

Research

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Sovereign Ratings Outlook

January 2012

- We expect a string of further ratings downgrades for advanced economy sovereign debt, and do not expect any ratings upgrades.
- In the nearterm (next 6 months), we expect Moody's to downgrade the sovereign ratings for Italy, Spain, Portugal and Greece, as well as for the EFSF. We expect that Moody's will place France and Austria on "negative outlook". In addition, we expect S&P to further downgrade Greece into either "selective default" or outright default.
- In the longer term (next 2-3 years), we expect a wide range of sovereign debt downgrades, including (by at least one major agency) the US, Japan, France, Italy, Spain, Austria, Belgium, Finland, Ireland, the Netherlands and Portugal.
- In addition, we see risks that the UK and Germany will both be put on "negative outlook" over the next 2-3 years. For Germany, ratings pressure comes from the slowing economy and the potential burdens of supporting domestic banks and other EMU countries. For the UK, the main issue is the prospect that extended economic weakness will limit the pace of fiscal improvement. The UK's AAA rating could be at risk if the coalition falls apart or eases up on the fiscal consolidation programme.
- We regard the smaller EMU-outs (Switzerland, Denmark, Norway, Sweden) as fairly solid AAAs and expect them all to retain that rating in coming years. Among these, Denmark's rating is perhaps the least secure, reflecting the deteriorating fiscal trend, high private debts and sluggish housing market. Our projection implies that in a few years, there may well be very few pure AAAs (ie top rated with stable outlook and ratings watch) – just Canada, some smaller European economies, and the Antipodean countries.

Michael Saunders

+44-20-7986-3299
 michael.saunders@citi.com

Mark Schofield

+44-20-7986-9224
 mark.schofield@citi.com

With thanks to Peter Goves and Jan Maguire

Figure 1. Global — Expected Sovereign Ratings Changes (measured from current ratings by S&P and/or Moody's), 2011-14

Forecast NearTerm Ratings Changes (Next 2 Quarters)		Forecast Longterm Ratings Changes (Next 2-3 years)	
Upgrades	Downgrades	Upgrades	Downgrades
None	Italy, Spain, Greece, Portugal	None	US, Japan, France, Italy, Spain, Austria, Belgium, Finland, Ireland, Netherlands, Portugal, EFSF

Source: Citi Investment Research and Analysis

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Sovereign Ratings Outlook — January 2012

Michael Saunders
(44-20) 7986-3299
michael.saunders@citi.com

Mark Schofield
(44-20) 7986-9224
mark.schofield@citi.com

Peter Goves
(44-20) 7986-3215
peter.goves@citi.com

This publication is a joint product between the Citi economics and rate strategy teams, with input from various other research teams. We aim to forecast the direction and scale of sovereign debt ratings (local currency), as well as any changes in the ratings outlook, for a range of countries. These are our judgments over the ratings outlook, rather than model-determined recommendations. All economic and fiscal forecasts are consistent with those published in Citi's monthly "Global Economic Outlook and Strategy" or other research. This publication does not aim to make a judgment on the financial market implications of ratings changes, except in so far as we expect any such market implications to affect other sovereign ratings. The full publication is released roughly once per quarter, with a briefer monthly summary in the "Global Economic Outlook and Strategy".

Figure 2. Advanced Economies — Sovereign Long-Term Debt Ratings and Citi Ratings Forecasts

Country	S&P Ratings				Moody's Ratings			
	Current Rating	Current Outlook	Citi Nearterm (Up to 6 Months) Forecast Rating	Citi Longterm (Next 2-3 Years) Forecast Rating & Outlook	Current Rating	Current Outlook	Citi Nearterm (Up to 6 Months) Forecast Rating	Citi Longterm (Next 2-3 Years) Forecast Rating & Outlook
US	AA+	Neg	AA+ (Neg)	AA ↓	Aaa	Neg	Aaa (Neg)	Aa1 ↓
Canada	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	Aaa
Japan	AA-	Neg	AA- (Neg)	A+ ↓	Aa3	Stable	Aa3	A1 ↓
Germany	AAA	Stable	AAA	AAA (Neg)	Aaa	Stable	Aaa	Aaa (Neg)
France	AA+	Neg	AA+ (Neg)	AA ↓	Aaa	Stable	Aaa (Neg)	Aa1 ↓
Italy	BBB+	Neg	BBB+ (Neg)	BBB- ↓↓	A2	Neg	Baa1 ↓↓	Baa3 ↓↓↓↓
Spain	A	Neg	A (Neg)	BBB+ ↓↓	A1	Neg	A2 ↓	Baa1 ↓↓↓
Austria	AA+	Neg	AA+ (Neg)	AA ↓	Aaa	Stable	Aaa (Neg)	Aa1 ↓
Belgium	AA	Neg	AA (Neg)	AA- ↓	Aa3	Neg	Aa3 (Neg)	Aa3
Finland	AAA	Neg	AAA (Neg)	AA+ ↓	Aaa	Stable	Aaa	Aaa (Neg)
Greece	CC	Neg	SD ↓↓	CC/C	Ca	Developing	C ↓	Ca
Ireland	BBB+	Neg	BBB+(Neg)	BBB- ↓↓	Ba1	Neg	Ba1 (Neg)	Ba2 ↓
Netherlands	AAA	Neg	AAA (Neg)	AA+ ↓	Aaa	Stable	Aaa	Aaa (Neg)
Portugal	BB	Neg	BB (Neg)	CC/C ↓↓↓↓	Ba2	Neg	Ba3 ↓	Ca ↓↓↓↓
UK	AAA	Stable	AAA	AAA (Neg)	Aaa	Stable	Aaa	Aaa (Neg)
Switzerland	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	Aaa
Sweden	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	Aaa
Denmark	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	Aaa
Norway	AAA	Stable	AAA	AAA	Aaa	Stable	Aaa	Aaa
EFSF	AA+	Developing	AA+	AA+	(P) Aaa	Stable	Aa1 ↓	Aa1 ↓

Note: Arrows denote expected ratings changes from the current rating. (Neg) denotes negative outlook. (Neg W) denotes negative watch. SD means Selective Default. (P) means Provisional. The number of arrows denotes the expected change in ratings notches from the current level. We show a maximum of five arrows even for countries where we expect more than five notches of ratings change. In the outlook we have not included an extension of the actual EFSF lending beyond the now targeted €440bn maximum capacity. In the event that a substantial extension of the EFSF takes place and is likely to incur sizeable fiscal costs, various Euro Area countries may be at risk of downgrade. NA Not available.

