



Economic Outlook

September 2011

Editorial

Since April this year the Atradius Economic Research team has taken a new shape. Two teams, previously operative in Group Risk Management and the Dutch State Business, now operate as an integrated unit. This merger brings together the knowledge of our OECD and emerging markets economists, providing scope for more efficient and enhanced economic research within the Atradius Group. As a step in this process we have drafted a slightly extended Economic Outlook. In addition to the analysis of the advanced economies that dominated previous Economic Outlooks, this edition also covers emerging economies. Moreover, we have this time chosen to publish the Economic Outlook in report format to allow for a more extensive coverage of developments. We hope that these changes are seen as an improvement by the reader.

In broad terms, the economic developments that took place over the past seven months were largely on track with previous expectations of a continued recovery in global activity. Global economic growth reached 4.0% in 2010, while business activity improved and international trade volumes returned to pre-crisis levels. The expansion has been led by countries in Asia and Latin America, while advanced economies have continued to display more muted rates of economic growth. Looking forward, we still expect this two-speed economic recovery to continue. Although the pace of global growth is expected to slow from 4.2% in 2010 to 3.1% in 2011, the recovery in the global economy is expected to gain a firmer footing in 2012.

But this projection is neither uniform across countries, nor balanced in terms of risk. While some emerging markets begin to show signs of overheating, the protracted recovery process in advanced economies is burdened by high unemployment and waning sentiment indicators. In addition to the most recent spell of financial turmoil, the first half of 2011 was also characterised by a series of large-scale events, which have significantly increased the uncertainty surrounding the future growth path. The European sovereign debt crisis has intensified further and pressures are mounting on policy makers to find a credible solution. A failure to do so could potentially have large-scale consequences for economic performance in the Eurozone, with global repercussions. This poses a risk of slowing growth across emerging markets as well, following on rapid credit growth and rising inflation.

Nevertheless, our main scenario for economic performance in the year ahead is still cautiously positive. Assuming that the imbalances discussed in this report can be addressed by way of successful implementation of policy measures across advanced as well as emerging markets, we foresee a continued period of improving growth in the real economy. Based on this scenario, we anticipate a period of robust trade growth and further improving corporate credit conditions.

John Lorié, Chief Economist Atradius

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Part 1

The global macroeconomic environment:

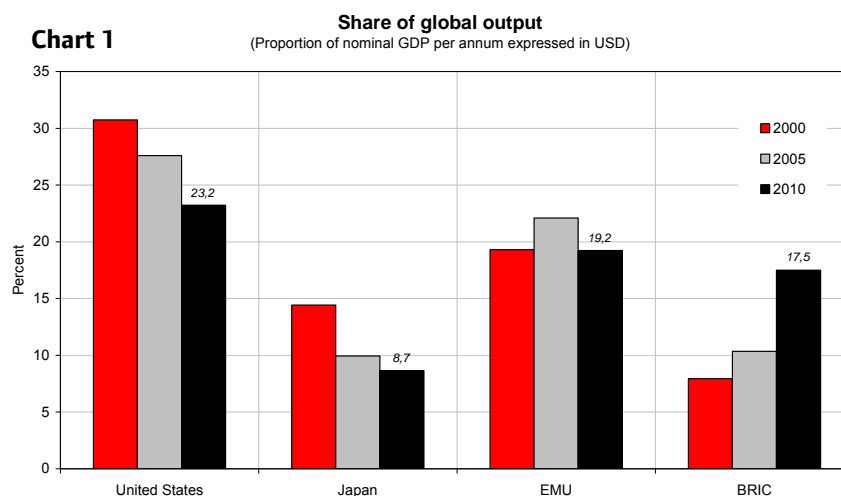
Global recovery at two-speed pace

Over the past 10 years, there has been a manifest shift in the balance of world economic power: with emerging economies becoming a driving force in the global economy. And they have played an important, if not critical, role in the recovery since 2009. The ongoing recovery can best be characterised as two-speed in terms of growth, with the advanced economies trailing the emerging ones. Policy reaction in response to the credit crisis has also differed markedly and, in the resulting post-crisis setting, advanced economies are characterised by high sovereign debt levels and low interest rates, while their currencies depreciate in real terms.

For emerging countries, the situation is precisely the opposite: lower debt levels and higher interest rates, as well as appreciating currencies in real terms. These countries face the challenge of protecting their economies from overheating and managing increasing capital inflows due to the loose monetary policy in advanced economies. As a result, current account imbalances have improved somewhat on a global scale, although they remain large. Meanwhile, new challenges have materialised in the first half of 2011: the Japanese earthquake, the upheaval in the Middle East North Africa (MENA) region, and rapid deterioration among highly indebted sovereign nations in the Eurozone. Since the end of July the volatility in financial markets has increased sharply, raising concerns of a second possible bout of recession. These serious challenges, however, are not yet enough to invalidate the main scenario of a continued global recovery. The growth difference between advanced and emerging economies is expected to prevail over the medium term, in view of the fiscal consolidation that is underway in advanced economies.

The global trend suggests an ongoing shift in the balance of power...

Rapid expansion in emerging markets over the past decade has led to a visible shift in global economic power (see Chart 1).



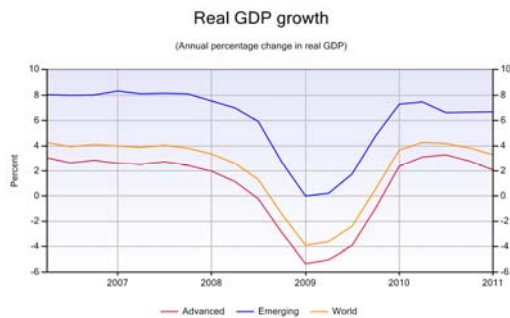
Sources: Global Insight; IMF; Atradius Economic Research.

The leading emerging markets, broadly represented by the so-called BRIC nations (Brazil, Russia, India and China), today account for almost 20% of global output, compared to less than 10% in 2000. At the same time, mature markets like Japan and the United States have witnessed a decline and, given current growth expectations, this trend is set to continue.

...and the two-speed growth pattern reinforces that trend

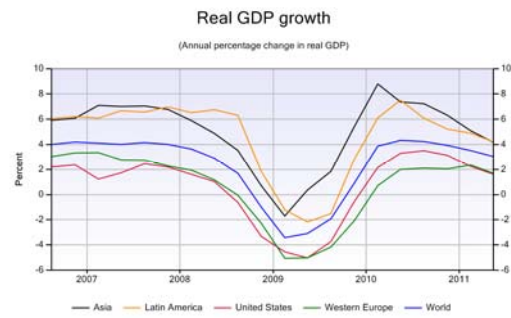
Global economic activity started to recover in the second quarter of 2009 and has broadly continued over the last few quarters, although its pace has now moderated. The expansion is led by emerging countries (see Chart 2). Economies in Asia and Latin America are currently recording rates of growth above 4%, which is well above the global average of 3.0%.

Chart 2



Source: Global Insight.

Chart 3



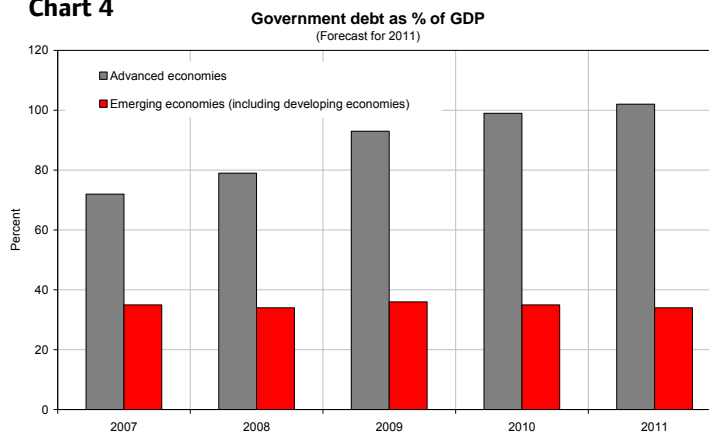
Source: Global Insight.

More advanced economies have lagged behind (see Chart 3). Output growth in the United States has moderated since the second half of 2010 (to 1.7% in the second quarter of 2011), while GDP growth slowed slightly in Western Europe: also reaching 1.7%. Despite this recovery in economic activity, growth in the advanced economies is still below potential and the shift in economic power is likely to continue.

Policy reactions to the global crisis have differed markedly...

The global growth difference would undoubtedly have been more pronounced in the absence of the unprecedented policy reaction in the advanced world following the credit crisis of 2008. The policy response across emerging markets has been far more muted, and this has arguably prevented growth rates from diverging even more.

Chart 4



Sources: IMF; Atradius Economic Research.

Firstly, advanced markets stimulated their economies by fiscal policy in the period between 2008 and 2010 to the extent that their gross debt level as a percentage of GDP rose from 80% to 100% (see Chart 4). The emerging markets stimulated their economies later - in 2009 - and at a far more modest scale. This large debt increase among advanced markets is partly, but not wholly, due to the rescue packages for the financial sector that governments put in place.¹ As a result of this, the underlying upward trend in the difference of gross debt levels in the advanced and emerging economies has widened. The gross debt level of governments in the advanced economies is now above 100% of GDP, compared to 35% of GDP in emerging markets.

Chart 5



Source: Global Insight.

Chart 6



Source: Global Insight.

Secondly, monetary authorities in the advanced economies have pursued an accommodative policy, with ample liquidity provision in combination with very low official interest rates. This has resulted in negative real interest rates in advanced economies (of about -2 percentage points) and positive but still very low rates (now around 1 percentage point) in emerging markets (see Chart 5 and 6). The key underlying factor is inflation (see Chart 7 and 8). The recent increase in the rate of inflation, which originates in rising commodity prices, has triggered a modest interest rate hike in the Eurozone but without significantly affecting the overall accommodative stance of monetary policy. The resulting liquidity glut in the advanced economies has presumably contributed to the growth performance in emerging markets.

