TRADE LINE

Coface's magazine for its clients and partners

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SPECIAL EDITION

Main lessons from the 2011 Country Risk Conference held in Paris

coface

Contents

We would like to thank **Clara Dufresne** and **Félix Delhomme** for having participated in collecting the contents and writing the articles of this special edition.

You can find the slides dedicated to the 2011 Conference and used by the speakers on the website www.coface.com under "Country Risk and Economic Research" -> "Country Risk" -> "News"

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A day to decode the main trends for 2011

Worldwide growth should be robust in 2011. But how can we analyse its driving forces and risks? Between the United States, where the recovery is hiding the weaknesses of an economic model that is overly based on debt, Europe, weakened by its heavy public debt and eroded competitiveness, and the emerging countries whose dynamism is continuing but needs to find new balances, decision-makers more than ever need reliable decryption and analyses to find their way.

As it has done annually for the last 14 years, the Country Risk Conference in Paris was an opportunity for Coface to share its expertise on developments in the business environment in France and on the international scene. At this day-long event, renowned French and foreign economists, business leaders, bankers and academics held debates and presented their vision for the year 2011, which should be rich in opportunities but also uncertainties, as the cards are being redistributed on the economic, monetary, commercial and geostrategic fronts.

The 2011 Country Risk Conference was organised under the high patronage of the French Ministry of Economy, Finance and Industry

MINISTÈRE DE L'ÉCONOMIE
DES FINANCES ET DE L'INDUSTRIE

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The moderator of the Conference:

Raphaël Kahane
journalist, reporter,
France 24

Robust growth worldwide, but unequally distributed

François David,
Chairman of Coface

In opening the conference, François David, Chairman of Coface, pointed out that growth was robust in 2010, at 4%, and the danger of a “double dip” was avoided. As was the case in 2010, the year 2011 will be one of robust growth worldwide (3.4%), but there will be several risks, the three most important of which were the subject of this conference.

The first risk concerns American consumer behaviour: the American consumption accounts for 18% of global GDP, compared with 15% for the Europeans and 3% for the Chinese, the Chairman of Coface pointed out. The Americans have been hard hit by unemployment - will demand pick up? The second risk concerns the future of the euro zone, which has been weakened by the sovereign debt crisis. Lastly, even though the emerging countries have come out of the crisis stronger, the risk of bubbles persists and could lead to new crises.

The United States: a model in need of reconstruction

Growth will be strong in the United States in 2011 thanks to extended government support for business. But for Raghuram Rajan, we should not let this recovery hide the need for structural reforms. The American political class will have to reach a consensus on balancing public finances and solving the structural problem of unemployment that the country is unaccustomed to. Will they be able to meet the challenge?

Raghuram Rajan,
Professor of Finance
at the University of Chicago
Booth School of Business

“The American model is based on innovation and flexibility. If you change it, the American economy could suffer”

A political compromise to support growth

The United States should experience growth exceeding 3% in 2011. Four factors can explain this:

- **1.** The double dip scenario will be avoided thanks to the tax compromise that the Democrats and Republicans reached at the end of 2010;
- **2.** In response to the crisis, large banks and corporations massively laid off workers and made productivity gains to improve their profitability, which has enabled them to get back to good financial health today;
- **3.** The household savings rate has stabilised and consumption appears to be recovering well, as can be seen in the sharp rise in automobile sales;
- **4.** Businesses should therefore begin hiring again in the coming months.

This recovery is however unequal from one State to the next. Those which experienced the worst real estate bubbles and have the most indebted households are recovering more slowly. To deal with their deteriorated financial situations, the local authorities in these States are going to lay off even more workers in the coming months. Furthermore, the recovery could be accompanied by increased inequalities: consumption among the most affluent households has increased much faster than among the least privileged households.

Construction still stalled

Despite the recovery, the United States is confronted with a high unemployment rate that has been unresponsive to stimulus policies. While it is difficult to estimate the exact share of structural unemployment, it appears that nearly one-third of the unemployment that affects 9.5% of the labour force is related to the construction sector. With nearly 14 million homes unoccupied in the United States, it is unlikely that this sector will be hiring massively in the coming months. Only structural reforms of the job market could reabsorb this kind of unemployment. These reforms should focus on training more qualified workers, which is the key to a knowledge-based economy and a factor in reducing inequalities.

The public deficit dilemma

Democrats and Republicans have managed to reach an agreement on the need to extend government support for business in 2011. It will no doubt be more difficult to reach a further consensus on measures for reducing public deficits. Are we headed for massive cuts in spending for social welfare programmes such as Medicare or Medicaid? Will taxes be increased? According to Raghuram Rajan, “The American model is based on innovation and flexibility. If you change it, the American economy could suffer”. He calls for the implementation of structural reforms in education and social protection to fight against the income inequality that has considerably grown in recent years (see the interview on page 18). Whatever the political solutions chosen in the end, it is of utmost importance that they be found before the United States falls victim to a public finance crisis.

Roundtable:

Recovery or back to crisis in Europe?

Tito Boeri

Laurence Boone

François Heisbourg

Europe in all its States

The crisis has weakened and divided Europe. Some countries, notably in Southern Europe, have seen their risk levels rise. They are faced with an increase in their public debt and eroded competitiveness. Germany appears to have become the zone's economic driving force. Under these conditions, how can we find a political compromise to solve the problems of some members without dragging the entire euro zone down into a critical situation? Laurence Boone, Tito Boeri, François Heisbourg and Michael Hüther have differing opinions on this question.

The transfer of private debt to public debt has deteriorated risks

Country risks have sharply deteriorated in Europe since the crisis. Only one country in the European Union, Sweden, now has an A1 rating. The risks of heavyweight economies, Germany and France, have improved, but have not yet returned to their pre-crisis ratings. Many European countries have even been downgraded: the United Kingdom, Italy, Greece, Portugal, Ireland, Spain and Denmark have lost between one and three notches in their ratings(1).

This deterioration is notably related to the increase in foreign debt in the euro zone(2). This debt exceeds 100% of GDP in nearly all euro zone countries. It exceeds 200% of GDP in Belgium, Portugal and the United Kingdom and is over 1,100% in Ireland (see tables 1 and 2, pages 7 and 8). Yves Zlotowski pointed out that a large share of this debt is from the private sector: it is not systematically related to fiscal profligacy or poor governance as in Greece, but to a transfer of business and household debt to the banks and then on to the State. This is notably the case in Spain and Ireland.

Could Spain and Portugal be next?

The debts of all euro zone countries will continue to rise. But Greece, Ireland and Italy have debts that are much higher than the euro zone average, which is not the case of Spain and Portugal. The level of debt in these two countries is lower, but the speed with which it is rising is worrisome.