Sources: Moody's, S&P and Citi Investment Research and Analysis

Key Expected Ratings Issues

US

Economist: Robert V. DiClemente
(1-212) 816-7942
robert.diclemente@citi.com

Strategist: Brett Rose
(1-212) 816-6439
brett.rose@citi.com

Citi Ratings Outlook: US

	Current	Near- Term	Long-Term
S&P	AA+ (Neg)	AA+ (Neg)	AA
Moody's	Aaa (Neg)	Aaa (Neg)	Aa1

Source: Citi Investment Research and Analysis

Failure to agree on a full-year extension of payroll tax relief and long-term jobless benefits in December has reinforced worries that ideological divides in Congress will prevent progress toward fiscal consolidation anytime soon. Near-term deficits continue to shrink as economic recovery and modest cuts in appropriations are narrowing the budget gap to about 7% for FY2012. However, longer-term current policy projections show federal debt levels spiralling upward as entitlement caseloads and health care costs rise. Near-term, major confrontations – and a key test – loom over the convergence in 2013 of defence and other spending cuts (triggered by the Budget Control Act), sweeping income and health care tax increases, and the need to increase the public debt limit, all in the immediate aftermath of the November election. We are therefore keeping our near-term outlook unchanged, but we cannot rule out further downward pressure on ratings over the next 2-3 years.

Canada

Economist: Dana M. Peterson
(1-212) 816-3549
dana.peterson@citi.com

Strategist: Brett Rose
(1-212) 816-6439
brett.rose@citi.com

Citi Ratings Outlook: Canada

	Current	Near- Term	Long-Term
S&P	AAA	AAA	AAA
Moody's	Aaa	Aaa	Aaa

Source: Citi Investment Research and Analysis

The fiscal and political situations in Canada remain stable and therefore we maintain that rating agencies are likely to keep Canada's AAA status in both the near and long-term. The majority Conservative government continues to pursue its objectives as outlined in the March 2011 Budget and November 2011 Update. The Finance Ministry projects that the federal deficit will be eliminated over the medium-term; and federal net debt as a percent of GDP will return to the pre-crisis level within the next five years. The IMF projects that gross general government debt will retreat to its pre-crisis level within the next five years.

Canadian governments have already initiated the consolidation process by cutting investment, expenses and labourers. However, debt as a percent of GDP is on course to rise in 2012 and 2013 as the slower Canadian expansion reduces revenue. Debt is also expected to rise as a consequence of modest additional stimulus, which, with the exception of the extension of employment insurance benefits for the long-term unemployed, was preannounced in budget communications. Measures included the 3 January 2012 corporate tax cut to 15%, a family caregiver tax credit, and a capital cost allowance for investments in manufacturing or processing machinery and equipment.

Consultations for Budget 2012 are currently underway, and should be completed by month-end. The Budget is set for release in either February or March. Certain federal Government departments may face cuts of between 5 and 10%, as the Finance Ministry aims to find C\$4 billion a year in permanent savings, or 5% of outlays on direct programs. Reformation of public sector pension rules are also under consideration.

Economist: Kiichi Murashima
(+81-3) 6270-4980
kiichi.murashima@citi.com

Strategist: Eiji Dohke
(+81-3) 6270-7245
eiji.dohke@citi.com

Citi Ratings Outlook: Japan			
	Current	Near-Term	Long-Term
S&P	AA- (Neg)	AA- (Neg)	A+
Moody's	Aa3	Aa3	A1

Source: Citi Investment Research and Analysis

Economist: Jürgen Michels
(44-20) 7986-3294
juergen.michels@citi.com

Strategist: Robert Crossley
(44-20) 7986-9255
robert.crossley@citi.com

Citi Ratings Outlook: Germany			
	Current	Near-Term	Long-Term
S&P	AAA	AAA	AAA (Neg)
Moody's	Aaa	Aaa	Aaa (Neg)

Source: Citi Investment Research and Analysis

Japan

We are keeping our outlook on Japan's ratings outlook unchanged from our last publication. This highlights the chance of a one notch downgrade by both S&P and Moody's agencies over the longer term from AA- to A+ and from Aa3 to A1 respectively. Late last month, the DPJ (Democratic Party of Japan) Administration published a blueprint for comprehensive tax and social security reform calling for a consumption tax rate hike to 8% in April 2014 from 5% currently and to 10% in October 2015. In our view, however, there remain significant hurdles for this proposal to be officially approved by the Parliament and to be implemented. First, there is not broad support for the consumption tax hike within the DPJ. Second, public support for the Noda Administration and the consumption tax hike appears to have fallen markedly in recent months. Third, the ruling coalition does not have an absolute majority in the Upper House and the opposition parties are opposed to the DPJ's proposal. Finally, PM Noda promised to hold the general elections before implementing the consumption tax hike. But it seems likely that the DPJ will suffer a significant setback in the next elections. Thus, there are significant uncertainties surrounding the government's proposal.

Meanwhile, were it to be implemented, the consumption tax hike would likely create a huge distortion in the economy. We estimate that a planned 3ppt tax hike in April 2014 would result in front-loaded demand of nearly ¥10tn (2% of GDP), followed by a sharp reactionary drop in spending. Moreover, the consumption tax hike would have a lasting impact on real consumption by eroding real incomes. We estimate that a 3ppt consumption tax hike would cut real consumption by 0.8ppt (-0.5ppt on real GDP) in the first year through a squeeze on household real incomes. Thus, the consumption tax hike to 8% would create huge distortions in the economy and that might make the planned second hike (to 10% in October 2015) difficult. In that case, concerns over fiscal sustainability would intensify further.

Germany

Germany was not part of S&P's January round of euro area sovereign downgrades. However, if the sovereign debt crisis escalates further, we think the rating agencies are likely to put Germany's AAA status on negative outlook as well in the course of this year. In addition to contributions to the EFSF and capital injections to the ESM, the German government's balance sheet is also likely to come under pressure from extra support to the banking system. So depending on the crisis escalation, Germany could be put on Negative Outlook over the longer-term.

According to the flash estimate of the German statistical office, the general government deficit ratio was 1.0% of GDP in 2011, a bit lower than expected. We expect the deficit to rise in 2012 amidst the economic slowdown and capital injections into the ESM, but only to a modest level of about 1.7% of GDP. However, with the impact of the contributions to the EFSF, the debt-to-GDP ratio is likely to rise from 89.2% in 2011 to 93.0% in 2013, which probably will be the peak. In order to hit criteria for the national balanced budget rule, which will have to be fully respected in 2016, Germany will probably have to implement modest fiscal tightening in coming years. Depending on the final version of the new fiscal compact, the country probably will have to increase its efforts to reduce its debt. As a reaction to this, the government might cancel the targeted income tax reduction for 2013. Regarding the long-term outlook, the broad based debate to water down the increase in the retirement age to 67, which has started to gradually kick in, suggest that it will be difficult to address problems in the public health sector, which pose sizeable long-term fiscal risks. And given the intra-coalition disputes on the euro area crisis management plus the weak polls of the junior coalition partner FDP,

it looks unlikely that these issues will be addressed before the next regular election in autumn 2013.