Chart 7



Source: Global Insight.

Chart 8



Source: Global Insight.

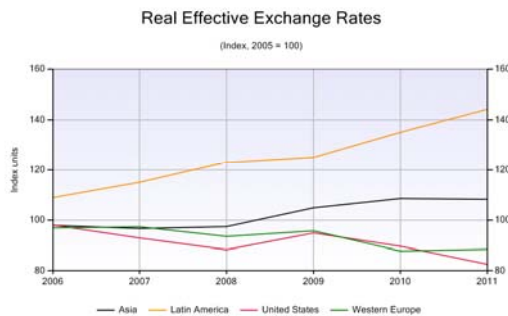
...but global imbalances are being addressed

One of the key underlying causes of the global crisis was that of the growing imbalances between emerging and advanced economies. Emerging countries such as China were accumulating liquidity while running large current account surpluses with undervalued currencies. The resulting global surplus liquidity found its way into ever higher risky assets, such as the subprime mortgages in the United States – until the collapse. These imbalances are now slowly being addressed, although there still seems to be quite a way to go. The real effective exchange

¹ The United States spent US\$ 1.2 trillion stimulating the economy in 2008 and 2009 alone.

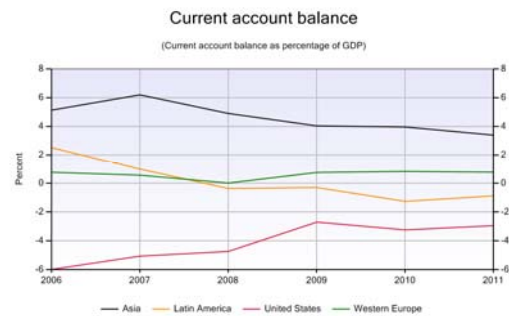
rates show trends that are balance restoring²: currencies in emerging economies (in particular Latin America) are appreciating, whereas those of the advanced economies (particularly the United States) are depreciating (see Chart 9). This is reflected in the regional current account balances where the gap between advanced markets and those in Asia and Latin America have narrowed slightly, indicating movement in the right direction (see Chart 10). Further adjustments in this direction are largely dependent on demand improvement in the advanced economies.³

Chart 9



Source: Global Insight.

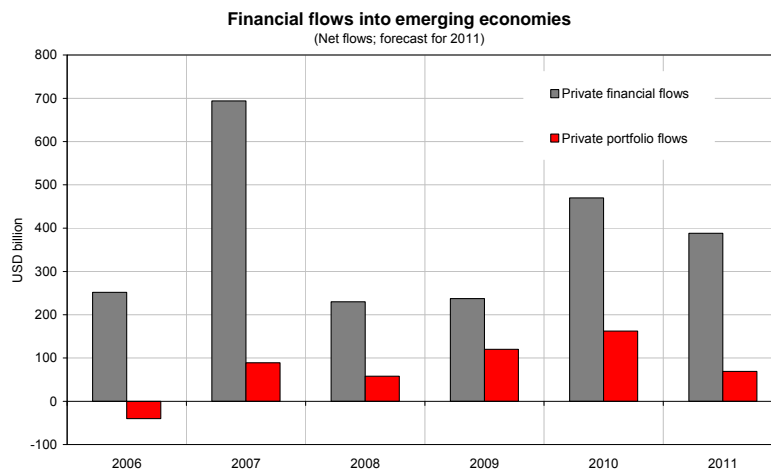
Chart 10



Source: Global Insight.

Meanwhile, the risk that large financial flows into emerging countries will become a source of a balance of payment crisis should not be exaggerated. Although capital flows (reaching US\$ 400 billion in 2010) have increased as a result of the lax monetary policy stance across advanced markets, they have primarily taken place in the form of (long term) foreign direct investment rather than more volatile (and short term) portfolio flows (see Chart 11). Only 25% of the total financial flows were portfolio flows in 2010, suggesting that the risk of a crisis in the period ahead may be played down somewhat.

Chart 11



Sources: IMF; Atradius Economic Research.

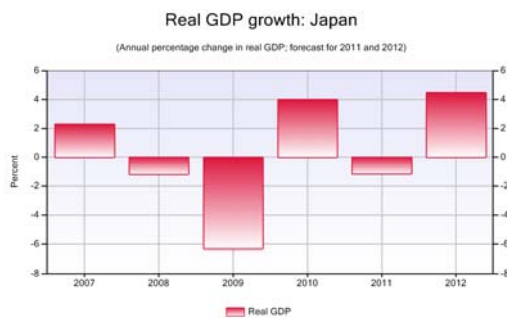
² The real effective exchange rate is a measure for competitiveness. It represents a trade weighted average of bilateral exchange rates corrected for inflation differences.

³ See IMF, World Economic Outlook, April 2011, p.24. The effect largely runs via increased imports in the advanced markets, mirrored by higher exports from emerging markets.

New challenges appeared on the global scene in 2011

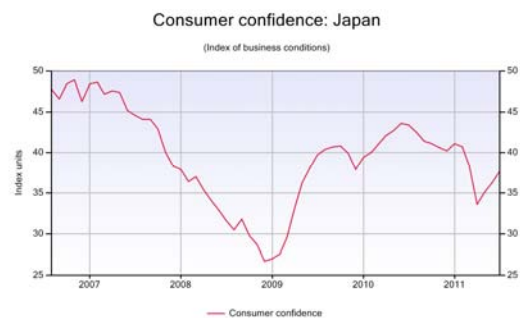
The first half of 2011 has been characterised by a number of serious events with global implications. The Japanese earthquake and subsequent tsunami in February left 26,000 people dead and a bill to repair the damage (primarily in infrastructure) in excess of US\$ 300 billion. The direct effect on economic activity in Japan has been significant following power shortages and production stoppages: since March the GDP forecast for 2011 has been sharply revised from 1.4% to -0.7%. Although reconstruction efforts will help growth to pick up in the second half of 2011, the shock will still imply negative growth for the full year. At the same time, this has translated into expectations of a slightly stronger rebound in growth in 2012 (see Chart 12). Given the size and scope of the disaster, the Japanese economy has managed to adapt quickly to the new circumstances: with consumer confidence, for example, starting to increase again since April (see Chart 13).

Chart 12



Source: Global Insight.

Chart 13



Sources: Global Insight; ESRI.

The effects on the global economy, as well as on the surrounding Asian region, have so far turned out to be relatively limited. Even if supply chain disruptions have had a significant impact on industries outside Japan and much uncertainty remains regarding the nuclear situation, we expect the disaster to have only temporary economic effects.

High and volatile commodity prices pose uncertainty...

Commodity prices, excluding oil, have risen sharply since 2009, threatening the global economy with inflation and a global wealth shift between producers and consumers (see Chart 14). The structural factor underlying the surge can be attributed to the rapid demand growth in emerging markets, while at the same time the supply response has been slow. This is due partly to the time necessary to adjust supply, and partly to temporary factors such as adverse weather conditions. In 2011, the supply factors are expected to show more favourable signs, with the acreage increased and better harvesting prospects. As a result, prices are expected to flatten: a picture so far confirmed by the latest data. Uncertainty remains, however, as continued unrest in the Middle East could lead governments to step up food purchases to ensure sufficient supply in subsidised food markets. Furthermore, price volatility due to the erratic behaviour of uninformed investors increasingly seeking refuge in the commodity market cannot be ruled out.⁴

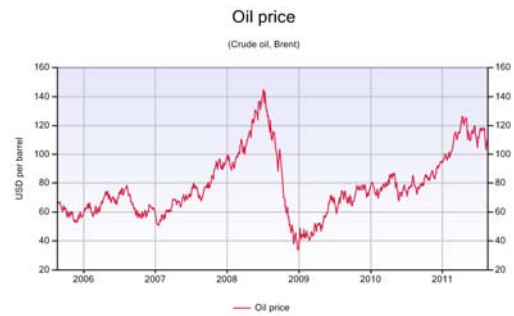
⁴ See IMF, World Economic Outlook, April 2011, p.32.

Chart 14



Source: Global Insight.

Chart 15



Source: Global Insight.

In the market for oil, similar demand forces were at work during 2010. The unrest in the Middle East pushed the price up further: to levels above US\$ 120 per barrel at the beginning of the year (see Chart 15). Since then, the price has stabilised, fluctuating around US\$ 110 per barrel. The severe global economic disruptions that would be likely to arise at a much higher oil price (e.g. US\$ 150 per barrel) seem part of an extreme scenario for the moment. The rising commodity prices have come to a halt, although these developments will remain an issue in the long term.

...but the two-speed recovery is still set to continue

Despite these new challenges and potential threats, including the most recent turmoil in financial markets, the global recovery is still on track. Apart from a few Eurozone countries still in recession, the overall expectation for real economic conditions is positive, with global growth projected to be 3.1% this year and to reach 3.5% in 2012 (see Table 1).

Table 1: Regional growth forecasts⁵

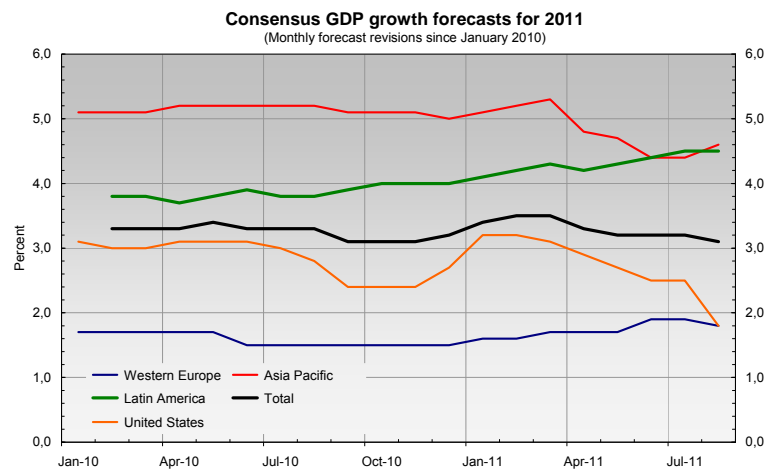
	Consensus Forecast August 2011 Survey	Real GDP % Growth				2011 Trend	2011 M-o-M forecast revision
		2009	2010	2011	2012		
Major Regions	Western Europe	-4.1	1.8	1.8	1.6	→	↓
	United States	-2.6	3.0	1.8	2.4	↓	↓
	Asia Pacific	1.9	7.0	4.6	5.8	↓	↑
	Latin America	-1.7	6.0	4.5	4.2	↓	→
	Total	-1.8	4.2	3.1	3.5	↓	↓

Source: Consensus Forecast (survey date 8 August).