According to Laurence Boone, to evaluate a State's solvency, you have to

(1) Ratings are available at www.coface.com

(2) Editor's note: foreign debt corresponds to the cumulative debt of governments, businesses, households and banks owed to non-residents

From left to right:

Tito Boeri,
Professor of Economics, Bocconi University, Milan

Laurence Boone,
Chief Economist France, Barclays Capital

François Heisbourg,
Special Adviser, Foundation for Strategic Research

Michael Hüther,
Director and Member of the main board, Cologne Institute for Economic Research

Michael Hüther

establish a precise diagnosis based on four points:

- **1.** The level of public debt (which reflects past financial management);
- **2.** The public deficit (which establishes how far the deficits increased during the crisis);
- **3.** Private-sector debt (credit excesses end up in the States' financial accounts);
- **4.** Growth capacities.

Under these conditions, Spain and Portugal are in very different situations. While Spain is confronted with a banking crisis, Portugal is hobbled by its weak competitiveness. Aware of this situation, the Portuguese government massively invested in the education system and technology before the crisis, but Laurence Boone points out that it will take 5 to 8 years for the effects of those reforms to be felt.

What are the risks related to this level of debt? Could a European country find itself in a situation of defaulting on its payments? For Yves Zlotowski, we should pay particular attention to the management of the conditionality attached to the rescue plans announced for Greece and Ireland. It may be tricky to monitor public finances and structural reforms designed to ensure the financial viability of the States that have been bailed out. After a year or two, the population and government often get tired of austerity, leading to a loosening of compliance with conditionality.

European institutions: progress has been made, but more is needed

Michael Hüther pointed out that the Monetary Union's regulatory framework before the crisis was based on the Maastricht Treaty and the Stability and Growth Pact. Since the Greek crisis, the European Union has set up various mechanisms to avoid default by a Monetary Union State. Europe is betting on isolating countries with financial difficulties from the markets while keeping them in the zone.

The European Financial Stability Facility (EFSF) is a 440-billion-euro fund designed to grant loans, in agreement with the IMF, to cover the financing needs of Member States that encounter difficulties, under strict conditionality.

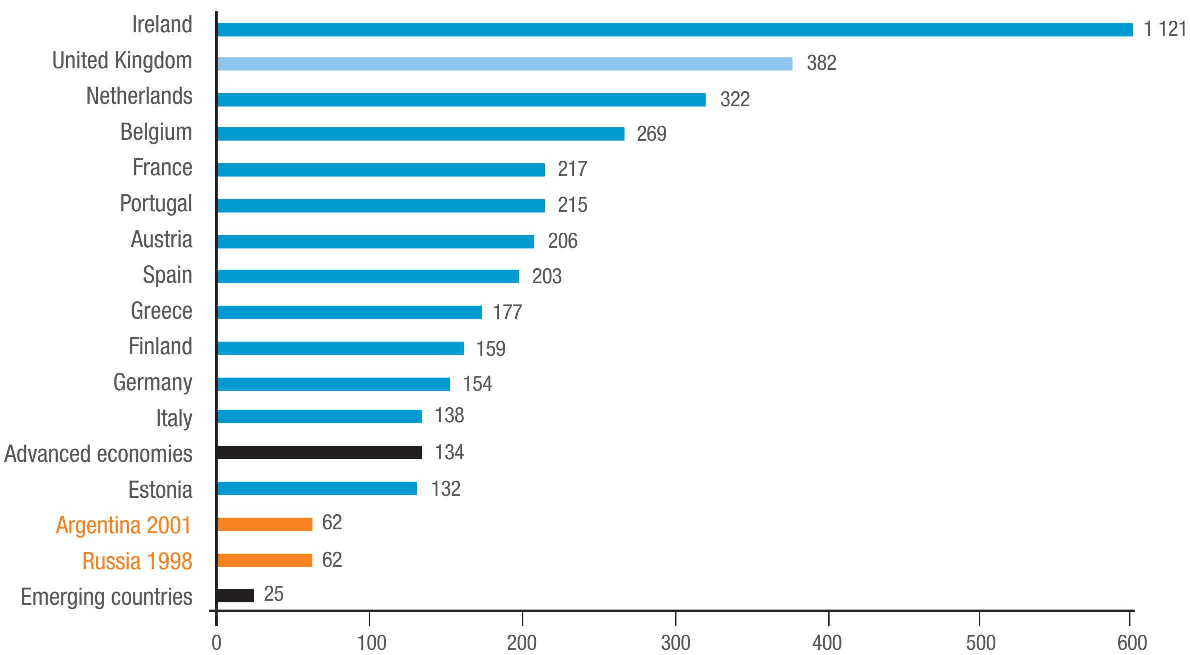
For Michael Hüther, this fund prevents all speculation on the non-repayment of loans by the euro zone until 2013. It gives Member States time to balance their budgets. In 2013, the European Financial Stabilisation Mechanism (EFSM) will come into effect, which will be controlled by the European Commission, the ECB and the IMF. This mechanism establishes clear differentiation between liquidity crises and solvency crises. In case of a liquidity problem, EFSM support will be granted under the condition of adopting an adjustment plan, and private lenders will be encouraged to maintain their exposure. In case of a solvency problem, the State will be able to restructure its debt with private creditors.

On 1 January 2011, a European Banking Authority, in charge of monitoring increases in private sector credit, was set up. Other ideas are on the Commission's agenda, such as more automatic sanctions in case of non-compliance with the Stability and Growth Pact and increased budgetary integration, for example with the implementation of peer supervision that is truly binding. Tito Boeri emphasised that if the sanctions are financial, they mainly risk increasing the risk of default. Laurence Boone indicated that strengthening peer supervision is not insignificant for national sovereignty, and it would be normal for this transfer of sovereignty to be accompanied by nationwide democratic

External debt / GDP (%) in 2010 in European countries*

* With, as a reminder, that of Argentina and Russia respectively in 2001 and 1998

Table 1



debates. But François Heisbourg found it hard to imagine the European peoples accepting this transfer of sovereignty in a political context marked by the rise of radical parties that are hostile to Europe.

Restructuring: inside or outside the euro zone?

Will the European institutions be up to the challenge of maintaining countries with financial difficulties inside the euro zone? For Yves Zlotowski and Michael Hüther, it is unlikely that the euro zone will break up. It would be extremely tricky for a country leaving the euro zone to meet its foreign debt obligations on its own. In this hypothesis, devaluating its currency would make it incapable of covering a debt issued in euros, which would inevitably lead to a wave of sovereign defaults, business bankruptcies and bank failures.

Excluding a member of the euro zone, François Heisbourg pointed out, is not provided for in the treaties. And yet, he says, if a country's debt has to be restructured, the temporary withdrawal of the defaulting State would be the only way to keep the euro zone from sinking. The State could devalue its currency and revive its growth. This possibility should not be excluded out of hand. That is why he warned against pessimistic claims predicting the euro zone's explosion, leading to the fall of the European Union. "The European Union existed without the euro, and without Greece!"

While this position was shared by Tito Boeri on a theoretical level, Laurence Boone on the other hand asserted that restructuring a debt is harder to do outside the euro zone than inside it.