Economist: Guillaume Menuet
(44-20) 7986-1314
guillaume.menuet@citi.com

Strategist: Robert Crossley
(44-20) 7986-9255
robert.crossley@citi.com

Citi Ratings Outlook: France

	Current	Near-Term	Long-Term
S&P	AA+ (Neg)	AA+ (Neg)	AA
Moody's	Aaa	Aaa (Neg)	Aa1

Source: Citi Investment Research and Analysis

France

On 16 January, Moody's noted that it continued to review France's Stable Outlook and was planning to provide an update on all EU sovereign ratings as part of an initiative to revisit the overall sovereign rating methodology. Looking at Moody's rationale on factors likely to affect sovereign ratings, we conclude that the likelihood of further support to neighboring euro area member states will probably lead to a Negative Outlook being assigned in coming months. We believe that additional downward revisions to the GDP baseline lead to a similar conclusion. At this juncture, because debt issuance is expected to remain affordable and the potential size of further contingent liabilities to the national banking system appears limited, we think that in the short-term a Negative Outlook is more likely than a rating downgrade. We suspect that the large liquidity take-up at the December 3-year LTRO could be interpreted as an effective stabilization tool and could therefore help protect France's sovereign rating in the short-term.

Turning to S&P's decision to lower the country's rating by one notch to AA+ and assign a negative outlook to France, there were no country-specific comments. What is clear is that the risk of a "*more adverse economic and financial environment*" will probably lead to further rating actions over the near-to-medium term. Our debt-to-GDP ratio forecast of an increase from 85.4% in 2011 to a peak of 94% by 2014 will probably not be consistent with a rating of AA+. Political uncertainty aside, we argue that any delay in the implementation of structural reforms including another necessary round on pensions will probably lead to a further rating downgrade to AA in the next two to three years.

Italy

Italy's sovereign rating was downgraded by two notches from A to BBB+ by S&P on 13th January as part of the agency's general review of ratings for the Eurozone economies. Moreover, Italy's Outlook has been put on Negative, indicating the possibility of further downgrades over time by S&P. Downgrades are certainly possible in Moody's forthcoming review on broader European sovereign credit quality, especially as Moody's current rating of A2 is around two notches higher following S&P's recent move. Over the longer term, we also believe that a further downgrade or two are real possibilities from both agencies. Although the political and structural reform outlook in Italy has improved substantially since our last review, Italy's economic performance is likely to remain under severe pressure in the short-term as the country enters a period of economic contraction and protracted weakness.

While the 3Y LTRO probably gives Italian banks increased possibilities to purchase domestic sovereign securities, the EBA stress test - including the mark-to-market valuation of sovereign holdings - has created additional hurdles for banks to expand their government holdings. Hence, unless there is a relaxation in bank regulation, the ECB's cheap funding facility for banks will probably have only limited impact on the Italian sovereign funding situation. Furthermore, it remains very uncertain if the targeted extra funding sources for the IMF to support EMU governments will be available soon. In any case, any kind of official financial assistance programme by the IMF in combination with the EFSF/ESM might force downgrades by the rating agencies.

Economist: Jürgen Michels
(44-20) 7986-3294
juergen.michels@citi.com
With thanks to Carla Clifton

Strategist: Robert Crossley
robert.crossley@citi.com
(44-20) 7986-9255

Citi Ratings Outlook: Italy

	Current	Near-Term	Long-Term
S&P	BBB+ (Neg)	BBB+ (Neg)	BBB-
Moody's	A2 (Neg)	Baa1	Baa3

Source: Citi Investment Research and Analysis

Economist: Jürgen Michels
(44-20) 7986-3294

juergen.michels@citi.com

With thanks to Carla Clifton

Strategist: Robert Crossley
(44-20) 7986-9255

robert.crossley@citi.com

Citi Ratings Outlook: Spain

	Current	Near- Term	Long-Term
S&P	A (Neg)	A (Neg)	BBB+
Moody's	A1 (Neg)	A2	Baa1

Source: Citi Investment Research and Analysis

Economist: Jürgen Michels
(44-20) 7986-3294

juergen.michels@citi.com

Strategist: Robert Crossley
(44-20) 7986-9255

robert.crossley@citi.com

Citi Ratings Outlook: Austria

	Current	Near- Term	Long-Term
S&P	AA+ (Neg)	AA+ (Neg)	AA
Moody's	Aaa	Aaa (Neg)	Aa1

Source: Citi Investment Research and Analysis

Spain

Spain was another Eurozone country that saw its sovereign rating downgraded by two notches, from AA- to A by S&P on 13th January. This is in line with recent developments in the country where, although the swift adoption of an austerity package indicated the new Government's commitment to the fiscal consolidation plan, the large fiscal slippage in 2011 makes it very likely that Spain will need to take additional measures to meet its 4% deficit target for 2012. Such additional measures, whilst helping to meet the deficit target will however very likely lead the country into a deeper renewed recession thereby putting upward pressure on the country's debt to GDP ratio.

Recent auction results suggest that banks are using the favourable ECB funding to purchase government securities. This will help to ease the immediate sovereign funding needs and reduces the need to ask for external support from the IMF/ EFSF/ ESM – which would probably have some negative rating implications.

Austria

As expected, Austria lost its AAA status from S&P, in particular because of the banking sector's high exposure to Hungary and other Central and Eastern European countries where economic problems are mounting. Austrian banks also have sizable exposure to the euro area periphery countries. And as the EcoFin made clear that any form of bank guarantees or required bank recapitalization has to come from the member countries, the Austrian sovereign would face a sizable burden in the event of an escalation of the sovereign debt crisis.

As a reaction to the downgrade, we expect that the Austrian government will announce additional austerity measures to try and meet the targeted deficit-to-GDP ratio of 3.3% in 2012. However, depending on the required measures for the banking sector, it is uncertain if the country will actually meet this deficit target. But, in any case, the additional austerity measures are likely to lead to a mild recession in Austria in 2012. We think that this could prompt Moody's to put the sovereign on Negative Outlook and we think a further downgrade by S&P is a possibility over the longer term.