The largely stable forecasts for 2011 since the beginning of last year suggest a certain robustness of the projection (see Chart 16). In this environment the two-speed recovery is set to continue, with the large growth differential between expansive and advanced regions expected to persist over the forecast horizon. Asia-Pacific and Latin America are expected to sustain growth rates significantly higher than 4%, while Western Europe and the United States will grow by less than 2% in 2011. The steeply declining trend in growth expectations for the United States is an exception, and a source of concern: since January the GDP forecast for 2011 has been revised downwards from 3.2% to just 1.8%. This has not only implied a weaker short-term U.S. outlook, but also that the downside risk to the main global scenario has increased over past months.

⁵ The arrows in the last column of the table indicate the direction of revised forecasts compared to the July survey.

Chart 16



Source: Consensus Forecast. Note: The chart depicts the evolution in Consensus GDP growth forecasts for 2011 across 20 consecutive surveys (between January 2010 and August 2011).

The unfolding of this main scenario for 2011 and 2012 is dependent primarily on developments in the advanced economies: fiscal consolidation and the related European sovereign debt crisis, as well as the labour market slack. The fiscal problems in the United States also constitute a downside risk, posing a significant threat in the medium term. These are key issues for the determination of the global economic environment, as well as the business environment for credit insurance, and will be further discussed in the following sections.

Part 2

Prospects and risks in advanced economies

Slower rates of growth across advanced economies...

As mentioned in the previous section, we expect the recovery in the advanced economies to continue in 2011 and 2012. But the strength of the expected recovery is both slow and protracted (see Table 2): at 1.8% the projections of economic growth in the United States and Western Europe are well below potential. Growth rates vary rather significantly, with Germany growing by 3.4%, whereas Japan is expected to contract by 0.7%. Moreover, the expectations for growth in 2011 signal a moderation in activity.

Table 2: Growth forecasts

	Consensus Forecast August 2011 Survey	Real GDP % Growth				2011 Trend	2011 M-o-M forecast revision
		2009	2010	2011	2012		
Major Markets	France	-2.5	1.4	1.9	1.7	▲	▼
	Germany	-4.7	3.6	3.4	1.9	▼	▶
	Italy	-5.1	1.2	0.8	0.8	▼	▶
	Japan	-5.3	4.0	-0.7	3.1	▼	▶
	Netherlands	-3.9	1.7	2.0	1.6	▲	▼
	Spain	-3.7	-0.1	0.7	1.1	▲	▶
	United Kingdom	-5.0	1.4	1.3	2.0	▼	▶
	United States	-2.6	3.0	1.8	2.4	▼	▼

Source: Consensus Forecast (survey date 8 August).

One reason behind this growth moderation is that many of the underlying drivers of the economic recovery, such as industrial production, have lost momentum over recent months (see Chart 17). In the first half of 2011 the inventory cycle was running off, as firms have replenished their inventories during the recovery, creating a downward effect on production. Temporary government schemes and support in the form of production and demand subsidies were also being phased out.

Chart 17



Chart 18

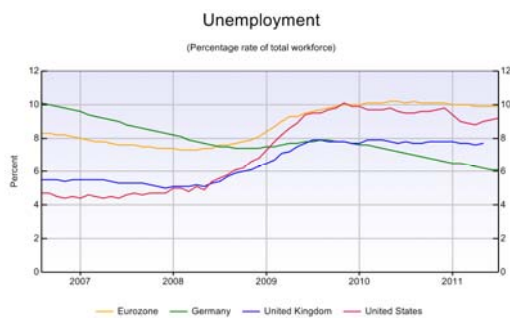


This is also reflected in manufacturing confidence, which has shown some retrenchment since the beginning of the year (see Chart 18). Private consumption, which may be considered as a primary driver of sustainable growth, has remained moderate.

...is reflected in weak labour markets

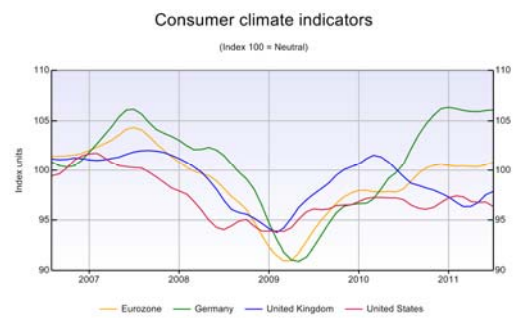
The broad pickup in activity has fed through to the labour market with unemployment rates stabilising at around 10% in the Eurozone and 8% in the United Kingdom (see Chart 19). Unemployment in the United States has increased somewhat over past months and remains at high levels. This signals a lack of sufficient strength in underlying economic conditions and even in countries where labour markets are recovering, weakness is likely to linger for some time.

Chart 19



Sources: Global Insight; OECD.

Chart 20



Sources: Global Insight; OECD.

Firms remain hesitant to create employment amid uncertainties about the strength of the recovery and, on average, rates of investment growth are low. Within the Eurozone, the differences in labour market performance across member countries are large. Germany, for example, with high export-driven growth and more fiscal headroom to subsidise short-time working and job creation, has outperformed its peers. At the same time, member countries in the South have continued to deteriorate from already high levels of unemployment: in Spain, well above 20%. These persistent labour market overhangs, together with weak wage growth and public spending cuts, help to explain the flattening consumer confidence since the start of the year (see Chart 20).

Policy constraints start to bite as monetary expansion has reached its limits ...

The swift action taken by governments in advanced markets since the onset of the crisis may have prevented a wholesale collapse of the banking sector and helped to restore output growth. But the corollary is that the economic recovery seen so far has been underwritten by the state. Support has been supplied through three principal channels: (i) an unprecedented easing of monetary policy rates plus extraordinary liquidity support through central bank balance sheet operations; (ii) bank sector recapitalisation and the placing of sovereign guarantees on bank funding, and; (iii) direct economic support offered via discretionary fiscal spending. This policy now seems to run against constraints, and these will bite.

Chart 21


Source: Global Insight.

Chart 22


Sources: Global Insight; OECD.

Monetary policy in advanced markets has remained extremely expansive for more than two years (see Chart 21). The United States, the Eurozone and the United Kingdom have gone far beyond conventional monetary policy to stimulate the economy. These unconventional measures have involved purchases of government and corporate debt, with the aim of stimulating private sector demand via lower borrowing costs, raising wealth, and increasing the funds available for bank lending. In view of the slow and vulnerable recovery, an extension of such measures would be warranted. But domestic consumer price dynamics have steepened sharply since the beginning of the year (see Chart 22).⁶ In the Euro area inflation has risen steadily over the past year and has recently reached 3.1%, which is well above the policy objective of the European Central Bank (ECB). At 4.5%, inflation in the United Kingdom is far in excess of the 2% target. This puts pressure on the low interest rate policies, which are necessary to sustain growth. Inflation expectations are still anchored, but the situation could become critical if they start to drift with central bank liquidity provision still in crisis mode. These inflation developments have already led the ECB to embark on a series of modest rate hikes in 2011, but the other central banks have kept their low rates untouched.⁷

...and public finances have become strained

Synchronised fiscal loosening across advanced markets during the downturn has had a dramatic impact on public finances (see Table 3).⁸ The fiscal stimulus has now turned into synchronised consolidation as governments seek to return public finances to sustainable levels, and this process seems to be becoming a delicate matter. On the one hand, financial markets have grown increasingly concerned over Eurozone debt capacity since the beginning of the year and these tensions need to be removed. On the other hand, the recovery in the real economy could still use a good dose of public support. There is considerable cross-border variation in the degree of tightening required, but virtually no country is left unaffected.

⁶ The rise of commodities prices (including the oil price) is the main underlying cause of the rise of inflation. See for example IIF, Global Economic Monitor, June 2011, p.16.

⁷ On August 9 the U.S. Federal Reserve committed to keep interest rates low until 2013, trying to assure investors that it will act as needed to bolster the flagging U.S. economy.

⁸ The resulting budget deficits reflects increased discretionary spending aimed at supporting the banking sector and aggregate demand, as well as collapsing tax receipts.

Table 3: Public finances

		Austria	Belgium	Finland	France	Germany	Greece	Ireland	Italy	Netherlands	Portugal	Spain	United Kingdom	United States	Japan
Public finances (as % of GDP)	Structural fiscal balance (average 2000 - 2007)	-1,5	-0,3	4,1	-2,7	-2,2	-5,4	1,5	-2,9	-0,6	-3,7	0,3	-1,6	-1,4	-6,7
	Fiscal balance (2011)	-3,0	-4,1	-2,9	-5,8	-1,4	-7,9	-10,4	-4,1	-5,0	-6,1	-7,3	-8,5	-9,3	-8,9
	Public debt (2011)	72	97	42	84	84	152	105	120	63	97	69	65	117	203

Sources: Global Insight; Atradius Economic Research.

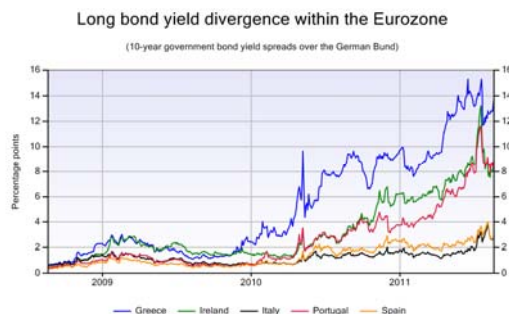
Note: By the term 'structural' we here refer to the average fiscal balance between 2000 and 2007.