> “Since the euro came into existence, no country has ever integrated it as being a common good”
>
> Laurence Boone

Beyond the fact that changing currencies would be prohibitively expensive, the advantage of keeping a country with difficulties within the euro zone lies in the fact that their principal creditors, who are inside the Monetary Union, would continue to lend to them in euros. Three options would be possible in case of debt restructuring:

- **1.** Ask the debt holder (financial institutions) to hold it until maturity;
- **2.** Extend the lending period;
- **3.** Impose a loss of capital on the creditors.

Not surprisingly, the financial markets have a preference for the first two options. In any case, Laurence Boone insisted on the fact that it is of utmost importance to find a way to reform the institutions, forcing countries to internalise their responsibility as members of the euro zone: "Since the euro came into existence, no country has ever integrated it as being a common good".

External private debt / total external debt (%) in European countries in 2010

Table 2

Ten years of Coface country risk rating: times are changing!

Yves Zlotowski,
Coface Chief Economist

In January 2001, Coface presented its country risk rating system for the first time. Ten years on, we can see a clear convergence in the ratings attributed to advanced countries and to emerging countries. The risk level of the emerging countries has never been lower than in 2010. That of the advanced countries has risen markedly since 2001 (see table 3, below). The crisis of 2008-2009 accentuated this convergence. Only nine advanced countries have maintained or recovered their pre-crisis A1 rating, notably Canada, Sweden, Australia and Japan. But these nine countries only account for 18% of global GDP, whereas the advanced countries as a whole account for 63%. Heavyweight economies, led by the United States, France and Germany, have seen their risk rating improve but have not yet returned to their pre-crisis level.

This convergence is an invitation for us to reflect on the notion of country risk. The risk levels of European countries were underestimated. Some foreign debt levels exceeded 100% of GDP in the euro zone, which is considered the critical threshold for emerging countries. Country risk has traditionally privileged the "original sin" of the emerging countries – they are forced to take out debt in foreign currencies, exposing themselves to a greater dependence on currency exchange risks. On the other hand, the possibility for countries in the euro zone to take out debt in their own currency at low interest rates has led to an underestimation of the risk of default among the European economies. The euro zone crisis thus demonstrates that the absence of currency exchange risks does not provide an insurance against the risk of default.

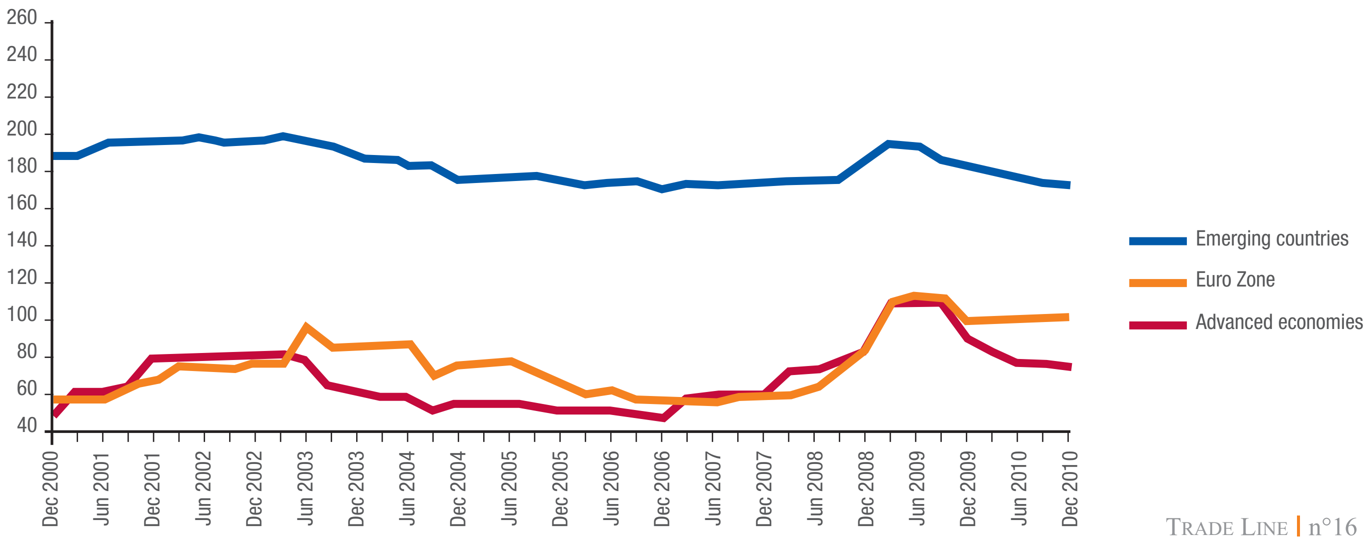
Crises arise from calling collective beliefs into question, whether in emerging countries or in advanced countries. The Russian crisis, a country everyone thought was "too big to fail", was an example of this. Today, the euro crisis has revealed that the status of euro zone member does not mean a rescue guarantee. Within a few months after the Greek crisis, excessive confidence gave way to excessive mistrust. We should learn the lessons of this collective mistake. We cannot settle for misleading implicit guarantees, we must set up procedures that are explicit, predictable and realistic. "Beware of collective beliefs!"

Yves Zlotowski

For more information on country risk: www.coface.com (under "Country Risk and Economic Research")

Evolution of the regional risk index (100 basis = December 2000)

Table 3



Roundtable:

After the crisis, what will be the new global strategies for companies?

Patrick Artus

Louis Gallois

Laurence Parisot

Combining the necessity for internationalisation and saving European industry

The crisis has amplified the shift from advanced countries toward emerging countries. The cards have been reshuffled and company strategies in the advanced countries are being refined: they are up against problems of labour costs, exchange rate volatility, R&D, protecting intellectual property rights, etc. The debate between Laurence Parisot, Patrick Artus and Louis Gallois shed some light on this subject.

For Laurence Parisot, "French companies understand that the emergency exit from the crisis is international". New business strategies therefore have to take emerging countries into account, including Eastern Europe. Louis Gallois added that the purpose of internationalisation is not mainly to take advantage of cheap labour, but to "penetrate the Chinese and Indian markets". This is indeed important for moving into these markets.

The competitiveness issue is central for companies seeking to export their products. On this subject, Laurence Parisot considered that the differences in competitiveness between France and Germany are related to labour costs. The hourly rate is 35 euros in France and 30 in Germany. For the MEDEF President, the priority is to reform how the French social security system is financed. Patrick Artus pointed out that the Germans have lowered the cost of their social welfare protection by 2 points of GDP while the French have increased it by 1.5 points of GDP since the start of the euro. "That makes 5 points of payroll between France and Germany".