Economist: Guillaume Menuet
(44-20) 7986-1314
guillaume.menuet@citi.com

Strategist: Robert Crossley
(44-20) 7986-9255
robert.crossley@citi.com

Citi Ratings Outlook: Belgium

	Current	Near- Term	Long-Term
S&P	AA (Neg)	AA (Neg)	AA-
Moody's	Aa3 (Neg)	Aa3 (Neg)	Aa3

Source: Citi Investment Research and Analysis

Economist: Jürgen Michels
(44-20) 7986-3294
juergen.michels@citi.com
With thanks to Carla Clifton

Strategist: Robert Crossley
(44-20) 7986-9255
robert.crossley@citi.com

Citi Ratings Outlook: Greece

	Current	Near- Term	Long-Term
S&P	CC (Neg)	SD	CC/C
Moody's	Ca (Dev)	C	Ca

Source: Citi Investment Research and Analysis

Belgium

Belgium's new government has been quick to pass a budget after agreeing to build a coalition in the final week of December. As we had feared earlier, the honeymoon period has proved short-lived, with the EU Commission successfully extracting an extra €1.3bn of fiscal tightening in January after rejecting Belgium's initial calculations of a budget deficit of 2.8% of GDP. Belgium is liable to suffer a one notch downgrade in coming years, particularly from S&P. In our view, Moody's will probably leave them on Negative Outlook over the coming months (it currently rates Belgium as Aa3 which is already one notch lower than S&P). The agency is likely to watch what efforts the coalition might make in February to identify further savings to ensure that the legal requirement of ending the excessive budget procedure with a deficit of less than 3% of GDP is met as the government revises its GDP baseline after the release of Q4 GDP. The main risk appears to be related to the persistent questions about the banking system and its potential recapitalization needs. In the past, Belgium has proven its ability to control its debt-to-GDP ratio, while maintaining an affordable level of debt financing and high domestic savings. Our forecast is that the debt to GDP ratio will peak at 108.8% of GDP in 2012 before falling below 100% in 2015. As a result, we believe that the authorities will do everything in their power to ensure that the rating remains above the AA- or Aa3 threshold.

Greece

Greece was not downgraded as part of S&P's latest review of the Eurozone economies. However, we expect Greece to be downgraded further this year as it becomes evident that the current PSI agreement – even if settled – will prove insufficient to return Greece to a sustainable fiscal path. We believe that a bigger debt reduction deal, potentially also involving official sector creditors, will have to be negotiated – meaning that Greece will be moved either into selective default, if there is agreement on the PSI and the second bailout programme, or to outright default and possible EMU exit if there is no agreement.

In our view, Greece has little chance of returning to a sustainable economic growth and fiscal path without a large debt reduction, including the public sector. In our scenario, with a continuing contraction in GDP to 2016 (partly caused by further austerity measures) and a €100bn debt reduction by the private sector (probably with a haircut larger than 50%), the country's debt will peak at around 157% in 2014 before declining very slowly.

Economist: Jürgen Michels
(44-20) 7986-3294
juergen.michels@citi.com

Strategist: Robert Crossley
(44-20) 7986-9255
robert.crossley@citi.com

Citi Ratings Outlook: Netherlands

	Current	Near- Term	Long-Term
S&P	AAA (Neg)	AAA (Neg)	AA+
Moody's	Aaa	Aaa	Aaa (Neg)

Source: Citi Investment Research and Analysis

Economist: Jürgen Michels
(44-20) 7986-3294
juergen.michels@citi.com
With thanks to Carla Clifton

Strategist: Robert Crossley
(44-20) 7986-9255
robert.crossley@citi.com

Citi Ratings Outlook: Portugal

	Current	Near- Term	Long-Term
S&P	BB Neg	BB (Neg)	CC/C
Moody's	Ba2 Neg	Ba3	Ca

Source: Citi Investment Research and Analysis

Economist: Tina Mortensen
(44-20) 7986-3284
tina.mortensen@citi.com

Strategist: Robert Crossley
(44-20) 7986-9255
robert.crossley@citi.com

Citi Ratings Outlook: Denmark

	Current	Near- Term	Long-Term
S&P	AAA	AAA	AAA
Moody's	Aaa	Aaa	Aaa

Source: Citi Investment Research and Analysis

Netherlands

The Dutch minority government is likely to put in place extra austerity measures to defend its AAA rating. But, depending on the development of the financial crisis and its implications for the Dutch banking sector, the measures probably will not be sufficient to prevent a downgrade over the longer term. First, available data for the beginning of 4Q suggest that the weak economic performance is starting to have some negative impact on central government tax revenues. Furthermore, the fall in house prices will likely affect economic performance and also tax revenues. Therefore it probably will be difficult for the country to reduce the deficit in 2012 and we expect an increase of the debt to GDP ratio to 70.3%, although this is still low compared to Germany.

Portugal

The latest downgrade of Portugal's sovereign ratings by S&P leaves the country's government bonds in the speculative category according to all three main rating agencies. As a result, we expect Portuguese bonds to drop out of most investment indices thereby making access to the markets virtually impossible for the foreseeable future. A potential downgrade of the EFSF, on which Portugal depends for some of its funding under the May 2010 EU/IMF bail out agreement, would also tend to raise the interest rates that Portugal will pay on its financing in the next few years. We expect that the country will not be able to return to market funding in 2013, and hence it is very likely that Portugal will require additional Troika funding. As Portugal has complied with the requested adjustment measures so far, we expect that the country will get additional public funding without requesting a PSI in a first round. However, we expect that eventually Portugal will face a PSI debt restructuring with a haircut of around 35%. If this materializes, the rating agencies are likely to react with further downgrades. S&P has just completed a review as stated and we look for further downgrades to occur over the longer term by this agency. We do not, however, rule out a downgrade by Moody's over the near-term as part of their broad review of European sovereign creditworthiness in Q1 2012.

Denmark

We are keeping our outlook on Denmark's rating the same as published last time at AAA and Aaa for both S&P and Moody's respectively. We do, however, point to the pertinent economic problems that might pose risks to this central scenario. From the very strong starting point (surplus of 5% of GDP in 2005-06), Denmark's fiscal position has worsened markedly in recent years, with a deficit of 2.6% of GDP in 2010. The government has used its fiscal room for manoeuvre to support growth, and will continue to do so, pushing the deficit above 5% of GDP in 2012. Government debt is still low relative to most other European economies at around 50% of GDP last year. Hence in the near-term the fiscal outlook is not too bad. Nevertheless, if Denmark does not get back on track in terms of growth (not generated by government spending) there could be some risks of a markedly worse debt profile in the medium term.