Whereas the consolidation plans in the advanced economies amounted to 1% of GDP in autumn 2010, they have now been scaled back to 0.25%.⁹ In the Eurozone, fiscal austerity will amount to an average of 1% of GDP (but unevenly distributed, as the burden will be much heavier in peripheral countries). The precise impact of the squeeze in net public spending on the real economy is uncertain. The current outlook is founded on the assumption that the direct effects will be limited, but the credibility of the measures taken will be imperative. Measures that are perceived as less credible will inevitably have further damaging impacts on sovereign risk premiums, confidence and investor behaviour.

Eurozone tensions have run up...

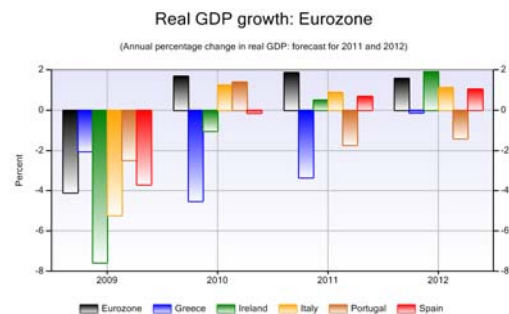
The situation in the periphery of the Eurozone provides some clear lessons in that respect. Despite aggressive public sector consolidation plans for the years ahead, investors have become increasingly concerned about creditworthiness across Eurozone member states. Although Greece, Portugal and Ireland are the immediate sources of concern, financial markets are also paying increasing attention to Spain and Italy. Funding costs have become increasingly elevated (see Chart 23) and this can be expected to feed through to domestic banking sectors and corporate borrowing rates. The deterioration in sovereign capacity is already reflected in an increasingly weak outlook for real growth: both Greece and Portugal are expected to contract in 2011 and 2012 (see Chart 24).

Chart 23



Source: Global Insight.

Chart 24



Sources: Global Insight; OECD.

The weak fiscal positions of these countries are exacerbated by a variety of country-specific factors, including fragile banking sectors which are particularly exposed to the risk of sovereign losses (Greece and Portugal) and

⁹ This largely reflects a major change in the policy stance in the United States, where the structural deficit is to widen by 0.6% instead of contracting by 0.9%, and fiscal stimulus provided by the Japanese government following the earthquake.

real-estate related losses (Ireland and Spain). This leads to acute funding frictions in wholesale markets for banks, increasing debt-service burdens, and hampers the possibilities of further borrowing over the next few years.¹⁰ Structural imbalances such as relatively high unit labour costs and persistent current account deficits add to the difficulties.

Table 4: Cross-border bank exposures

		Amounts outstanding on country in USD Billion				
		Portugal	Italy	Greece	Spain	Ireland
Banking sector claims	Germany	4,3	257,4	5,2	41,9	71,8
	France	7,8	42,4	2,1	27,4	16,5
	Austria	0,3	102,4	0,1	4,4	3,5
	Netherlands	10,8	24,1	3,9	17,5	7,1
	Belgium	0,5	4,2	0,2	5,4	5,4
	Finland	0,0	1,2	0,0	2,7	-

Sources: BIS; Atradius Economic Research.

The difficult situation in the Eurozone calls for a quick and credible negotiation of substantial support packages to manage the risk of contagion.¹¹ The threat of continued sovereign downgrades are adding to funding pressures, with subsequent pressure on the ratings of domestic financial institutions. Extensive exposure of European banks to the external liabilities of these countries underlines the risk of widespread cross-border contagion (see Table 4).¹² As uncertainty over the future path of policy remains elevated, it threatens to distort credit flows and create difficulties for both firms and households.

...and concerns over US performance are increasing

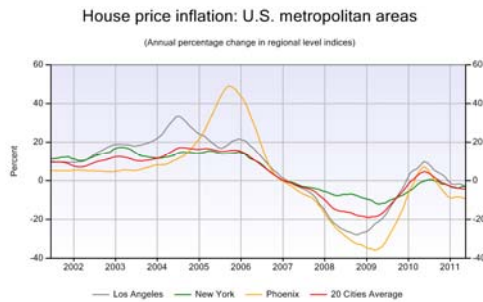
The substantial increase in public sector borrowing in the United States is also beginning to impede its perceived sovereign strength, with potential impact on future funding costs.¹³ The large fiscal deficit will require correction, which in turn may threaten growth in business investment and household consumption. Although the financial system has stabilised, weaning the sector off extraordinary central bank support will be a challenge, because of the still vulnerable position of financial institutions. The previous recoveries in the housing market have given way to renewed weakness, which is pressing further on collateral values and credit raising capacity (see Chart 25). The debt service burden on the US consumer is still high, despite the historically low interest rate levels.

¹⁰ The ECB has to provide a whole range of liquidity facilities to alleviate the liquidity issue. A large number of banks in peripheral countries have become fully dependent on this lifeline.

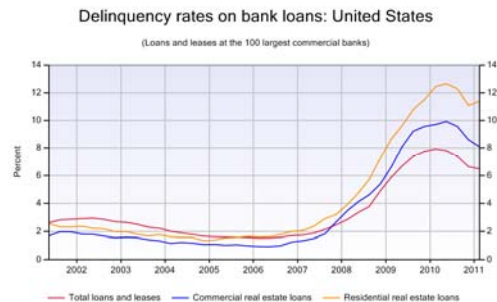
¹¹ On July 22, the Eurozone and the private sector agreed on an orderly debt exchange of the entire public debt of Greece coming to maturity between 2012 and 2020. The maturity extension in this debt exchange will include all of the debt maturing in the next decade, providing a larger amount of debt relief for Greece than in previously proposed arrangements. The effect on confidence, however, was short-lived: markets have remained unsettled following the decision.

¹² The table should be read from left to right. For example, the claims of German banks on Portugal are US\$ 4.3 billion.

¹³ On July 13, 2011 Moody's put the sovereign rating for the United States (Aaa) on 'negative watch'. S&P (AAA) followed suit on July 14. On July 31, a political agreement to raise the government debt ceiling by at least US\$ 2.1 trillion was reached, but this policy response was not sufficient to prevent a sovereign rating downgrade. Based on uncertainty regarding the implementation of accompanying measures in the agreement, including a US\$ 1 trillion in spending cuts over the medium term and identification of an additional US\$ 1.5 trillion in deficit reduction, S&P downgraded the United States to AA+ status on the 5th of August.

Chart 25


Sources: Global Insight; S&P/Case-Shiller.

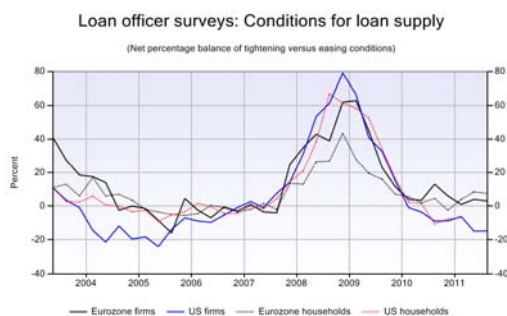
Chart 26


Sources: Global Insight; Federal Reserve.

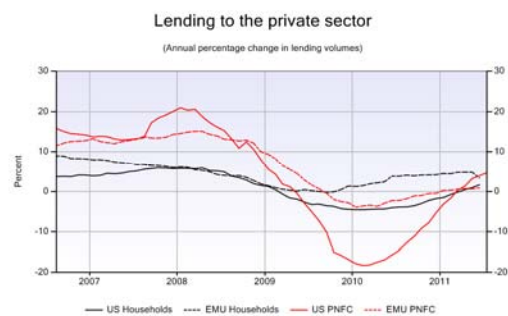
Foreclosures have continued to rise in the United States but delinquency rates with respect to loans show a declining trend, although they remain at elevated levels (see Chart 26). If further substantial write offs on residential and commercial loans are required, downward pressure on bank capital and lending will be felt. The resulting subdued credit flows, together with the weakness of house values as a source of financial wealth, add to the downside pressure on the possibility of domestic demand coming from the labour markets, as discussed earlier. The sharp drop in equity prices since July (a broadbased correction in the region of 20% over just three weeks) has affected financials in particular, signalling risk of future stress in the credit channel.

Credit conditions remain restrictive in general...

Against the background of continued uncertainty about future write-downs, weak capital positions and sovereign-related risks, there is evidence to suggest that the credit channel is not yet functioning effectively. Loan officer surveys across the advanced economies indicate that bank lending is lagging behind, instead of leading, the pick-up in real activity. This constrains economic growth. In the United States the net balance of credit standards eased over the first half of the year but, given the previous spell of aggressive tightening, access to bank finance is still considered restrictive (see Chart 27). Lending conditions in the Eurozone have, consistent with the ongoing sovereign turmoil in its periphery, been indicating a moderate pace of continued tightening over the same period.

Chart 27


Sources: Global Insight; ECB; Federal Reserve.

Chart 28


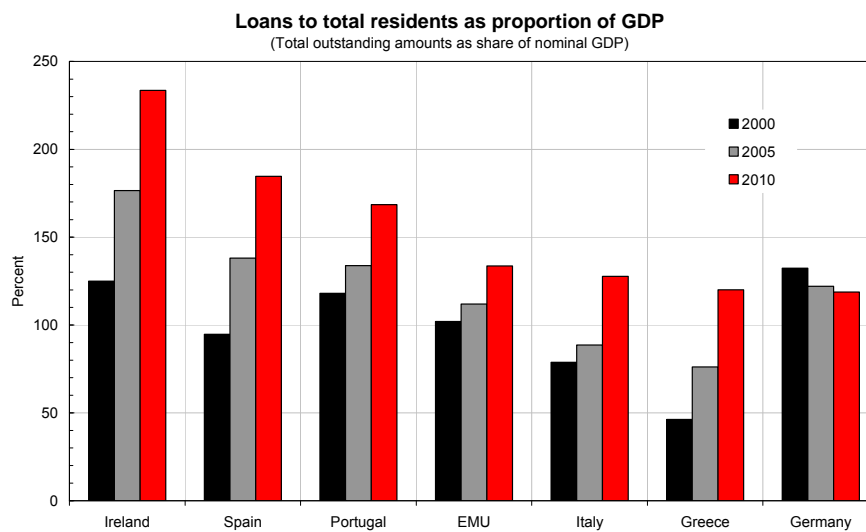
Source: Global Insight.