> "French companies understand that the emergency exit from the crisis is international" Laurence Parisot

Furthermore, small French companies are not very profitable and highly indebted. Patrick Artus noted that "the large CAC 40 companies have a 120% self financing rate, whereas all small French companies are at 60%!" As interest rates are probably going to rise, this indebtedness is a major risk factor which can only be resolved by increasing the margin rate of French companies. Laurence Parisot expressed

From left to right:

Louis Gallois,
Chief Executive Officer, EADS

Laurence Parisot,
President, MEDEF, Vice Chairman, IFOP

Patrick Artus,
Chief Economist, Natixis

the regret that the margin rate of French companies lost 10 points in comparison with German companies since the euro was launched in 1999.

Companies handicapped by exchange rate volatility

Louis Gallois said that a weaker euro would clearly be an element contributing to business competitiveness. He pointed out that "10 cents in currency appreciation means more than 10 billion euros in losses for EADS!" Patrick Artus refuted the idea put forward by some analysts for a veritable "currency war" between the different economic powers. He believes that "certain countries simply do not pose the question of the effects that their economic policy has on the rest of the world". This is the case of the United States, which continues to follow an expansionist monetary policy. Patrick Artus expressed his regret at the absence of a global coordination of monetary policies. The worldwide liquidity excess, fed by a weak yuan and an expansionist American monetary policy, increases the risk of bubbles, notably in raw materials. The question of raw materials therefore is not only related to speculation, but also to persistent macroeconomic imbalances. Laurence Parisot also pointed out the indispensable nature of monetary discussions at the G20, insisting on the risk posed by the extreme volatility of exchange rates and of raw materials prices. Risk-taking and investment are seriously handicapped by this, notably for SMEs.

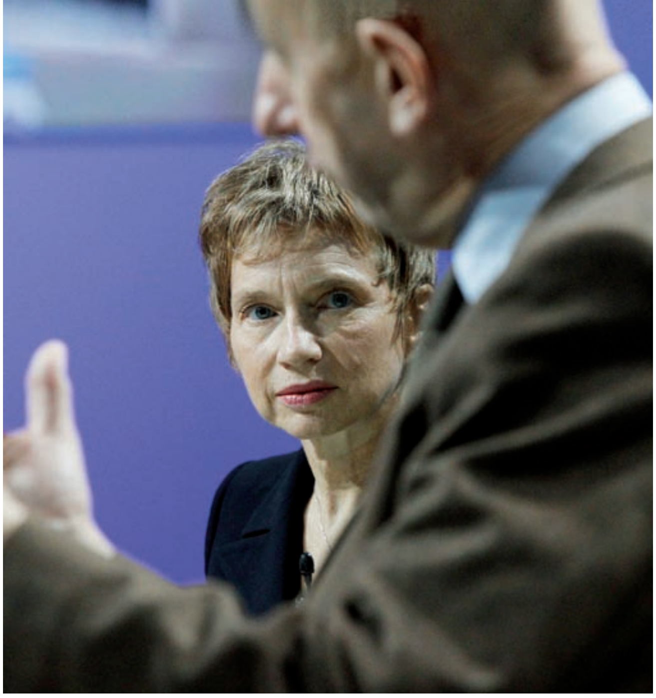
Company size - the key to maintaining local industry

The emerging countries, and notably China, are making progress in many areas. According to Patrick Artus, we should make no mistake as to the long-term objective of the Chinese. They are not seeking the best possible integration into the international division of labour, but rather to become self-sufficient in all sectors. But while the emerging countries are spending a great deal of money on research and development, Patrick Artus pointed out that they can only progressively catch up technologically.

Company shareholding in the advanced countries is also a challenge for maintaining local industry. In fact, savings reserves are found in the emerging countries, in China but also in oil-producing countries, and European countries need to increase their equity. For Louis Gallois, to maintain local industry, European and French savings (the savings rate in France is at 17%) must be redirected toward European and French industries.

On the question of offshoring, Patrick Artus was fairly pessimistic. He believes that certain regions of Europe are destined to become de-industrialised, and that France will no doubt be one of them: "We had 20% of our jobs in industry when the euro was set up and 11% today!" But, for Louis Gallois, it is of utmost importance for industry to remain in France: "a country that does not have any industries is a country that is not independent".

He said he was ready to undertake an "industrial reconquest", which will be done by developing new sectors and centres of excellence. It is not a question of bringing everything back to France, but rather of highlighting the attractiveness of Europe and France. This attractiveness is based on the level of education, the quality of infrastructures and services, lifestyle and research capacities. A European policy on this subject is needed for Brussels to place competitiveness back in the hands of the producers rather than the consumers. Germany and Italy are examples for France, as these two countries have managed to keep their medium-sized industries at home.



> "Certain countries simply do not pose the question of the effects that their economic policy has on the rest of the world" Patrick Artus

> "A country that does not have any industries is a country that is not independent" Louis Gallois

Roundtable:

What risks are hidden behind the dynamism of emerging countries?

François Heisbourg

Nicholas Kwan

Guy Longueville

Emerging countries: attractiveness, but not without risk

The crisis did not stop the dynamism of emerging countries, quite the contrary. Their risk levels have improved overall. Their public and private debt is under control. 2011 should be another year of strong growth. Yet we should not allow these indicators to hide possible factors of destabilisation: rising prices of raw materials and food products, social unrest, volatile capital flows, “currency wars”, etc. François Heisbourg, Nicholas Kwan, Guy Longueville, Jon Marks and Yves Zlotowski discussed these challenges, which will be central to the year 2011.

A spectacular comeback from the crisis

Growth in the emerging countries has come back much faster and much stronger than in the advanced countries. Business investment is often behind this recovery. The high level of foreign exchange reserves and less debt constitute advantages for the emerging countries. On average, public debt is 38% of GDP in emerging countries compared with 87% for advanced countries. This is a good way to maintain policies in favour of the economy longer. Private actors also have less debt overall in developing countries. The experience of past crises no doubt explains the financial prudence in these countries, making them more resistant to economic shocks today.

Latin America and Asia are particularly representative of this renewed growth and improved risk. Brazil has moved up a notch and now has an A3 rating. The country is characterised by a low number of payment incidents, strong growth and prudent economic management. Nicholas Kwan pointed out the increasing share of intra-zone exchanges in the recovery of exports in Asian economies.

Behind the dynamism of the emerging countries, however, certain risks are hiding and they must not be overlooked.