Economist: Tina Mortensen
(44-20) 7986-3284
tina.mortensen@citi.com

Strategist: Robert Crossley
(44-20) 7986-9255
robert.crossley@citi.com

Citi Ratings Outlook: Finland

	Current	Near- Term	Long-Term
S&P	AAA (Neg)	AAA (Neg)	AA+
Moody's	Aaa	Aaa	Aaa (Neg)

Source: Citi Investment Research and Analysis

Economist: Tina Mortensen
(44-20) 7986-3284
tina.mortensen@citi.com

Strategist: Robert Crossley
(44-20) 7986-9255
robert.crossley@citi.com

Citi Ratings Outlook: Norway

	Current	Near- Term	Long-Term
S&P	AAA	AAA	AAA
Moody's	Aaa	Aaa	Aaa

Source: Citi Investment Research and Analysis

Economist: Tina Mortensen
(44-20) 7986-3284
tina.mortensen@citi.com

Strategist: Robert Crossley
(44-20) 7986-9255
robert.crossley@citi.com

Citi Ratings Outlook: Sweden

	Current	Near- Term	Long-Term
S&P	AAA	AAA	AAA
Moody's	Aaa	Aaa	Aaa

Source: Citi Investment Research and Analysis

Finland

Finland is the only country in the euro area (except for Luxembourg), which is both AAA-rated and meets all of the Maastricht Treaty requirements; the country has a modest fiscal deficit (2.3% of GDP in 2011 according to the IMF) and public debt at about 50% of GDP. However, with a deteriorating economic outlook and an ageing population, public debt is set to rise in coming years. Finland is currently rated AAA, but with a Negative Outlook by S&P meaning that over the longer term, downward pressure on the rating is more likely than for the other Nordic countries who are all rated AAA Stable. As part of the plan to bring public finances onto a sustainable path, the 2012 budget implies a mild fiscal contraction this and next year. However, demands for tougher austerity measures have increased in recent months. Finland continues to have one of the lowest risk premiums versus Germany in the euro area (the 10-year bond spread has widened from about 20bp to 50bp during 2011), and although Finland's triple-A rating remains on Negative Outlook by S&P, we believe that the effects of a possible downgrade are likely to be limited in the near-term given its comparatively low level of public debt.

Norway

Norway found large oil resources in the North Sea in the early 1970s. On the back of this it has a large fiscal surplus, likely to be around 13% of GDP this year. The non-oil deficit is targeted to be around 4% of the value of the Government Pension Fund Global and is expected to roughly meet that target this year (after being slightly higher in 2009-11), i.e. suggesting a broadly neutral fiscal stance. If, however, the Norwegian economy deteriorates markedly the government will likely add more stimulus to the economy (fiscal policy added 2%-points to mainland GDP in 2009). The Norwegian government is selling bonds, but has vast financial assets and hence a net asset/GDP ratio of more than 150% of annual GDP. Both Moody's and S&P currently rate Norway as AAA Stable and we see little reason for this to change both in the near- and long-term.

Sweden

Swedish government finances are very strong in a European context and the deficit is expected to remain around zero this and next year before gradually rising above the government's medium-term fiscal target of a 1% surplus on the budget balance in 2015. General government debt is relatively low, at around 36% of GDP in 2011 and the debt/GDP ratio has been falling since 2001 (except in 2009) and probably will continue to fall in the next few years. The next election is in 2014, but none of the main political parties are proposing significant fiscal stimulus or retrenchment. The government has made it clear that it prioritizes safety margins in the budget over demand stimulation. However, with a rise in unemployment this year, we expect the government to make greater use of its fiscal flexibility (2011 budget indicates stimulus of 0.3% of GDP and 0.4% of GDP this and next year, respectively). Specifically therefore for the ratings outlook, Sweden is in a similar situation to Norway: both agencies rate the sovereign AAA and Stable and we think this will be maintained both in the near- and long-term.

Economist: Michael Saunders
(44-20) 7986-3299
michael.saunders@citi.com

Strategist: Robert Crossley
(44-20) 7986-9255
robert.crossley@citi.com

Citi Ratings Outlook: UK

	Current	Near- Term	Long-Term
S&P	AAA	AAA	AAA (Neg)
Moody's	Aaa	Aaa	Aaa (Neg)

Source: Citi Investment Research and Analysis

UK

We believe the UK will retain its AAA status among the major ratings agencies this year. To be sure, the UK suffers from some of the adverse factors cited by S&P to justify the euro area downgrades: S&P's list included 1) tightening credit conditions, (2) an increase in risk premia on government debt, (3) simultaneous deleveraging by governments and households, (4) weakening growth prospects, and (5) an open and prolonged dispute among European policymakers over the proper approach to address challenges. Of these, factors (3) and (4) apply to the UK, and indeed private deleveraging probably is greater in the UK. Arguably, factor (1) also applies to the UK. In 2011, UK economic growth was a little below France, although we expect that France's GDP growth will be weaker than the UK's in 2012. Public debt ratios are similar, and the UK's fiscal deficit is above France's. It is for these reasons that a Negative Outlook cannot be ruled out in the longer term. Note this has happened before: S&P last put the UK on Negative Outlook in May 2009. Moreover, the UK's AAA rating would be vulnerable if the coalition splits or the economic outlook for 2012-13 proves far worse than we currently expect.

Nevertheless, in other respects, the UK's ability to return to fiscal sustainability is significantly better than most EMU governments. First, the UK government is less exposed to risks of having to support the highly-strained EMU countries. Second, the UK government faces less risk of having to backstop banks against exposure to periphery sovereign debt, as evident in the EBA's finding that UK banks do not need to participate in the current capital-raising exercise. Third, the UK government's decision to accept the ICB reforms eventually will greatly cut the government's contingent liability to backstop major banks against losses from other factors. Fourth, the UK already has announced a detailed multi-year fiscal consolidation plan, with a sizeable share of the tightening front-loaded and implemented. Fifth, the OBR's role as fiscal watchdog, and the UK government's strong executive powers, are proving highly effective in locking the UK into a tough multi-year fiscal retrenchment. Almost all public spending is controlled by central government, while Budget announcements quickly pass into law. Sixth, the UK's monetary flexibility (floating exchange rate and independent BoE) provides some cushion against the adverse effects on growth of fiscal drag. Seventh, the UK government has very long maturity debt and hence faces much less rollover risk.

Ireland

Ireland has continued to meet its targets under the EU/IMF bailout of December 2010, with the positive Fourth Review being released in December 2011 – the Troika team is currently in Dublin undertaking the next review. The Irish Government expects the 2011 deficit to come in at 10.1% of GDP (target 10.5%) and the 2012 Budget (announced in December 2011) contains an adjustment of €3.8bn in order to meet the 8.5% deficit target for 2012. Ireland was also one of the sovereigns not to be downgraded by S&P on 13th January. Over the near-term, we are keeping our outlook on both Moody's and S&P unchanged at Ba1 and BBB+ respectively.