On the other hand, demand for commercial loans has picked up slightly in both the United States and the Eurozone. Lending flows to firms have turned marginally positive, where the pick-up in economic activity during 2010 should have raised the demand for bank financing. The demand picture across households mirrors that for firms, despite the signs of a double-dip in the US housing market and continued weakness across property markets in Europe. But this is not surprising considering the low interest rate environment, as reflected in negative real interest rates across Europe and the United States. Given access to financing, the private sector is in fact offered credit on relatively cheap terms despite the elevated risk margins on loans.

...while tightening across vulnerable economies.

The marked build-up of debt among households and firms over the last decade has left the private sector more exposed to changing financing conditions (see Chart 29). As sovereign conditions deteriorate this could lead to unanticipated debt servicing constraints, which in turn will drive rising delinquencies and financial sector losses with downside effects on the real economy.

Chart 29



Sources: Eurostat; Atradius Economic Research.

The increase in debt over this period has tended to be steepest in those countries that have experienced a housing boom and much of the accumulated debt among firms has been driven by property-related borrowing. In countries with relatively stable house prices, such as Germany, the private sector obligations as a share of GDP has actually declined. On the whole, corporate sector liabilities remain substantially higher than their long-term averages, suggesting that retrenchment will be required to bring debt down to sustainable levels. In the light of the most recent developments in financial markets, this situation contributes to significant downside risk to the main scenario across advanced markets.

Part 3

Prospects and risks in emerging economies

Emerging markets are leading the global recovery

After a brief slowdown in 2009, due to the fall in global trade and lower mineral prices, the emerging countries recovered strongly in 2010 at an average GDP-growth of 7.3%, according to IMF figures. Asia led the way, with a real growth figure of 9.5%, followed by Latin America with 6.1%. The BRIC nations performed well - in particular during last year's economic upswing - and are expected to continue to do so throughout 2011 and 2012 (see Table 5). Against the backdrop of slower growth in advanced markets, founded in an urgent need for debt consolidation and austerity measures, these emerging markets are becoming increasingly attractive for investors and businesses alike. But the high return prospects are associated with risks and all four BRIC countries display weaknesses to a varying degree, making them more or less vulnerable to adverse economic developments – domestically as well as externally. As such, the fortunes of these markets is dependent on continued recovery across advanced markets, and vice versa.

Table 5: Growth forecasts

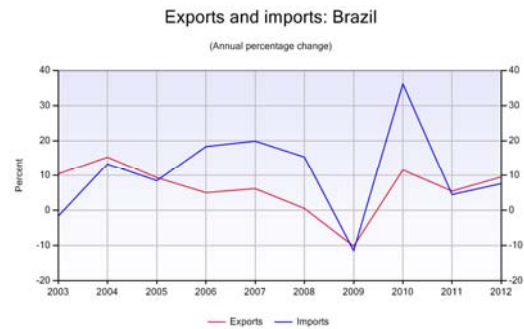
	Consensus Forecast July 2011 Survey	Real GDP % Growth				2011 Trend	2011 M-o-M forecast revision
		2009	2010	2011	2012		
BRIC Markets	Brazil	-0.6	7.5	4.0	4.2	↓	↓
	Russia	-7.8	4.0	4.5	4.5	↑	↓
	India	8.0	8.5	7.9	8.3	↓	↓
	China	9.1	10.3	9.2	8.8	↓	→

Source: Consensus Forecasts (regional surveys, July).

Brazil: booming economy with overheating risks

The Brazilian economy surged by 7.5% in 2010, thanks to strong growth in private consumption and a rebound in fixed investments (see Chart 30). This upswing also reflected the strong momentum in the corporate sector that benefited from buoyant exports to Asia (see Chart 31). The outlook for the remainder of this year and beyond is positive: although real GDP growth is due to moderate in 2011, it is expected to remain robust at 4%.

Chart 30

Chart 31


But there is a risk of the upswing spinning out of control and the economy overheating. There are already signs that the credit cycle is building up pressure, leaving commercial banks with a rapidly rising proportion of disputable debts in their portfolios. To counterbalance rising inflation – one of the side-effects of the economic boom – the monetary authorities have increased the official interest rate. But higher interest rates attract more short term investment capital and these capital imports are right now the last thing that Brazil needs: capital inflows and higher inflation force the real exchange rate of the Real to appreciate, gradually eroding the competitiveness of Brazilian exports.

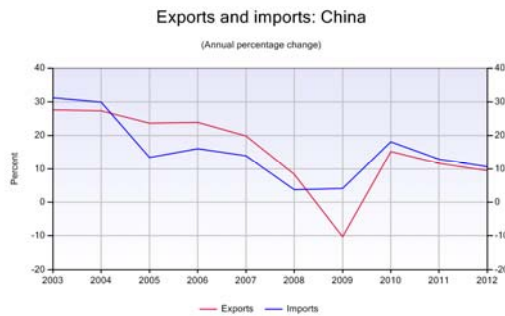
Exploration of the huge off-shore oil reserves that were discovered a few years ago poses another challenge for Brazil: to manage these reserves skilfully without letting the competitive position of non-oil exports be overly weakened by a strong currency (a phenomenon often referred to as the 'Dutch disease'). The main objective for the authorities is to obtain GDP growth that is sustainable while keeping inflation and the current account deficit under control. As Brazil is a large market, with about 200 million inhabitants, there are ample prospects for trade with buyers in this country. The financial sector is generally in good shape but other fundamental aspects of the domestic economy (such as infrastructure) call for improvements. To accomplish such improvements, however, the government would have to implement additional public sector investments: extra stimuli that would further increase the risk of economic overheating.

China: the economy powers ahead

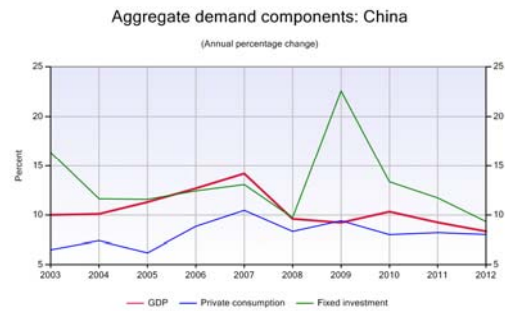
China is the fastest expanding economic power in the world and growth remained impressive in 2009 even as world trade slumped. Large-scale public sector support in the shape of fiscal stimuli counterbalanced the drop in exports and cushioned against the negative impact of the global credit crisis. As world trade recovered strongly last year, Chinese exports followed suit: recording a real growth rate of 20% (see Chart 32). In 2010 the Chinese authorities took measures to gently cool down the economy with real GDP growth reaching 10.3%. The outlook for this year and the next is equally expansive, although some moderation is expected. The domestic Chinese market continues to expand briskly, fuelled by business investments and growing private consumption (see Chart 33).

Despite more restrictive monetary and fiscal policy, the rate of inflation is currently higher than 5%.¹⁴ Increasing commodity prices in combination with the strong growth in domestic demand put pressure on inflation and increasing signs of overheating have emerged. In a country with 1.3 billion inhabitants, a rapid rise in food prices, energy and commodities constitutes a significant risk for social discontent. The authorities are therefore faced with the challenge of finding a balance between high growth (to sustain improving living standards) and keeping inflation under control (to avoid an erosion of living standards).

¹⁴ This figure represents an estimate, and may be understated. The reliability of the official statistics is often questioned.

Chart 32


Source: Global Insight.

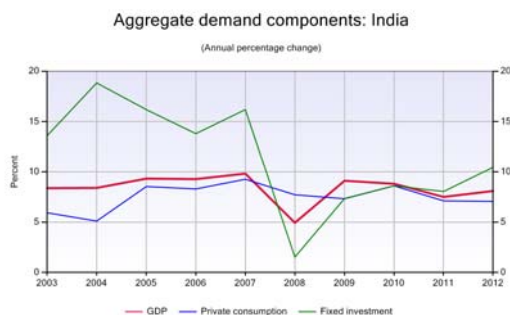
Chart 33


Source: Global Insight.

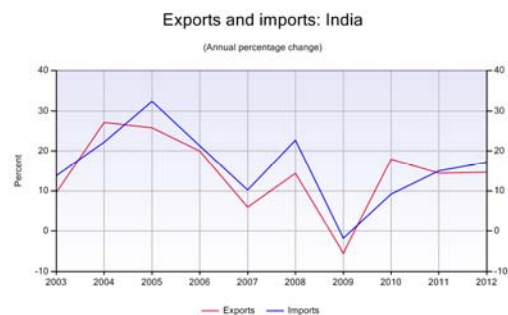
Apart from underlying political tensions, there is a risk that the overheated property market will experience a hard landing. The aggressive investments made over the past few years have certainly not been all that productive. The major risk connected with these developments is the deteriorating quality of assets in the banking sector. Non-performing loans are still low but may increase over the years as the property market cools off. Questionable investment quality and reports of already high debt levels may also fuel concerns about the financial health of local governments. Moreover, it must be borne in mind that China is, and will remain for the foreseeable future, a one-party state. Economic decisions are taken for political reasons, resulting in an over-regulated market and a system that inherently leads to widespread corruption. Apart from these potential risks, however, the country has a large cushion of international reserves (amounting to approximately US\$ 3.2 trillion) in addition to negligible foreign debt obligations. This position enables the authorities to increase awareness on the world stage politically and to expand its economic power in the coming decades.