Bubble factors

For Guy Longueville, there are no significant bubbles in the emerging countries at the moment. But there are risks of having bubbles form in the short or medium term, especially in Asia. For Guy Longueville, the greatest risks of bubbles are concentrated in agricultural and industrial commodities. They would be dangerous if they were to coincide

From left to right:

Nicholas Kwan,
Head of Research, East Global Research, Standard Chartered Bank, Hong Kong

François Heisbourg,
Special Adviser, Foundation for Strategic Research

Guy Longueville,
Head of Country Risk Research, BNP Paribas

Jon Marks,
Chairman Cross-border Information, Researcher Royal Institute of International Affairs, Chatham House, London

Yves Zlotowski,
Chief Economist, Coface

Jon Marks

Yves Zlotowski

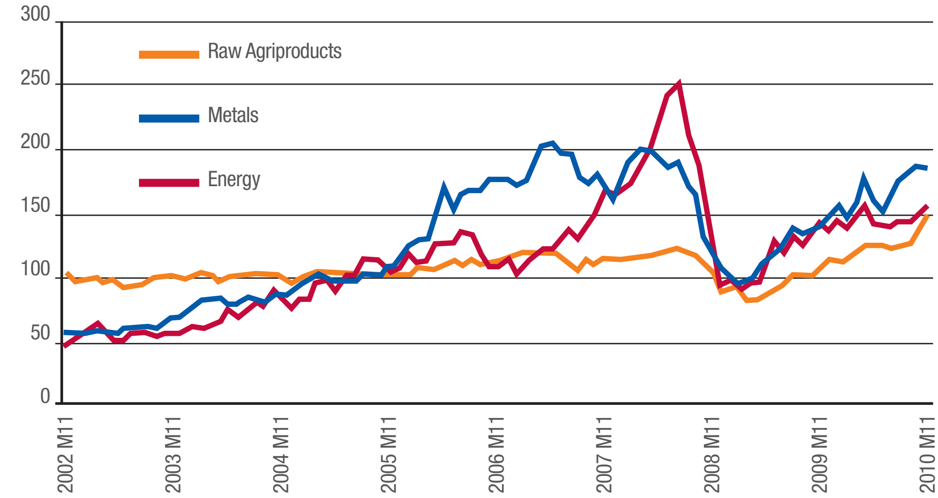
with real estate bubbles. If the rising price of raw materials is justified in part by the fundamentals (gap between supply and demand), it is amplified by the reallocation of assets of investment funds. Nicolas Kwan shared the idea that the price of Asia's success is the risk of inflation, notably for food products.

Dutch disease and imported inflation

Setting aside the risk of bubbles, the structural increase in raw materials prices is an opportunity for many exporting developing countries, notably in Latin America (see table 4, below).

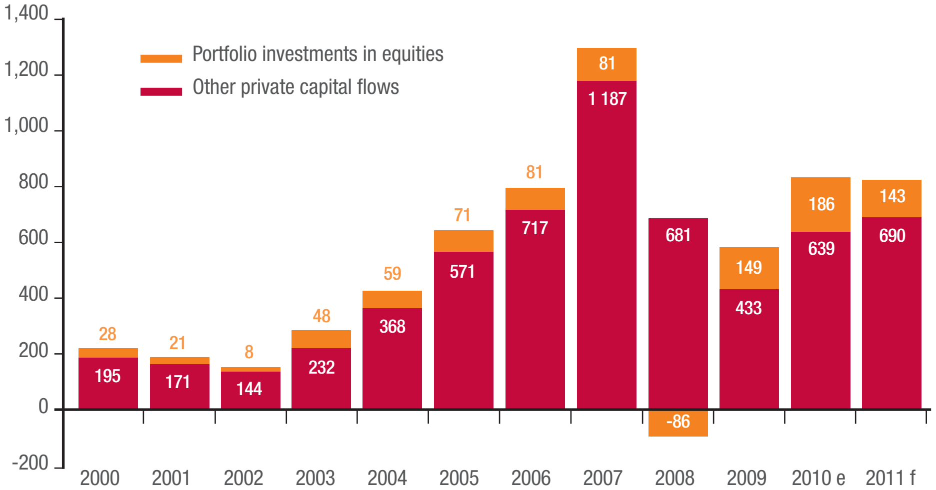
World Commodities Prices (100 index = 2005)

Table 4



Flows of private capital towards emerging countries (Bn USD)

Table 5



And yet it contains three major risks:

- **1.** It reinforces specialisation on raw materials to the detriment of manufacturing industries (Dutch disease).
- **2.** It also creates strong political and social tensions. The movements that broke out in North Africa in January were in part triggered by the increase in raw materials prices.
- **3.** The existence of revenue from raw materials often goes hand-in-hand with poor public governance.

Countries that import raw materials are going to have payment difficulties in the coming years. For importing countries in Asia, the weight of food and transports in the consumer price index varies from 30 to 60%. It is nearly 50% in China. Nicholas Kwan pointed out that this country will have to use its raw materials more efficiently. It consumes 30 to 60% of the worldwide production of aluminium, zinc and copper, consumption that increases by 10% every five years. Nicholas Kwan considered that "the Chinese use their resources 7 times less efficiently than the advanced countries, and if this problem continues for another ten years, they will be faced with major supply difficulties".

Capital inflow can be a trap

Foreign investments are a considerable advantage for emerging countries (see table 5, opposite). But volatile capital inflow poses a serious risk of destabilisation. Guy Longueville noted that, since 2010, a growing share of portfolio investments focuses on Latin America and Asia. South Africa, Brazil, India, Indonesia, Turkey and especially China are the principal countries receiving these speculative investments. Faced with this inflow, the Central Banks do not always have the necessary means to control the massive arrival of speculative capital and the resulting growth in their money supply. They do, however, have financial tools to avoid undershooting exchange rates and their systemic consequences. According to Yves Zlotowski, the emerging countries are questioning the consequences of international financial integration and are starting to limit the inflow of volatile capital, as is the case in Brazil.

Tunisia: between hopes and risks

The Conference was held a few days after President Ben Ali left power in Tunisia. Jon Marks gave an overview of the revolution, which he called democratic. The first phase took place in Sidi Bouzid, where students protested against the rising cost of living and persistent unemployment that has hit them hard. The revolt then spread to the entire population. The middle class, which had been less affected by unemployment and inflation, then took to the streets as well. The entire country appears to have revolted against the political elite which had monopolised the country's economic resources to their own advantage. François Heisbourg even spoke of an "economic mafiocracy" to describe President Ben Ali's entourage. All the speakers shared the same observation – the need for healthy economic governance and a democratic political framework. According to Jon Marks, "throughout the region, politics has prevailed up until now".

