risk

A1

Business climate



Main economic indicators

	2011	2012	2013 (e)	2014 (f)
GDP growth (%)	0.1	-1.6	-1.2	1.2
Inflation (yearly average) (%)	3.1	2.4	1.5	0.1
Budget balance (% GDP)	-9.6	-10.6	-7.1	-5.6
Current account balance (% GDP)	-3.8	-1.1	0.7	0.8
Public debt (% GDP)	70.5	85.9	93.9	100.2

(e): estimate
(f): forecast

Risk assessment

Recovery speeds up driven by exports

Spain came out of recession in the second-half of 2013 thanks to expanding exports, benefiting from the improved productivity following the reduction in labour costs and the upturn in external demand. The balance of trade is now in surplus. This recovery was then confirmed in first quarter 2014 with growth recorded at 0.4%, its best level since 2008. GDP growth will accelerate through the year, continuing to be driven by external demand. Domestic demand should become more dynamic and make a positive contribution to growth. Unemployment, whilst still very high (26% of the active population), does seem to have reached a plateau and the low rate of inflation should help sustain household purchasing power. The strength of exports and the need to upgrade the existing industrial tool should see an increase in capital investment. The level of activity will nevertheless be restricted by continuing budgetary austerity, tight credit access conditions and household debt reduction. In addition, investment in housing will remain depressed despite the ongoing adjustment of property prices.

Companies gradually recover competitiveness and confidence

Faced with the contraction in their home market Spanish companies were forced to look for new outlets abroad, capitalising on their substantial productivity gains. The export sector has therefore done very well. The scale of corporate debt has also begun to shrink, with debt dropping from 119% to 98% of GDP between 2010 and 2013, marking an improvement in their financial situations. Levels of confidence among companies, whilst still fairly pessimistic, are also on the up. The situations of companies dependent on the domestic market however remain perilous. With the improvement in the economic climate, the number of insolvencies fell in the first quarter 2014. The hardest hit sectors remain construction (25% of company insolvencies) and services (20%). There is also an over-representation of the SME sector (6.1% of entrepreneurial fabric) at 36.7%.

Healthier banking sector slowly emerging from the crisis

Thanks to the assistance from the Eurozone in recapitalising its banks, the banking sector is now much healthier. The weak banks have been restructured and their toxic property assets transferred to a defeasance entity. The number of banks has been reduced from the 45 that existed prior to the crisis to 12 now. The banking system is now better capitalised, with increased liquidity and better provisions for losses, with stress tests for European banks being applied in autumn 2014. Non-performing loans however continue to grow (13.5% of the total in January 2014). The progress has nevertheless been real and Eurogroupe approved in November 2013 the end of the assistance plan set up in June 2012 to stabilise the sector. The country will only have drawn €41 bn out of the €100 bn made available.

Two of the four banks nationalized in 2012 have been privatized, and the gradual privatization process for Bankia started in March 2014.

Increasing public debt

The budgetary cutbacks are continuing in 2014, at a slower pace than in 2013. Despite the return to growth, the budgetary targets will still be hard to achieve and public debt will continue to increase. Public finances will continue to bear the cost of the banking support and the precarious financial situation of a number of the autonomous local authorities. The costs of borrowing have fallen on the bond market but the viability of the debt is likely to remain an area of concern. Spanish government however never lost its access to the markets and has therefore not had to have recourse to European aid in stabilizing its finances.

Difficult political context

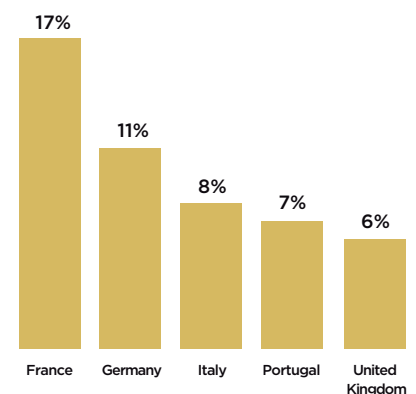
Despite sizeable majority in Parliament, the Mariano Rajoy government remains somewhat frail. It has to cope both with the scandal of alleged corruption involving a number of senior figures in the People's Party and the re-emergence of demands for independence within the regions. The political class lacks credibility and the danger of the secession of Catalonia cannot be totally discounted, even though Madrid has said that the referendum on the issue is illegal. Parliament last April rejected, by an overwhelming majority (299 votes to 47), the demand to hold a referendum on Catalan independence on 9 November.

Strengths

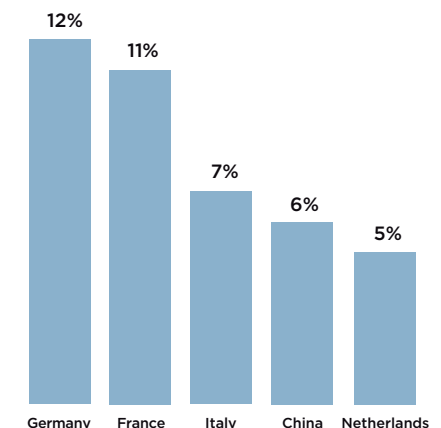
- Renewed competitiveness and strength of the export sectors
- Major groups with an international presence
- Close links with Latin America
- Development of wind and solar energy; quality transport infrastructure
- Significant tourism potential
- Restored financial health of companies (margins, self-financing), but debt levels remain high

Trade exchanges

Exports of goods, as a % of total



Imports of goods, as a % of total



Weaknesses

- Damaged construction sector
- Heavy private debt
- Banking sector weakened by the property crisis and the recession
- Deterioration of the state's financial situation
- Very high unemployment, particularly among the youth