India: still much to be done

India has been one of the world's strongest performers in the last decade. Between 2000 and 2008, GDP growth has averaged around 7% per year: second only to China among the large emerging markets. In terms of economic growth, India remained largely unaffected by the global crisis. This growth is strongly driven by private consumption and investment, taking profit from the economic liberalisation measures of the late 1990s and the subsequent rise in living standards (see Chart 34). Exports of manufactured goods, software and business services have also contributed to economic success, although exports dropped by nearly 5% in 2009 (see Chart 35). As evidenced by current strong growth figures, it is expected that the period of high GDP growth in India is far from over, despite the large dependency on agricultural output. But inflation is high, undermining India's competitive position; the increase in prices for commodities, which have to be imported, has contributed strongly to the erosion of living standards for large parts of the population.

Chart 34


Source: Global Insight.

Chart 35


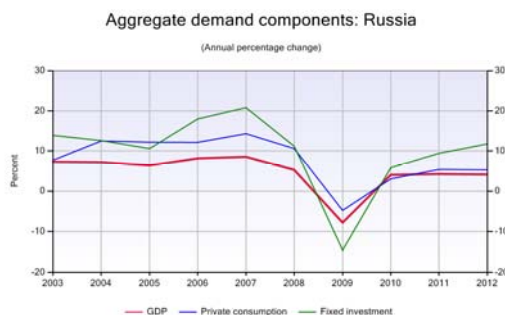
Source: Global Insight.

As a lower-middle income country, India still has a long way to go in terms of development. Welfare is unequally distributed among regions and social groups, but a middle class that is able to sustain a buoyant domestic market is rapidly catching up. Moreover, the economic structure has to be significantly upgraded, especially with regard to the poor infrastructure of the country. The issues of power supply, roads and railways, and the poor education system urgently need to be addressed. The growth profile of India, in contrast to that of China, is reflected in a substantial 'twin deficit': both the public sector account and the current account register negative figures. India's public sector deficit adds to the government debt which reached 70% of GDP in 2010. Fiscal discipline in India is rather poor, based on low tax revenues and the extensive programme of subsidies on food, fuel and fertilizers. Although the current account is structurally negative, ample international liquidity and a low level of external debt ensure that India will continue to be a fast-growing and robust market.

Russia: vulnerable mono-culture

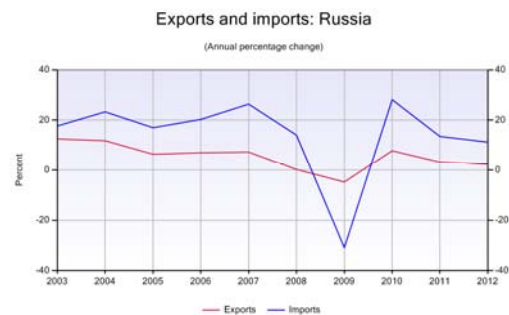
In 2009 the Russian economy was severely hit as energy prices dropped sharply in response to the crisis and trade surpluses, which are standard for this country, showed a marked deterioration. Imports also dropped in the deep recession that emerged in Russia, with real GDP plunging by 7.8% in 2009. In 2010 the global recovery triggered higher energy prices on the world market and the Russian economy recovered at a real growth rate of 4%. The domestic market required substantial fiscal support during the downturn, helping out state banks and firms financially. This is now reflected in the public sector accounts, which turned into a sizeable deficit in 2010. Economic growth is currently expected to exceed 4% in 2011 and 2012 but this means that, given the severe contraction experienced during the crisis, the recovery will be protracted (see Chart 36).

Chart 36



Source: Global Insight.

Chart 37



Source: Global Insight.

The Russian government has taken measures to reduce the public finance gap but the poor economic structure of the country is a handicap. For the forthcoming years, Russia will continue to be a mono-culture largely dependent on the output and export of oil and gas. The performance of the economy is ultimately linked to the vagaries of the global markets for energy and the economy is lacking the dynamic export sector of the other BRIC nations (see Chart 37). The Russian economy is heavily monopolised by state-owned or state-loyal companies, and the executive and legal systems of the country are weak and opaque. As a result, corruption is high and the business climate unreliable. Property rights are not always honoured and business decisions are sometimes subject to political interference. The banking sector is in urgent need of reform and this fragile structure will continue to limit business opportunities in Russia.¹⁵

¹⁵ In the beginning of 2011 the Bank of Moscow had to be rescued by the state, representing the largest bail-out operation in Russian history.

Putting the risks into context

In summary, all BRIC economies show relatively high rates of growth at present. But the global economy is facing enormous challenges in terms of adjustment and these growth prospects are conditional on the assumption that this transition process goes smoothly. The expansion since the second half of 2009 has coincided with rising prices of food and commodities and the end result of this process has been rising inflation (see Chart 38). High inflation puts pressure on the political structures as it drives the cost of living higher for poor population segments, paving the way for social discontent. Monetary policy has responded to these developments, although it has differed in size and effect across the BRIC countries: while Brazil is characterised by a relatively high interest environment, the real interest rate is relatively low in the other countries (see Chart 39).

Chart 38



Source: Global Insight.

Chart 39

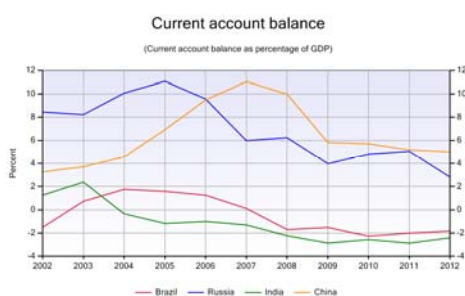


Source: Global Insight.

The macroeconomic stability and political risk situation of the BRIC countries have nevertheless improved considerably since 2005, as reflected in their sovereign ratings. All are now regarded as investment grade quality by the major rating agencies, with China on a par with Japan. But rapidly changing country conditions have been shown to create instability in the past, raising the risk of abrupt adjustments which could be manifested in severe output losses or currency devaluations. Even countries with seemingly strong fundamentals, as reflected in their international credit standings, may be subject to rapid transition under adverse circumstances.

For that reason, there are a number of underlying vulnerabilities in the BRIC countries that should not be neglected. Firstly, governance and developed regulation are key determinants of economic performance. Flaws in these structures may pass unnoticed in good times, but will bite if conditions become unfavourable. Regulation and supervision is lagging behind the expansion in economic activity, making generally opaque systems and corruption a major issue. Secondly, perceived signs of overheating should be taken seriously as they eventually will need to be corrected. Again, the situation differs for each country: while Brazil and India are running structural current account deficits, the opposite is true for Russia and China (see Chart 40).

Chart 40



Source: Global Insight.

Chart 41



Source: Global Insight.

Thirdly, capital inflows are increasing and all the BRIC economies except China have experienced appreciating exchange rates since 2009 (see Chart 41). Although we argued in the first chapter that there is reason to worry somewhat less about the composition of capital flows in general terms, the situation differs from country to country. Brazil has for example witnessed short term capital inflows combined with a sharp appreciation in the real exchange rate. This erodes its competitive position, hampering exports and the fundamentals for growth. But there is a major mitigating factor to cushion against these vulnerabilities: a sufficient level of foreign exchange reserves – the greater the size of this buffer (as measured in proportion to debt or exports), the greater the capacity to withstand sudden adverse shifts in market conditions.

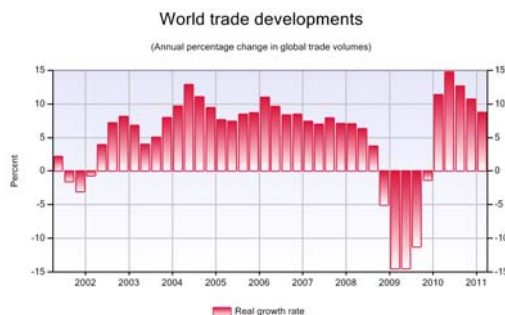
Part 4

Implications for trade and credit

Export growth is still expected to remain robust

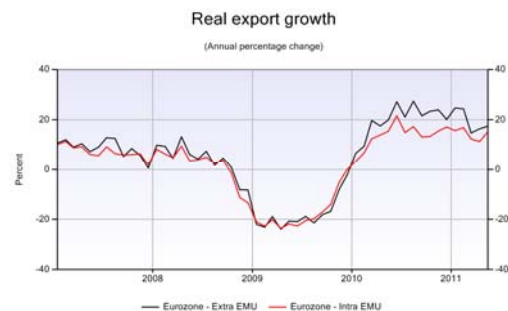
The volume of traded goods and services is linked to the level of GDP and the global outlook also guides our view on international trade. After falling by almost 11% in 2009, reflecting the sharp contraction in economic activity, world trade rebounded strongly in 2010 displaying an annual rate of growth of 12.4% (see Chart 42). This has restored the volume of international trade to its pre-crisis peak of nearly US\$ 4 trillion. The most recent trade data indicate a fading in the pace of trade growth, which is in line with the moderation in the business cycle. Given the current economic outlook, we expect world trade to grow by 6% in both 2011 and 2012. Although this pace is significantly slower than in 2010, it still represents a rate of growth in line with the average over the past 20 years.

Chart 42



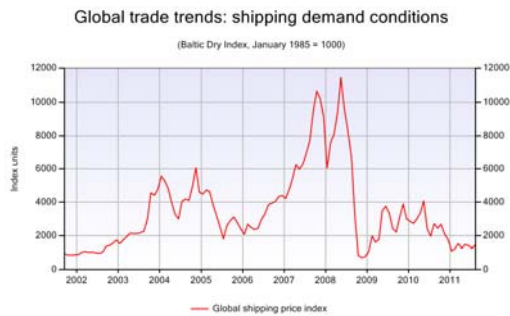
Sources: Global Insight; OECD.