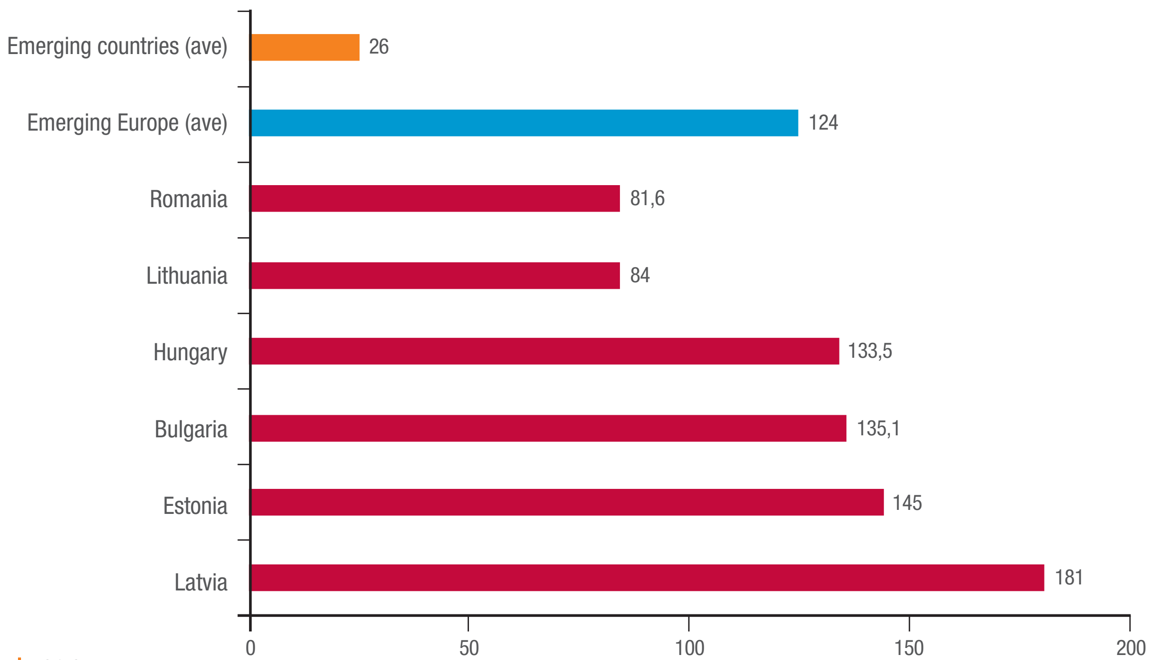
Yves Zlotowski and François Heisbourg confirmed what Jon Marks said. It was a popular revolt combined with a reaction of exasperation by the Tunisian bourgeoisie whose property rights were trampled. Yves Zlotowski explained that various pitfalls could still impede the country's democratic transition. A large part of the country's economic assets are held by the former President's associates. The democratic revolution calls for a transfer of assets, but how to do this remains uncertain.

Will the first overthrow of an authoritarian regime in the Arab world spread to the rest of the region? François Heisbourg argued that the Tunisian revolution could spread, since Tunisia has traits in common with the entire Middle East: the region has asset-based or family-based economies with high unemployment rates, and successions have not been organised: "Chairman Mao Zedong said that a single spark could set fire to the entire plain. For me, the Middle East is a vast plain", François Heisbourg said.

> "Chairman Mao Zedong said that a single spark could set fire to the entire plain. For me, the Middle East is a vast plain"
>
> François Heisbourg

External debt / GDP in emerging Europe

Table 6



Christine Lagarde: three priorities for the G20

In a message to the participants at the 2011 Conference, Christine Lagarde, Minister of the Economy, Finance and Industry, presented the three priorities for the French presidency of the G20. The summit will focus first of all on reforming the international monetary system. A few weeks ago, President Hu Jintao denounced a system from a bygone era. The second priority will be transparency and the role of derivative products in the commodities market. Lastly, world governance and the reform of international institutions will be on the negotiating table at the international meeting.

Central and Eastern Europe: emerging countries running out of steam

Risks in Central Europe do not improve as easily as in many other emerging countries. "Except for Poland and the Czech Republic, which are getting back to their pre-crisis levels, many countries in Central and Eastern Europe have a downgraded risk level", Yves Zlotowski pointed out. Several problems make this area an atypical case. Its main trading partners, the other European countries, will not be very dynamic in 2011. Furthermore, foreign debt in emerging Europe has reached 124% of GDP compared with 26% on average in all emerging countries. The debt-reduction processes adopted in some countries such as Hungary, Bulgaria and Romania are handicapping private demand and therefore recovery (see table 6 page 14). Private debt also raises the currency exchange risk for these countries. Turkey, a country in emerging Europe, has managed to ride out the storm spectacularly with very strong growth in 2010 and favourable payment behaviour of its companies.

The traditional risks in the CIS countries have not gone away. These economies are based on energy revenues and are having a hard time improving corporate governance. Financial transparency has not been ensured, the decisions handed down by the arbitral courts are unpredictable and property rights are unstable. A closer look at property rights is needed, as Yves Zlotowski pointed out, since investment in a country depends on this. "You aren't going to invest if, through various mechanisms, as existed in Tunisia or Russia, you can't be sure to hold your assets over the long term". Investment rates therefore constitute a good indicator of governance.

The four paths of Chinese power

François Heisbourg gave an in-depth talk on China's long-term development. In his opinion, "You cannot look at the economic planet and the strategic planet in an uncorrelated way". China has become a very major power and Deng Xiaoping's traditional geopolitical framework from the 1990s, according to which China should remain a "status quo" power, no longer applies. Now the question is what will replace that framework. "China's foreign policy is currently illegible, as can be seen in the tensions that China has had for a year with some of its neighbours such as the Philippines, Thailand, Malaysia, Singapore or South Korea". François Heisbourg considers the protagonists to be disorganised, notably the People's Liberation Army, the Ministry of Foreign Affairs and the Chinese Communist Party. China is bound to position itself in the coming years on one of the following four options: "a multilateralist China (as at the G20 in Pittsburgh), a G2 China establishing a strategic dialogue with the United States, a China that unites with the East against the West as it did in Copenhagen, or a Middle Kingdom China running its region and seeking to run the world". For him, these four models are not necessarily incompatible. In foreign policy, the election of the new head of the Chinese Communist Party in 2012 will be decisive in the formation and scope of risks in the coming years.

Yves Zlotowski nonetheless insisted on the stability of Chinese economic policy. While there was a real change in strategy during the crisis between June 2008 and June 2010, with a stable yuan and expanded credit, China now appears to be oriented toward a growth model that focuses much more on household consumption. Yves Zlotowski pointed out that, in economic questions, strategic changes are always gradual, and the yuan's appreciation will be slow in any case, which limits risks.

Guy Longueville summarised these two positions, pointing out the consistency of the economic policy followed by China while mentioning the possibilities of strategic changes in Chinese foreign policy and the risk that this raises for the upcoming G20 negotiations.

> "Bubbles are concentrated in agricultural and industrial commodities in emerging countries.
> They would be dangerous
> if they were to coincide with real estate bubbles" Guy Longueville

Interview with François Heisbourg

The Chinese will be less inclined to go along with the G20

According to the special advisor to the Fondation pour la Recherche Stratégique (Foundation for Strategic Research), the United States unquestionably remains the global superpower. And if China should catch up with them economically one day, it will take a great deal of time for China to compete with their geopolitical influence. On the other hand, the trend is toward "less Europe" within the European Union.

Unlike those who speak of reduced American influence, in your book "Les conséquences stratégiques de la crise (The strategic consequences of the crisis*)", you state that their role is and will remain central to the international scene for a long time. Why?