The main risk factor to Ireland's bailout programme is weak economic growth, both within Ireland and globally. After average growth of 1.6% quarter on quarter in 1H 2011, GDP fell 1.9% QQ in 3Q and risks to current forecasts (from IMF and Irish Government) of 1.0% YY growth in both 2011 and 2012 are to the downside. Consumer spending remains weak (down 3.9% YY in 3Q 2011), hit by increased personal levies and the latest 2 percentage point rise in VAT (to 23%). Export growth, the main contributor to GDP growth in 1H 2011, fell back to 2.2% YY in 3Q

Economist: Michael Saunders
(44-20) 7986-3299
michael.saunders@citi.com

Strategist: Robert Crossley
(44-20) 7986-9255
robert.crossley@citi.com

Citi Ratings Outlook: Ireland

	Current	Near- Term	Long-Term
S&P	BBB+ (Neg)	BBB+ (Neg)	BBB-
Moody's	Ba1 (Neg)	Ba1 (Neg)	Ba2

Source: Citi Investment Research and Analysis

(from 6% in 1Q), and is likely to be affected by a slowdown in euro-area and global growth. Unemployment has remained around 14% throughout 2011 (having been just under 5% in 2007 before the property crash) and has only been capped at this level by increased emigration of Irish nationals (40,200 in the year to April 2011 compared to 27,700 in the year to April 2010). Property prices continue to fall and are now 46% lower than the 2007 peak, while the number of mortgages in arrears of more than 90 days continues to rise (8.1% of all mortgages at end Sep 2011, compared to 7.2% at end June). Over the longer term therefore, further downward pressure on the rating is likely in our view.

EFSF

In the aftermath of the downgrade of both Austria and France to AA+ by S&P on 13th January, S&P also downgraded the EFSF to AA+ on 16th January. The secondary market reaction was relatively muted. It has been clear for some time that the EFSF was not funding at core AAA rates. S&P cited two key factors underlying the ratings action. First, the EFSF's obligations (of €440bn) had ceased to be fully supported by guarantees from EFSF members rated AAA. Rather, they are backed by guarantees from members rated AAA and/or AA+. Second, S&P stated¹ they considered that *"credit enhancements sufficient to offset what we view as the reduced creditworthiness of guarantors are currently not in place"*.

S&P's outlook is currently "developing" meaning that the rating could be restored to AAA or move lower still, dependent on how the structure evolves (specifically, if sufficient credit enhancements are forthcoming). In our view, the EFSF rating will depend on the credit quality of the underlying guarantee structure as well as the scope and scale of any further potential liabilities. Over the longer term, both France and Austria could see further ratings pressure down to AA, Finland and the Netherlands (which remain on Negative Outlook) could move to AA+ and even Germany might return to Negative Outlook. This could put further downward pressure on the EFSF's rating in coming years. In the short term however, the EFSF certainly remains capable of fulfilling existing commitments to both the Irish (€17.7bn commitment of which €12.5bn disbursed) and Portuguese programmes (€26bn commitment of which €5.9bn disbursed) and we think the AA+ rating should be maintained over coming months.

Moody's currently rates the structure Provisional Aaa². In a recent note dated 29th October 2011, Moody's re-stated that downside risks to the rating *"include a potential deterioration in the creditworthiness of the participating euro area member states"*. As we believe it is more likely than not that Moody's puts several countries at least on Negative Outlook in coming months, we think a one notch downgrade by Moody's of the EFSF could occur in the near-term. This would also put it in line with the one notch downgrade just affirmed by S&P.

In order to bypass the rating issues of the EFSF, the euro area governments will have to work hard to enact the permanent rescue mechanism, the ESM, with a high capital basis at mid 2012. While this is a very ambitious target, it might allow the EFSF to stop providing new commitments, maybe even within the €211bn guarantees provided by Germany.

Economist: Jürgen Michels
(44-20) 7986-3294
juergen.michels@citi.com

Strategist: Peter Goves
(44-20) 7986-3215
peter.goves@citi.com

Citi Ratings Outlook: EFSF

	Current	Near-Term	Long-Term
S&P	AA+ (Dev)	AA+	AA+
Moody's	(P) Aaa	Aa1	Aa1

Source: Citi Investment Research and Analysis

¹ *European Financial Stability Facility Long-Term Ratings Cut to AA+; Short-Term Ratings Affirmed; Outlook Developing*. 16th January.

² "Moody's will often assign a provisional rating when the assignment of a final rating is subject to the fulfilment of contingencies but it is highly likely that the rating will become definitive after all documents are received or an obligation is issued into the market" *Moody's Rating Symbols and Definitions Dec 2011*.