Chart 43

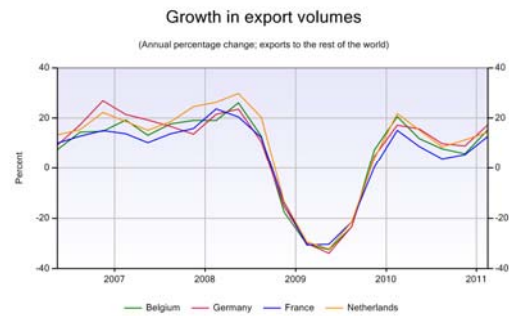


Sources: Global Insight; Eurostat.

Export growth from emerging and developing countries will continue to be faster than in advanced economies, and import growth even more so. The overall trend of strong performance and attractive growth prospects in emerging markets is reflected in these trade flows. At the same time as intra-regional trade picks up across Asia and Latin America, the slow economic recovery and weak financial sector conditions reduce the pace of flows between advanced markets. In the Eurozone, growth in exports to markets outside the monetary union has outpaced the growth in exports between member countries since the onset of 2010 (see Chart 43). In view of the increasingly problematic situation inside the Eurozone, it is reasonable to expect this gap to widen further over the forecast horizon. Growth in the domestic trade of goods is also expected to develop more slowly across advanced markets, in line with GDP forecasts.

Chart 44


Sources: Global Insight; Baltic Exchange.

Chart 45


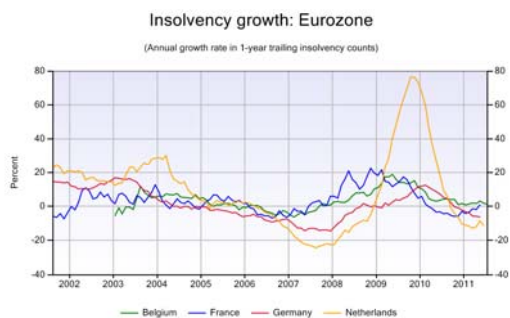
Sources: Global Insight; OECD.

While the expectations of a continued recovery bode well for businesses and trade, underlying trade data send mixed signals. The Baltic Dry Index, an often quoted indicator of global trade momentum, has developed weakly since the second half of 2010 (see Chart 44). Although this partly reflects over-capacity in the shipping sector (built up in the years before the crisis) the recent recovery has not generated a comparable demand for the transport of raw materials. The recent crisis episode has also proved how sensitive trade flows are to abruptly changing financing conditions (see Chart 45). The high degree of uncertainty surrounding sovereign capacity across advanced countries and the subsequent pressure on bank financing in Europe emphasises these risks, possibly feeding through in terms of tighter trade conditions.

The outlook implies stabilising insolvency conditions...

The projected economic developments, as described in the previous sections, ultimately have a bearing on solvency conditions and payment behaviour among firms. Although growth in real GDP represents the most central variable in our aggregate insolvency framework, other factors behind this summary measure of economic performance influence the likely path of insolvencies. Tight financing conditions, for example, have a more negative impact on the default environment within the corporate sector when the level of leverage is relatively high, as alluded to earlier in this report. The sharp contraction in real economic activity and excessively tight credit conditions in 2008 and 2009 led to a widespread increase in insolvencies, though the severity and timing of this increase varied from country to country.

The number of business failures in the Netherlands increased by almost 75% in 2009, and a number of major markets experienced insolvency growth in excess of 20% (see Chart 46 and 47). It is worth emphasising that GDP growth by no means needs to be negative for insolvencies to pick up and it is usually enough for growth rates to moderate in order for the insolvency environment to deteriorate.

Chart 46


Sources: Global Insight; National Statistics Offices.

Chart 47


Sources: Global Insight; National Statistics Offices.

The improvements in the real economy and somewhat stabilising (although still weak) credit conditions across advanced markets since 2010 have been mirrored by a widespread decrease in insolvencies. Insolvencies fell back on a global scale in 2010 across both advanced and emerging economies: on aggregate, insolvencies have decreased throughout North America, the Eurozone, the Nordic region, as well as in Eastern Europe.¹⁶ Since we perceive insolvency growth, as an indicator of business failure conditions, to be most informative in developed markets, this section focuses on a selection of major advanced countries.¹⁷

Turning first to a selection of key markets in Western Europe, we expect the recovery to yield a modest improvement in the insolvency environment compared to 2010. It should be stressed that the magnitude of future adjustments is limited, which, given the large movements observed over past years, merely represents a stabilisation of insolvency conditions. We anticipate insolvencies to fall further in Austria, Germany, and the Netherlands (see Table 6). The latest insolvency figures for Belgium, France, Switzerland and the United Kingdom, however, suggest that default conditions will remain unchanged despite the expectations of a sustained recovery in economic performance.

Table 6: Insolvency projections – Western Europe¹⁸

Insolvency Forecast August 2011	Number of insolvencies and change in % from previous year						2011 Trend
	2007	2008	2009	2010	2011	2012	
Austria	6.295	6.315	6.902	6.376	6.057	6.057	↓
	%	-6,1	0,3	9,3	-7,6	-5	0
Belgium	7.677	8.472	9.420	9.579	9.579	9.100	→
	%	0,8	10,4	11,2	1,7	0	-5
France	42.840	51.254	53.743	52.106	52.106	49.501	→
	%	6,0	19,6	4,9	-3,0	0	-5
Germany	29.160	29.291	32.687	31.998	30.398	30.398	↓
	%	-14,6	0,5	11,6	-2,1	-5	0
Netherlands	4.602	4.635	8.040	7.268	6.541	6.214	↓
	%	-22,5	0,7	73,5	-9,6	-10	-5
Switzerland	4.314	4.221	5.215	6.255	6.255	5.942	→
	%	-4,7	-2,2	23,5	19,9	0	-5
United Kingdom	12.507	15.535	19.077	16.045	16.045	15.243	→
	%	-4,8	24,2	22,8	-15,9	0	-5

Sources: Global Insight; National Statistics Offices; Atradius Economic Research.





The Nordic countries experienced a concerted increase in insolvencies throughout 2008 and 2009, reflecting the depth and severity of the economic recession compared to previous downturns. Denmark, for example, which entered into recession as early as 2007 and saw output contract by 0.7% in 2008 and 4.9% in 2009, has experienced four years of double-digit insolvency growth. Given the current outlook, both Denmark and Norway are expected to improve in terms of insolvency growth this year and next (see Table 7). The latest insolvency figures suggest a stabilisation of insolvency conditions in Sweden, and even a slight deterioration in Finland, although both economies currently show strong growth momentum. For the Nordic region as a whole, the projected insolvency growth is nevertheless marginal compared to the fluctuations observed over past years.

¹⁶ Dun & Bradstreet, Special Report, June 2011.

¹⁷ This assessment is based on the quality of official statistics and sufficient comparability in terms of insolvency legislation.

¹⁸ The forecasts are based on the outcome of statistical models and expert opinion. 2010 values represent actual data. All views expressed here are those of Atradius Economic Research (date of final forecast: 10 August 2011).





Table 7: Insolvency projections – Nordics¹⁹

Insolvency Forecast August 2011		Number of insolvencies and change in % from previous year						2011 Trend
		2007	2008	2009	2010	2011	2012	
Denmark	%	2.401	3.709	5.710	6.461	5.492	4.943	
		20,8	54,5	54,0	13,2	-15	-10	
Finland	%	2.254	2.612	3.275	2.864	3.007	2.857	
		-1,4	15,9	25,4	-12,5	5	-5	
Norway	%	2.845	3.637	5.013	4.435	4.213	4.003	
		-6,2	27,8	37,8	-11,5	-5	-5	
Sweden	%	6.152	6.602	7.892	7.546	7.546	7.169	
		-5,2	7,3	19,5	-4,4	0	-5	

Sources: Global Insight; National Statistics Offices; Atradius Economic Research.

Insolvencies in the United States, which fell by 7% in 2010, are expected to decrease further in 2011 (see Table 8). Japan is expected to record a slight increase in insolvencies in 2011 following the disaster, and this is also supported by the trend in official statistics. As economic growth slows down this year in Australia and New Zealand, a reversal of the benign insolvency trend observed during 2010 is expected. In contrast to the regions discussed previously, the insolvency environment in the Asia-Pacific region is projected to deteriorate somewhat.

Table 8: Insolvency projections – Asia Pacific and the United States²⁰

Insolvency Forecast August 2011		Number of insolvencies and change in % from previous year						2011 Trend
		2007	2008	2009	2010	2011	2012	
Australia	%	12.018	14.173	14.580	14.385	15.104	14.349	
		-3,7	17,9	2,9	-1,3	5	-5	
Japan	%	14.091	15.646	15.480	13.321	13.987	14.686	
		6,4	11,0	-1,1	-13,9	5	5	
New Zealand	%	3.233	2.105	3.047	2.873	2.873	2.873	
		-5,4	-34,9	44,8	-5,8	0	0	
United States	%	28.137	42.861	60.530	56.046	50.441	47.919	
		42,0	52,3	41,2	-7,4	-10	-5	

Sources: Global Insight; National Statistics Offices; Atradius Economic Research.

Markets across Southern Europe have experienced a massive deterioration in the default environment between 2008 and 2010. This leaves the default outlook for the Eurozone mixed, which aligns with the large differences in economic performance across the north and the south. Country specific developments are dictated by a range of factors, including differences in the economic structure and financial profiles of individual countries. For those countries most affected by the sovereign debt turmoil, we expect the current weak conditions to persist. Firms will face increasing pressure now that the proposed austerity measures are being implemented and credit conditions remain tight.

¹⁹ See footnote 18.

²⁰ See footnote 18.