François Heisbourg (FH): For several reasons. First of all, the United States reacted more decisively than other advanced countries in terms of stimulus efforts, returning to growth and asserting itself on the international scene. Despite growing debt and public deficits greater than in the European Union, growth is around 3% and consumption is up by some 4%. And the traditional geopolitical advantages of the United States remain. Their military spending is twice that of the European Union or Japan. If China catches up with the United States economically in some ten years, it will take it much longer to catch up with them in terms of geopolitical influence. It is very hard to estimate China's military budget, but no matter how you measure it, the United States spends three to four times more in this field, and more importantly China is starting off from a very low level with archaic, underequipped armed forces. The United States remains the leading superpower.

(*) Editions Odile Jacob

> "Will a Sino-American G2 mainly be antagonistic or cooperative?"

Is there really a G2 between China and the United States?

FH: The stronger China gets, the more G2 areas there will naturally be. But a G2 is not necessarily a cooperative partnership. During the Cold War, there was a G2 between the United States and the Soviet Union. It was an antagonistic G2, but the major problems facing the two countries were managed directly. The question is whether a Sino-American G2 will mainly be antagonistic or cooperative. We don't know yet because the Chinese themselves have not yet determined what their future security policy will be.

Do you think the G20 will set up a certain international financial regulatory system?

FH: Much less than I did a year and a half ago. The G20 was resuscitated because at first it was a financial organisation designed as a response to the Asian crisis of 1997-1998, not a global financial regulatory organisation. It became one during the crisis of 2008. And its influence was strong in combating the crisis. There was remarkable mobilisation in Washington in November 2008, London in April 2009 and Pittsburgh in September 2009. The Chinese were fully on board. After Pittsburgh, will they continue to go along with it? Probably not, and I

> "Countries in crisis such as Ireland or Greece should be put on a euro holiday"

> “I am an Afro-optimist. French entrepreneurs should not walk away from the continent”

can see two reasons for this. The first is due the country's internal situation. China is preparing for changes in its leadership next year. This is not the time for major initiatives. The other reason is more structural. Thanks to the remarkable recovery plan adopted in November 2008, the Chinese pulled out of the crisis more quickly and vigorously than anyone else. Today, there is a clear divergence between the global path and the Chinese path: in 2010, worldwide growth, at 4.5%, was half that of China, at 10%. The country may feel that it has no need to tie its hands behind its back in a process like the G20. I don't know which explanation is more important. We will find out next year when the new leadership is in place and decides on its position.

During the Conference, you pointed out the trend toward “less Europe”, despite the various European mechanisms in place to combat the crisis. How can we get the European dynamic going again?

FH: “More Europe” would mean setting up a “transfer union”, i.e. a European Union with co-responsibility for budgetary and fiscal questions, with the creation of a Treasury Department and a Budget Department alongside the European Central Bank, as is the case in the United States, India and Brazil. This is impossible in the short term, because public opinion is opposed to it. This could be the solution in the long term, but in the meantime, there are real emergencies to deal with in Ireland, Greece, Portugal and perhaps Spain. But the decisions made for Ireland and Greece have worsened the situations in both countries. Europe's rescue consists in offering rates around 6% to countries upon which austerity measures are imposed that will mechanically bring the combination of inflation and growth to approximately 0%. We have just bought time with these rescue plans. The problems remain. Since “more Europe” is not feasible in the short term, should we think things over and “cut our losses”, in the strictest sense of the term? This means putting countries with financial difficulties, such as Ireland and Greece, on a euro “holiday”.

What exactly would such a “holiday” mean?

FH: For a country in difficulty, this consists in being able to issue a national issue currency for a set amount of time, 10 years for example, while remaining a member of the euro zone but without voting rights. The country would benefit from the monetary flexibility to be gained from such a situation. In the case of Greece, this would be very complicated, but it is possible for Ireland. We must get beyond the binary situation that consists in saying that if we don't have “more Europe” there will be a catastrophe. If we get too dramatic, we risk finding ourselves in a self-fulfilling prophecy.

For now, the treaty on how the Union operates does not provide for leaving the euro zone or a “holiday”, but the European institutions will be able to invent a formula to make it legally possible. That is one of its traditional strengths, creating new legal texts to deal with truly complicated problems.

Isn't there a major social risk in Europe due to the political rise of the extremes?

FH: Of course. For now, our governments have been very lucky. Public opinions have accepted the need for rigour, even in such a messy affair as the retirement system in France. People have widely understood the need for austerity. This will not last. In a year or two, when the populations see that public finances have grown even worse, that growth in the United Kingdom, Greece, Ireland or Spain continues to crawl along at extremely weak levels, the voters will become an obstacle to the policies adopted by European governments.

Lastly, a word about Africa. The continent came through the crisis very well. Do you think it will be able to take off in the coming years?

FH: I am an Afro-optimist. Of course, there are security situations that block all development, such as in Somalia or the Democratic Republic of the Congo. But Africa as a whole weathered the crisis remarkably well. Transfers of migrant workers dropped only very slightly in 2009. Furthermore, cash positions in a certain number of African nations were hit by the shock of the drop in raw materials in 2009. But in many cases, revenues from these assets are not redistributed to the inhabitants of the countries these resources come from, so this is of no importance to the average African. At the end of the day, growth rates have remained largely positive, notably in non-oil producing countries. That is the first reason for my optimism.

The second reason, and I don't know how much the two are correlated, is the small digital gap between the rich and the poor. Of all the gaps in the world, this is the narrowest. In sub-Saharan Africa, at the worst of the crisis in 2009, 10% of the adult population acquired a mobile telephone account for the first time, and this percentage can also be observed throughout the Indian subcontinent (Pakistan, India and Bangladesh). The telephone is a tool for development in both the commercial and banking sectors. I agree with the Brazilian Minister of Foreign Affairs, Celso Amorim, who a few months ago in Geneva said, “the 2010 decade will be the decade of Latin America, but you will see, the 2020 decade will be the decade of Africa!” There is a good chance that he is right and if that is the case, French entrepreneurs had better not walk away from Africa!

Interview by
Trade Line

Interview with Raghuram Rajan

We cannot afford another crisis of this size for the next 35 years

The Professor at the University of Chicago worries about the rising inequalities in the United States. If the private sector is recovering and creating more jobs, the governments are going to start firing. For the European Union, the ex-chief economist of the IMF excludes default for Greece and Ireland, but considers an "implicit" restructuration of their debt financed by the other Union members.

➔ In Fault Lines*, you insist on the economic policies that have addressed inequalities in the United States. Could you describe this process?