Figure 3. Selected Countries — Economic Forecast Overview (Percent), 2011-2016F

	GDP Growth						CPI Inflation						Short-Term Interest Rates					
	2011	2012	2013	2014	2015	2016	2011	2012	2013	2014	2015	2016	2011	2012	2013	2014	2015	2016
Global	3.0	2.3	3.0	3.5	3.8	4.1	3.8	2.9	2.8	2.9	3.0	3.0	2.67	2.63	2.74	2.93	3.20	3.55
<i>Based on PPP weights</i>	3.6	2.9	3.5	3.8	4.1	4.3	4.4	3.4	3.3	3.2	3.3	3.2						
Industrial Countries	1.3	0.6	1.1	1.9	2.3	2.7	2.6	1.6	1.4	1.4	1.5	1.6	0.77	0.55	0.57	0.69	1.07	1.62
United States	1.7	1.9	1.9	2.8	3.5	4.0	3.2	1.7	1.7	2.0	2.3	2.4	0.25	0.25	0.25	0.40	1.15	2.10
Japan	-1.0	1.0	1.3	1.5	1.5	1.2	-0.3	-0.4	-0.2	0.1	0.3	0.5	0.10	0.10	0.10	0.13	0.48	0.75
Euro Area	1.5	-1.5	-0.4	0.6	1.0	1.6	2.7	2.2	1.4	1.0	0.7	0.8	1.20	0.60	0.50	0.50	0.50	0.80
Canada	2.3	1.7	2.3	2.7	3.2	3.5	2.9	1.9	1.7	2.0	2.0	2.0	1.00	1.00	1.63	2.19	2.50	3.00
Australia	1.9	3.4	3.8	4.3	3.8	3.6	3.3	2.2	3.1	2.9	2.7	2.5	4.63	4.00	4.44	5.25	5.25	4.75
New Zealand	1.4	2.6	2.6	3.0	3.2	3.4	4.2	2.1	2.3	2.6	2.9	2.8	2.50	2.81	4.25	5.50	5.50	5.25
Germany	3.0	0.4	1.2	1.4	1.7	1.6	2.3	1.7	2.0	2.1	2.0	1.9						
France	1.6	-0.7	0.5	1.1	1.5	2.0	2.3	2.5	1.8	1.3	1.8	1.5						
Italy	0.4	-2.3	-0.7	-0.5	0.1	1.2	2.9	2.7	1.9	0.9	0.3	1.2						
Spain	0.7	-2.7	-1.3	0.6	0.8	1.9	3.1	2.4	1.8	1.1	1.2	1.8						
Greece	-5.4	-4.9	-3.1	-1.7	-0.4	0.9	3.2	1.5	-0.7	-0.3	-0.4	0.1						
Portugal	-1.8	-5.8	-3.7	-0.6	0.9	1.7	3.6	2.4	1.4	0.3	-0.2	0.0						
Netherlands	1.5	-0.7	0.5	1.1	1.5	1.7	2.3	1.8	1.8	1.6	1.9	1.8						
Belgium	1.8	-0.7	0.8	1.7	2.1	1.8	3.5	2.3	1.7	1.9	2.3	2.3						
Denmark	1.0	0.9	1.2	1.8	1.7	1.9	2.7	2.0	1.4	1.6	1.8	2.0	1.30	0.20	0.30	0.55	0.60	1.05
Norway	2.7	2.5	3.0	2.7	2.7	2.9	1.3	1.8	2.2	2.2	2.5	2.5	2.10	1.56	1.50	1.50	2.00	2.50
Sweden	4.5	0.5	1.9	2.6	2.7	2.7	2.9	1.2	1.9	1.9	2.1	2.0	1.80	1.13	1.00	1.00	1.50	2.00
Switzerland	1.8	0.7	0.9	1.3	1.3	1.3	0.2	-0.6	-0.5	-0.2	0.9	1.2	0.44	0.00	0.00	0.00	0.00	0.00
United Kingdom	0.9	0.2	1.0	1.7	2.5	3.1	4.5	2.6	2.3	2.2	2.1	2.1	0.50	0.50	0.50	0.50	1.04	2.04
Emerging Markets	6.0	5.2	5.9	5.8	5.9	5.9	6.2	5.2	5.1	5.0	5.1	4.9	6.10	6.08	6.18	6.30	6.25	6.17
China	9.2	8.4	8.6	7.7	7.6	7.5	5.4	3.5	3.9	4.5	5.0	4.5	3.22	3.72	3.88	4.25	4.75	5.00
Hong Kong	5.0	3.5	4.2	4.0	4.0	4.0	5.3	3.8	3.1	3.3	3.5	3.5	0.27	0.53	0.81	1.20	2.00	3.00
India	7.1	7.0	7.7	8.2	8.3	8.5	9.0	6.7	6.5	6.0	6.0	6.0	8.13	7.69	7.50	7.50	7.50	7.50
Indonesia	6.5	6.3	6.5	6.7	7.0	6.7	5.4	5.7	5.6	5.5	5.8	6.0	6.60	6.00	6.00	5.63	5.90	6.00
Korea	3.6	3.7	4.4	4.6	4.1	4.2	4.0	3.3	3.2	3.1	3.0	3.2	3.52	3.55	4.15	4.50	5.00	5.19
Singapore	4.8	3.0	5.0	5.0	5.0	5.0	5.3	3.0	3.1	2.5	2.5	2.5	0.44	0.50	0.70	1.70	2.60	3.20
Czech Republic	1.7	-0.5	2.0	2.8	3.6	3.8	1.9	2.6	1.6	2.5	2.0	1.6	2.53	2.80	3.10	3.20	3.50	3.50
Hungary	1.2	0.0	1.5	2.6	2.0	1.8	3.9	5.1	3.4	3.5	3.1	3.3	6.13	7.96	7.13	7.00	6.13	6.00
Poland	4.2	1.9	2.8	3.1	3.4	3.4	4.3	3.5	2.6	2.5	2.5	2.5	5.91	5.60	5.70	5.65	5.50	5.30
Romania	2.5	1.7	3.1	4.2	4.3	4.3	5.6	2.5	2.0	2.5	2.5	2.5	6.19	5.13	5.00	5.00	5.00	5.00
Russia	3.8	3.5	4.0	4.0	4.0	4.3	8.4	6.2	6.1	5.5	5.5	5.5	8.00	7.50	6.00	6.00	5.50	5.00
Turkey	8.2	2.5	4.3	4.4	4.5	4.5	6.5	8.1	6.6	6.2	5.7	5.2	5.75	5.75	7.25	8.00	7.50	7.50
Nigeria	7.1	6.7	6.5	6.9	7.2	7.0	10.9	10.9	10.4	10.3	9.5	9.0	13.00	15.00	12.50	10.50	10.00	9.50
South Africa	3.1	2.9	3.8	4.4	4.4	4.5	5.0	5.8	5.5	5.4	5.5	5.5	5.50	5.83	7.25	8.50	8.75	8.50
Argentina	9.4	5.0	5.0	3.5	3.5	3.5	9.8	9.6	12.2	15.0	15.0	15.0	14.04	19.52	18.24	16.00	14.00	13.00
Brazil	2.9	3.3	4.5	4.5	4.5	4.5	6.6	5.5	5.1	4.5	4.0	4.0	11.71	9.71	10.79	10.25	9.00	8.25
Mexico	3.9	3.0	3.4	3.7	3.8	3.7	3.4	4.3	3.7	3.9	3.8	3.7	4.50	4.50	5.38	7.00	7.00	6.75
Venezuela	4.0	4.0	3.4	4.0	3.0	2.5	27.0	26.3	28.0	25.0	28.0	28.0	14.60	14.50	14.50	14.50	14.50	14.50

Note: For inflation in India, we use the wholesale price index. Source: Citi Investment Research and Analysis