Table 9: Insolvency projections – Southern Europe and Ireland²¹

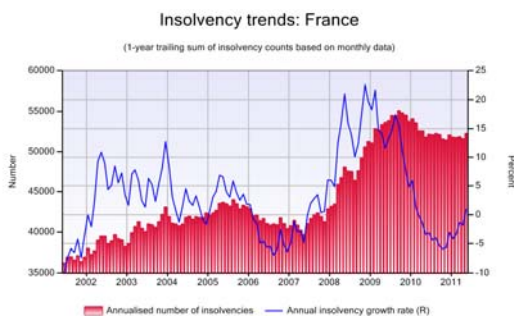
Insolvency Forecast August 2011		Percentage change in insolvencies from previous year						2011 Trend
		2007	2008	2009	2010	2011	2012	
Greece	%	0	30	40	30	30	5	↑
Ireland	%	19	100	50	10	0	-15	→
Italy	%	-35	18	40	20	5	0	↑
Portugal	%	-12	54	36	10	10	5	↑
Spain	%	10	100	50	5	0	-15	→

Source: Atradius Economic Research.

Greece and Portugal are forecast to experience continued default growth in 2011 as their economies contract (see Table 9). Similarly, we foresee a slight increase in defaults in Italy due to expected moderation in already weak economic growth. Spain and Ireland on the other hand are expected to experience a stabilisation in the insolvency environment as they slowly climb out of recession.

...although default levels remain elevated

While we broadly expect an improvement in the insolvency environment in 2011 and beyond, this positive trend is more reflective of an adjustment back toward long-run average default levels than a sign of economic strength. Both France and the United Kingdom, for example, display persistent high levels of default despite recent improvements (see charts 48 and 49). While treating insolvency growth as a proxy for the change in the default environment from one period to the next, it is therefore useful to simultaneously account for the levels of default.

Chart 48


Sources: Global Insight; INSEE.

Chart 49


Sources: Global Insight; The Insolvency Service.

Table 10 summarises the expected performance of each market in 2011, classified in terms of their perceived level of commercial risk in 2010.

²¹ The forecasts are based on statistical models and expert opinion. The history of growth rates in the table represent estimates based on official insolvency statistics and model-based calculations. As such they should be treated as indicative. All views expressed here are those of Atradius Economic Research (date of final forecast: 10 August 2011).

Table 10: Insolvency levels²²

		Frequency type assessment 2010		
		Low	Average	High
Insolvency Outlook 2011	Deteriorating	Japan Finland	Australia	Greece Portugal Italy
	Stable	Canada Sweden Switzerland New Zealand		Belgium France Ireland Spain United Kingdom
	Improving	Norway	Austria Netherlands Germany	Denmark Luxembourg United States

Source: Atradius Economic Research.

While most countries are expected to see stable or improving insolvency dynamics this year, the bulk will remain high insolvency markets. Greece, Portugal and Italy are examples of markets that were characterised by high insolvency levels in 2010 and in which we expect further deterioration in 2011. Conditions in Belgium, which was also classified as a poor insolvency market in 2010, are expected to remain unchanged. In contrast, Denmark for example, with a similarly high default level, is expected to display improvement in 2011. Given the modest size of the forecast improvement, however, the level will remain high. The bottom line is that although many countries are expected to move in the direction of pre-crisis insolvency levels during 2011, the high default environment is likely to persist for some time.

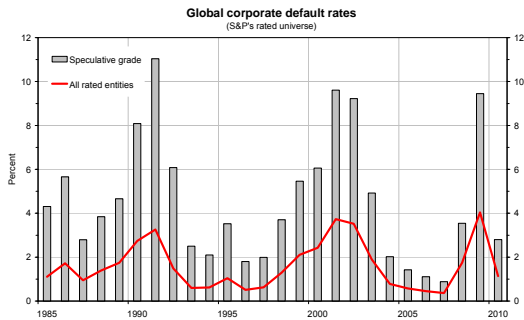
The number of large-scale defaults has decreased...

The elevated number of broad-based insolvencies across markets in 2009 was mirrored by a wave of large-scale defaults. The global default rate trailed above 9% in 2009 but fell to 2.8% in 2010, in line with the general insolvency environment (see Chart 50).²³ Corporate bond spreads also remained fairly stable throughout the first half of 2011 but show levels far higher than their pre-crisis readings (see Chart 51). It should be noted that corporate credit spreads have widened considerably since the beginning of August as the financial turmoil intensified. Taking a longer view, these measures suggest that the perception of risk has stabilised over the past two years although it is clear that credit risk remains high. Moreover, evidence from the previous downturn suggest that the perception of credit risk may quickly deteriorate.

²² This assessment is based on the outcome of statistical models and expert opinion. The categories 'Low', 'Average' and 'High' describe our perception of absolute default risk across different countries. For example, any country classified as belonging to the 'Low' category in the table was associated with a perceived low default rate in 2010. The default rate is here defined as the fraction of business failures in the entire pool of firms in a country measured within a calendar year. The buckets 'Improving', 'Stable' and 'Deteriorating' further describe how we project insolvencies to develop in 2011, as illustrated in the previous forecast tables. All views expressed here are those of Atradius Economic Research.

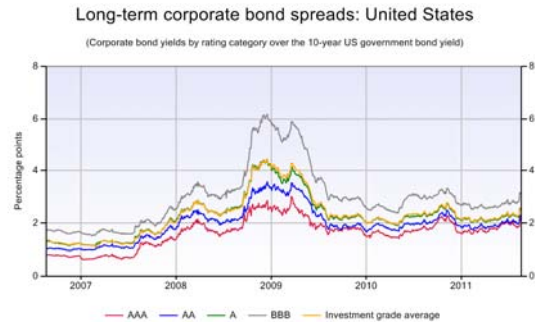
²³ This rate represents the value-weighted fraction of defaulted firms rated by Standard & Poor's.

Chart 50



Source: Standard & Poor's.

Chart 51

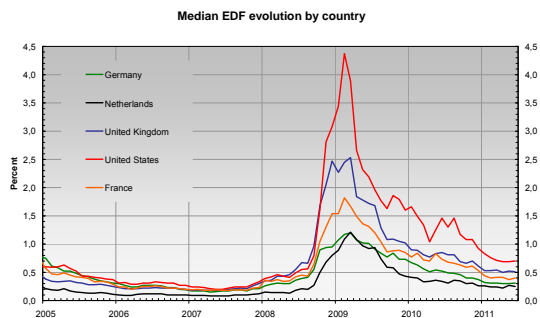


Source: Global Insight.

...but default expectations remain elevated

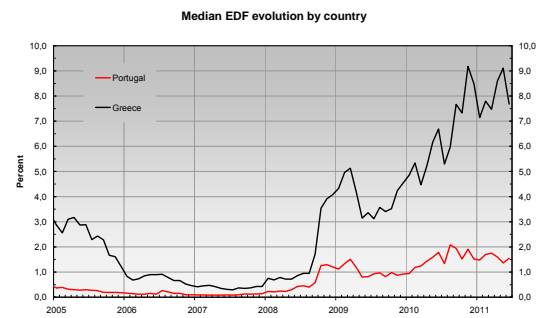
The prolonged uplift in stock markets that took place between April 2009 and July this year has in fact been a major factor driving the general perception of a sustained recovery. The rebound in equity prices and the simultaneous reduction of market volatility have generally translated into lower corporate default expectations. Expected Default Frequencies (EDFs)²⁴ have continued to moderate in 2011, both in North America and across major European countries. The median corporate EDF in the US pool trailed below 0.7% in June, which implies a 20 basis point reduction since the onset of 2011 (see Chart 52).

Chart 52



Source: Moody's KMV Credit Monitor.

Chart 53



Source: Moody's KMV Credit Monitor.

Despite the overall improvement, however, the pool of large firms in the listed corporate universe is associated with significantly higher default risk compared to five years ago. The trend across Eurozone markets directly affected by the sovereign financial turmoil is also markedly different, with Greece displaying increasing default expectations over the same period (see Chart 53). Plunging equity valuations combined with high debt levels on the balance sheets have ensured that half of the listed corporate universe in Greece currently runs a default risk higher than 7% over the next 12 months. The extreme level of volatility across equity markets in general during August, together with the accompanying large drop in valuations, suggests that we may anticipate a broadbased reversal in the previously benign trend in default expectations. Although it is too early to assess the full impact on real activity from the turmoil in financial markets, it is clear that the risk picture has deteriorated significantly since July.

²⁴ The EDF represents a measure for tracking default risk among stock listed companies. Combining balance sheet and stock market information for a particular firm yields a 1-year default forecast. The median EDF represents the 50th percentile in the firm aggregate of interest.

The main scenario is predominantly associated with downside risks

At any point in time, attempting to forecast economic conditions is an exercise fraught with a great deal of uncertainty. Country dynamics are diverse and depend on unique structures, regions display vast heterogeneity, and various indicators often send conflicting signals. At the time of writing we are also experiencing a severe period of stress in financial markets, with levels of volatility last seen in 2008, and unclear implications for real conditions going forward. Abstracting from these obvious difficulties and taking a broad view, we may still condense our benchmark scenario into two headline conclusions. First, the anticipated improvement in real economic activity as described in this report is expected to manifest itself in a broadly stabilising environment for credit. The number of insolvencies is still high, but gradually decreasing. Forward-looking credit metrics such as corporate bond spreads and expected default frequencies have also remained rather stable. Secondly, we anticipate the sustained improvement in real economic activity to support continued robust momentum in world trade. This view is partly anchored in strong performance across emerging markets, which compensates for the slow progress in advanced economies and offers new opportunities.

But the downside risks attached to this benchmark scenario are unusually large. The projected path rests on fragile assumptions and the degree of uncertainty has increased significantly. The debt crisis in Europe has intensified and this poses large risks to future economic performance in the Eurozone, with a direct impact on firms through financing and credit conditions and potential global repercussions. The strength of the real economy is hampered by the still weak financial sector conditions across advanced markets and structural vulnerabilities in the rapidly expanding countries. In such an uncertain environment, even minor disruptions may cause large adjustments and force trade to plummet.

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