Raghuran Rajan (RR): The starting point is that America is becoming a knowledge society, and manufacturing jobs are being lost. The jobs created require more education, high level skills, but the number of people with degrees is not growing as fast as what we want. As a result the income inequalities are rising in the United States. The wages of university degree holders are going up while the high school educated people lose their jobs and do not have the skills to take on the new jobs. When you have rising inequalities, something needs to be done. Typically what happens is redistribution. The problem is that there is a very strong antipathy to redistribution in the United States. So I argue that there are two things that came into place instead. The first solution was expanding credit, especially housing credit. Nobody is against credit! The people who buy houses, the financers, the politicians… There was a consensus on all sides that credit was the way to go! This went a little too far. The other part of it was to some extent supported by the policy of the Federal Reserve Board. Why? Because the safety net in the United States is very thin. So if people lose jobs, there is a lot of anxiety. They do not have healthcare, and little savings and unemployment benefits run out very quickly. So, I think it puts tremendous pressure on the US administration and the Fed to respond, and Greenspan responded by keeping low interest rates. This is happening again: Bernanke has been keeping very low interest rates for a sustained period of time and is essentially saying "jobs are the big problem, until jobs come back we keep the interest rates low". So you couple these two things, somebody pushing for credit, and somebody keeping interest rates very low and you have a volatile situation.

➔ Now unemployment in the United States is about 9.5%, even 16% if we add precarious employment as suggested by the IMF. Is this a jobless recovery?

RR: A big part of unemployment now can be explained by the fact that construction collapsed. Once you had built so many houses, house prices started falling, and construction died. Many people depended on the construction sector: the brokers, the financers, and all the people that produce what goes in the construction sector. I think this is structural unemployment: jobs in construction will not be recovered.
Also, we are in the first phase of the recovery. Typically in a recovery you first hesitate to create jobs because you are trying to rebuild profitability and you are waiting to be more confident. That phase is now coming to an end. Now the private sector is healthy enough to start hiring in a bigger way. My sense is that it is going to happen in the next few months…
However, there is another problem, which is that the state and local governments have to start firing in a bigger way because their budgets are getting tight. So on the one hand you'll have the private sector recovering and creating more jobs but the governments are going to start firing.

➔ Do you think there is a risk a European country could default?

RR: It is very hard to see circumstances in which Greece could, with any degree of comfort, pay down its debt. At some point somebody has to start taking the hit. Now there are ways the hit can be taken so that it can be disguised for a little bit. For example the lending to Greece from official sources could be done at a much lower interest rate. Right now it is done at a pretty high interest rate (around 6.5%). If you cut that interest rate to a very low number, a number similar to German interest rates, the chances for Greece would look a lot brighter. If you extend out the maturities, the official lending for a long time, again the chances looks better. These are ways to essentially give Greece more room. In the traditional definition, these would

(*) Princeton Editions

be called rescheduling or default. But they do not actually refuse to pay, only the payments are lower over time and are stretched out. You could visualize a situation where Greece does not default but is essentially carried on the European books for another 10, 12, 15 years… for a long time! That seems to be where we are going: there will be no explicit default in the sense of Argentina, but there will be this implicit government supported restructuring for Greece and Ireland. Portugal and Spain may be able to escape.

The sooner you decide what your solution is, the better. But you also have to accompany whatever solution you manage with some kind of a recapitalization of the banks which are in trouble. Right now because you do not want to recapitalize any of the banks, you are essentially taking on the whole problem to government balance sheets. Remember this was the problem of Ireland. Ireland's direct exposure was quite small. It was the fact that Irish banks needed to be supported, and Irish bank debt was held outside, which caused you to hold up the whole banking system. The private debt became public debt. And as a result the problem has magnified.

What if it does come to Spain?

RR: If it comes to Spain it's bigger: it's both costly to let it go and also costly to save it. The hard question does not come up so long as Spain does not get in worst trouble. If they have good policies in place, which reassure people about Spain's competitiveness and growth, maybe they will escape.

The tension in Europe of course is that Germany does not want to write open blank checks to everybody. Germany has been pushing the envelope just a little every time because it does not want to be held responsible for the whole collapse. But this is one of the situations where you may need to accept that responsibility to quell the problem. So long as you just push the envelope a little, the envelope will be tested. The question is at what point do you say: "OK, we accept that we need to save the system, but in return we need this, this this, and this?" It may be that Spain will have to test the envelope before some kind of grand solution is devised…

> "If companies are willing to service people who make $5,000 a year instead of $30,000, the market becomes enormous"

Could the condition for a bailout of Ireland be to raise their corporate tax to the EU average?

RR: This is certainly a very tough issue. How much can conditionality intervene in fiscal choices? It is clear what the passions are. It is less clear where the right economic outcome is. If you were one country, would you still want harmonisation? Some countries have enclaves where they have relatively low taxes in order to get a certain kind of industry in, which would not come otherwise. Is Ireland the enclave for Europe? But then, how much are you going to subsidize that enclave? When you come to taxation and distribution, ultimately it is a question of power.

Amercian consumers represent 18% of global GDP, the Chinese only 3%. Is this imbalance going to change?

RR: There is a transition in demand taking place. The demand of emerging countries has been growing quite substantially. For this shift to happen, you need some things to take place. First, the emerging markets have to move away from being overly focused on exports. Second, they have to let their exchange rates appreciate. I think in the medium term this is going to happen, and I think there are lots of interesting things that could happen as this shift takes place. For example I think industrial country corporations are overly focused on saying: "who out there looks like us so we can make goods for them? How many middle class, people earning more than 30,000 dollars are there?" When you look at it that way there aren't that many. But if you are willing to service people who make $5,000 a year instead of $30,000, and you make products that they can buy, your market becomes enormous. For example, if you have a $100,000 X-ray machine: nobody buys that stuff! Small dispensaries in small villages cannot afford it. If you reduce the functionality, make it a $3,000 machine, suddenly the market expands hundredfold!

Do you think progresses have been made fixing the financial system? What about the G20?

RR: Small steps have been taken. They are not dramatic steps, which may be a good thing because some of the dramatic steps involve shutting down the system. Some people would say the problem still is the big banks and that suggest they should be split into many small banks. I do not think that this solution would be much better because many small banks may do exactly what the big banks did and create the same kind of trouble. I would rather that we focused on getting the incentives inside the system right, building bigger buffers so if they make mistakes the buffers absorb the mistakes and does not feed back into the system. There should also be more variety in the system so it is more resilient: if banks want to make the same mistakes at least there might be the insurance companies, the private equity firms, the hedge funds which still survive. I think the truth is that given government finances we cannot afford another crisis of this size for the next 35 years. We need to make really sure that we are not building up the next crises.

Interview by
Trade Line

2011 Country Risk Conferences Agenda

- **31 March 2011**
Mexico
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- **7 April 2011**
Buenos Aires
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- **14 April 2011**
Milan
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- **19 April 2011**
Moscow
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- **3 May 2011**
Johannesburg
ibrahim_kurubally@cofaceza.com

- **10 May 2011**
Vienna
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- **12 May 2011**
Mainz
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- **12 May 2011**
New York
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- **12 May 2011**
Warsaw
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- **24 May 2011**
Hong Kong
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- **26 May 2011**
Beijing
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- **7 June 2011**
Madrid
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- **8 June 2011**
London
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- **8 June 2011**
Porto
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- **15 June 2011**
São Paulo
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- **21 September 2011**
Bucharest
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