Figure 4. Selected Countries — Economic Forecast Overview (Percent), 2011-2016F

	Current Balance (Pct of GDP)						Fiscal Balance (Pct of GDP)						Government Debt (Pct of GDP)					
	2011	2012	2013	2014	2015	2016	2011	2012	2013	2014	2015	2016	2011	2012	2013	2014	2015	2016
Global	0.2	0.1	0.3	0.3	0.3	0.3	-5.0	-4.4	-3.5	-3.0	-2.6	-2.4	74	75	76	75	74	73
<i>Based on PPP weights</i>	0.5	0.2	0.4	0.3	0.3	0.2	-4.4	-4.1	-3.3	-2.9	-2.6	-2.4						
Industrial Countries	-0.9	-0.7	-0.5	-0.5	-0.4	-0.4	-6.9	-5.9	-4.6	-4.0	-3.4	-3.0	106	111	113	114	115	115
United States	-3.0	-2.4	-2.4	-2.5	-2.7	-3.0	-9.3	-7.3	-6.2	-5.5	-5.0	-4.7	99	104	108	110	111	112
Japan	1.9	1.2	1.6	1.7	1.7	1.7	-10.7	-10.9	-8.5	-8.2	-7.8	-7.4	233	243	250	254	258	262
Euro Area	-0.5	-0.7	-0.5	-0.4	-0.2	-0.1	-4.4	-3.8	-2.6	-2.0	-1.5	-1.0	89	94	94	93	92	91
Canada	-3.1	-3.5	-3.1	-3.3	-3.3	-3.0	-1.8	-1.5	-0.9	-0.4	-0.2	0.0	79	79	79	78	76	75
Australia	-2.2	-3.0	-5.0	-4.9	-3.5	-3.2	-3.4	-2.5	0.1	0.3	1.2	1.7	6	9	9	6	6	5
New Zealand	-3.9	-5.3	-7.2	-6.9	-5.8	-5.5	-8.0	-6.0	-3.0	-0.5	1.0	1.5	21	27	30	29	28	27
Germany	5.2	3.8	3.1	3.4	3.3	3.3	-1.0	-1.7	-1.3	-1.2	-1.1	-1.0	89	93	93	92	91	90
France	-2.6	-2.2	-1.4	-0.6	0.0	0.4	-5.5	-4.5	-3.2	-2.1	-1.1	-0.5	85	92	94	94	93	90
Italy	-3.5	-2.9	-2.4	-2.2	-2.0	-1.7	-4.2	-2.7	-1.2	-1.1	-0.8	0.1	121	129	131	132	132	130
Spain	-3.7	-2.9	-2.3	-2.0	-1.8	-1.5	-8.0	-5.6	-3.0	-1.6	-0.9	-0.2	71	83	90	91	91	89
Greece	-9.2	-4.4	-2.9	-1.9	-1.0	-0.9	-12.6	-10.4	-5.8	-3.4	-0.2	0.5	165	144	152	157	156	154
Portugal	-8.7	-6.4	-4.3	-3.6	-3.0	-0.7	-9.6	-5.1	-3.4	-3.0	-0.7	0.3	113	99	108	112	112	109
Netherlands	8.1	7.1	7.1	7.1	7.0	6.6	-3.6	-3.6	-3.0	-2.3	-1.5	-1.0	65	70	69	69	68	67
Belgium	-0.7	-2.0	-1.4	-0.5	0.5	1.0	-3.7	-2.7	-1.5	-0.6	0.2	0.5	97	109	108	104	100	96
Denmark	6.7	5.7	5.5	3.7	3.3	3.5	-4.0	-5.2	-3.9	-2.6	-2.1	1.0	46	50	53	54	54	51
Norway	14.0	14.3	14.9	15.2	15.8	16.5	12.0	12.5	13.5	15.0	17.0	18.5	NA	NA	NA	NA	NA	NA
Sweden	7.4	7.7	8.0	6.7	6.9	7.3	0.1	-0.4	-0.2	0.5	1.5	1.9	36	36	35	33	30	27
Switzerland	14.4	14.5	15.7	17.1	18.1	19.4	0.3	0.6	0.6	0.9	0.9	0.9	53	51	50	48	47	46
United Kingdom	-2.4	-0.2	1.3	1.8	1.9	1.8	-8.4	-7.9	-7.0	-6.0	-4.7	-3.7	82	87	91	94	96	95
Emerging Markets	2.2	1.5	1.7	1.4	1.3	1.2	-1.7	-2.1	-1.7	-1.5	-1.4	-1.5	16	16	16	16	16	15
China	3.0	2.0	1.5	1.0	1.0	1.0	-1.0	-2.0	-1.5	-1.0	-1.0	-1.0	15	16	15	15	14	14
Hong Kong	7.0	10.3	12.4	10.0	10.0	10.0	2.7	2.2	2.5	1.9	3.4	3.5	1	2	2	3	3	4
India	-3.4	-3.6	-3.0	-2.9	-2.8	-2.5	-8.3	-8.0	-7.5	-6.0	-6.0	-6.0	67	67	66	64	62	62
Indonesia	0.3	-0.3	-0.5	-0.7	-0.6	-0.5	-1.5	-1.0	-0.7	-0.3	-0.5	-0.5	26	25	24	23	23	22
Korea	2.2	1.3	1.0	0.7	-0.3	-0.3	0.5	0.7	1.2	1.5	1.4	2.1	33	33	31	29	28	26
Singapore	16.5	15.0	13.0	13.0	12.0	11.0	1.5	1.0	1.0	1.0	1.0	1.0	110	115	118	120	120	120
Czech Republic	-3.7	-3.6	-3.8	-3.8	-3.3	-3.1	-3.7	-4.0	-3.4	-2.3	-1.5	-0.5	37	40	44	46	46	45
Hungary	1.5	1.2	1.2	2.0	2.2	2.1	3.0	-3.2	-3.0	-3.3	-2.9	-2.5	80	82	81	79	78	76
Poland	-4.3	-3.4	-4.0	-5.7	-6.1	-4.9	-5.2	-3.5	-2.4	-1.8	-1.6	-1.6	53	53	53	51	49	48
Romania	-3.5	-4.5	-4.7	-5.0	-5.0	-5.0	-4.4	-2.0	-2.0	-2.5	-2.3	-2.0	38	39	39	39	39	38
Russia	5.7	3.5	1.4	-1.0	-1.0	-1.0	-1.4	-3.1	-2.7	-2.3	-1.9	-1.7	8	9	11	12	13	13
Turkey	-10.2	-8.4	-5.8	-5.0	-4.4	-3.8	-1.3	-2.2	-2.5	-2.5	-2.7	-3.0	43	40	40	38	38	37
Nigeria	5.9	5.3	6.0	4.7	3.7	3.2	-3.2	-2.8	-2.0	-2.4	-2.8	-2.4	NA	NA	NA	NA	NA	NA
South Africa	-3.4	-4.7	-5.6	-6.6	-6.4	-5.8	-5.0	-4.8	-4.3	-3.6	-3.5	-3.5	35	38	41	42	43	43
Argentina	0.4	0.3	0.2	-0.5	-0.5	-0.5	-0.9	-0.4	0.4	2.0	2.0	2.0	49	49	49	52	53	53
Brazil	-2.1	-2.1	-2.4	-2.7	-3.0	-3.2	-2.7	-2.7	-2.9	-2.7	-2.5	-2.8	63	63	63	63	70	71
Mexico	-1.0	-2.1	-2.1	-2.5	-2.5	-2.7	-2.5	-2.2	-2.0	-1.9	-1.9	-1.8	39	40	39	38	38	38
Venezuela	10.4	8.6	9.9	8.4	9.3	9.1	-5.0	-5.0	-4.0	-5.2	-5.0	-4.8	36	38	33	32	33	33

Note: Fiscal deficit and debt figures for all countries are general government debt and deficits. We assume sovereign debt restructuring in Greece, Ireland and Portugal in 2012-13.

Source: Citi Investment Research and Analysis

Notes

Notes

Notes

Appendix A-1

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Sovereign Ratings Outlook

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